Statutory Accounting Principles (E) Working Group
Combined Agenda
June 28, 2023
10:00 – 11:30 a.m. CT

ROLL CALL

Dale Bruggeman, Chair	Ohio	Judy Weaver	Michigan
Kevin Clark, Vice Chair	Iowa	Doug Bartlett	New Hampshire
Sheila Travis	Alabama	Bob Kasinow	New York
Kim Hudson	California	Diana Sherman	Pennsylvania
William Arfanis/Michael Estabrook	Connecticut	Jamie Walker	Texas
Rylynn Brown	Delaware	Doug Stolte/David Smith	Virginia
Cindy Andersen	Illinois	Amy Malm/Elena Vetrina	Wisconsin
Melissa Gibson/Stewart Guerin	Louisiana		

NAIC Support Staff: Julie Gann, Robin Marcotte, Jake Stultz, Jason Farr, Wil Oden

Note: This meeting will be recorded for subsequent use.

Hearing Agenda

REVIEW of COMMENTS on INT 23-01T: Net Negative (Disallowed IMR)

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
INT 23-01T Ref #2022-19 (Julie)	**Net Negative (Disallowed) IMR**	**1 – Exposed INT 2 – Agenda Item**	**Comments Received**	**LATF Response – 1 ACLI – 3 ACLI Q&A – 24 Hedge Examples – 30 Academy – 33**

Summary:

On December 13, 2022, the Working Group moved this agenda item to the active listing, categorized as a New SAP Concept and exposed the agenda item with a request for comments by industry on potential guardrails and details on unique considerations. The Working Group directed NAIC staff to coordinate with the Life Actuarial (A) Task Force and request regulator-only sessions with industry to receive specific company information.

On March 22, 2023, the Working Group directed NAIC staff regarding the consideration of negative interest maintenance reserve (IMR) with an intent to work on both a 2023 solution and a long-term solution as follows:

a. Draft a referral to the Life Actuarial (A) Task Force on further consideration of the asset adequacy implications of negative IMR. Items to include: 1) developing a template for reporting within asset adequacy testing (AAT); 2) considering the actual amount of negative IMR that is admitted to be used in the AAT; 3) better consideration of cash flows within AAT (and documentation), as well as any liquidity stress test (LST) considerations; 4) ensuring that excessive withdrawal considerations are consistent with actual data (sales of bonds because of excess withdrawals should not use the IMR process); and 5) ensuring that any guardrails for assumptions in the AAT are reasonable and consistent with other aspects.

b. Draft a referral to the Capital Adequacy (E) Task Force for the consideration of eliminating any admitted net negative IMR from total adjusted capital (TAC) and the consideration of sensitivity testing with and without negative IMR.

c. Develop guidance for future Working Group consideration that would allow the admission of negative IMR up to 5% of surplus using the type of limitation calculation similar to that used for goodwill admittance. The guidance should also provide for a downward adjustment if RBC ratio is less than 300.

d. Review and provide updates on any annual statement instructions for excess withdraws, related bond gains/losses and non-effective hedge gains/losses to clarify that those related gains/losses are through asset valuation reserve (AVR), not IMR.

e. Develop accounting and reporting guidance to require the use of a special surplus (account or line) for net negative IMR.

f. Develop governance related documentation to ensure sales of bonds are reinvested in other bonds.

g. Develop a footnote disclosure for quarterly and annual reporting.

On April 10, 2023, the Working Group exposed a limited-time, optional INT to allow admittance of net negative (disallowed) IMR in the general account up to 5% of adjusted capital and surplus. The exposed INT proposed restrictions on what is permitted to be captured in the net negative IMR balance eligible for admittance as well as reporting and disclosure requirements. These restrictions exclude realized losses from fair value derivatives and net negative (disallowed) IMR in the separate account from being admitted.

NAIC Staff Broad Recommendation:
NAIC staff recommend that the Working Group receive and discuss comments on the exposed INT 23-01T as well as a potential effective date timeframe. NAIC staff recommend direction from the Working Group on requested revisions (if any) to the interpretation. If revisions are requested, NAIC staff will work to incorporate timely with a plan to re-expose the INT for a shortened comment period that allows for discussion and possible adoption consideration at the Summer National Meeting. (Regardless of if any revisions are directed to the tentative INT from the June 28 discussion, NAIC staff recommend that consideration of adoption be deferred until the Summer National Meeting.)

The introduction and summary comments from the ACLI and the Life Valuation Committee of the American Academy of Actuaries (Academy) are included below. Subsequently the detailed points from the ACLI are included with NAIC discussion. **NAIC staff recommend that the Working Group consider each of these key points separately with direction to NAIC staff.** (**Attachment 3 includes the comment letters received**.)

1) Surplus Considerations – 5% Cap on Adjusted Capital and Surplus – Page 8
2) Exclusion of Fair Value Derivatives from Determining Admitted Net Negative IMR – Page 10
3) Book Value Guaranteed Separate Accounts – Page 16
4) Reinvestment and Allocation – Page 20
5) Special Surplus Account – Page 24
6) Other Existing Safeguards – Page 25
7) RBC Sensitivity With and Without Admitted Negative IMR – Page 26
8) Effective Duration / Automatic Nullification Date – Page 26

In addition to the ACLI comment letter, NAIC staff raised questions to the ACLI and received written responses. These questions / answers are also included in the comment letter packet.

<u>ACLI – 21 Pages – Introductory and Conclusion Comments</u>:

The American Council of Life Insurers (ACLI) appreciates the thoughtful and timely attention the Statutory Accounting Principles Working Group (SAPWG) and Life Actuarial Task Force (LATF) are dedicating to this important topic. We also appreciate regulators' recognition that action to provide an interim solution for negative Interest Maintenance Reserves (IMR), while a longer-term solution is pursued, will help mitigate punitive unintended consequences the current statutory accounting rules are giving rise to including creating a disincentive for long-standing prudent investment and risk management practices and creating a perception of decreased financial strength of the industry.

However, ACLI is concerned with several interim solution provisions that could undermine an insurer's ability to mitigate the unintended consequences noted above. In particular, we believe it is important for the framework to more broadly encompass the type of business and risk management practices insurers have long engaged in to protect policyholders and properly address risks. To this end, rather than fully excluding material contributors to negative IMR balances across the industry, we believe the framework should employ practical disclosure requirements and appropriate guardrails as measures for addressing regulators' concerns.

Following on the points above, ACLI recommends that the following revisions be made before the interim solution framework is finalized:

- The cap of up to 5% of surplus should be raised to 10% and the surplus figure should not be adjusted.
- Negative IMR related to interest rate risk management derivatives that are effective hedges should continue to be IMR eligible (i.e., there should be no exclusions for hedging derivatives held at fair value).
- Negative IMR related to relevant insulated and non-insulated Book Value Guaranteed Separate Accounts (BVG S/A) should be IMR eligible.
- Admittance of negative IMR should not be predicated on immediate reinvestment of proceeds of bond and fixed income sales, rather regulators should focus on a macro level reinvestment proof and disclosure. ACLI is recommending this as an additional safeguard.

In the pages that follow, we share further perspective on why we believe these revisions are warranted and justified.

While the SAPWG proposal covers key components of the interim solution, ACLI would note that other safeguards are operational today, which would further strengthen the interim package of safeguards. These existing safeguards include:

- Asset Adequacy Testing (AAT)
- Excess Withdrawal Safeguard
- Domicile regulator review and approval of Derivatives Use Plans (DUPs), which can be subject to auditing procedures

Finally, ACLI would also support several additional safeguards for the interim solution that we believe would provide regulators improved transparency:

- Macro proof of reinvestment and disclosure
- Company attestation that IMR losses comply with documented investment or liability management policies and/or are in accordance with prudent and documented risk management procedures and in accordance with a company's DUP
- Confidential (regulator-only) reporting of risk-based capital (RBC) sensitivity with and without admitted negative IMR
- Disclosure of the admitted versus non-admitted amounts of gross negative IMR

- The reporting of negative IMR as a write-in to miscellaneous other-than-invested assets and its allocation to special surplus
- The proposal where admittance is only permitted for entities with authorized control level RBC greater than 300%

ACLI is firmly committed to working with the NAIC to develop both an appropriate interim framework and a long-term solution that does not disincentivize sound ALM and investment and risk management practices. Both of which help ensure policyholders are protected under the vital insurance and retirement products they hold.

Asset Liability Management (ALM) and Negative IMR

Life insurers generally exercise prudent portfolio and ALM activities across both General Accounts (G/As) and Separate Accounts (S/As) to manage product, investment, disintermediation, and duration risk to meet future policyholder obligations. As previously discussed in our October 31, 2022, and February 16, 2023, letters, these include asset liability modeling and asset allocation plans that help direct sales and reinvestment in fixed income investments and duration hedging activities. These prudent practices are also the primary generators of negative IMR in a rapidly rising or prolonged high-rate environment. We believe the current interim proposal would leave many insurers with significant non-admitted negative IMR on their balance sheets. In addition to understating the financial strength of the insurer, this outcome would incentivize the same imprudent ALM activities regulators are hoping to avoid, including:

- Limiting trading of fixed income investments and/or usage of derivatives could create a mismatch between assets and liabilities; and/or
- Avoidance of hedging or trading to mitigate future reinvestment risks and/or limit credit concentrations. Insurers could be more focused on managing the misrepresented short-term financial position (due to disallowed negative IMR), generating misalignment in asset-liability duration and retention of undesirable interest rate and credit risks.

Such outcomes are not in the best interest of insurers, their policyholders, or regulators. ACLI encourages SAPWG to incorporate the following changes to the interim solution framework to avoid these outcomes.

<u>ACLI Summary Comments:</u>
It is clear the NAIC wants to be diligent and methodical in determining a long-term solution:

- To ensure there are no unintended consequences with adopting the theoretically appropriate symmetrical treatment of both gains and losses on a longer-term basis, by
- Ensuring proper consideration can be given to such things as the excess withdrawal safeguard and the other considerations referred to other working groups/task forces, as well as getting additional understanding/coordination with LATF, because while an accounting determination, at its core this issue is really an actuarial construct, while
- Still recognizing the need for an interim solution effective for year-end 2023 that does not disincentivize prudent investment, risk management and ALM strategies in the near term.

As noted in our previous letters, since statutory accounting practices for life insurance companies are the primary determinant of obtaining an accurate picture for assessing solvency, it is imperative that the long-term statutory accounting practices be financially consistent for assets, liabilities, and income. If assets and liabilities were not reported on a financially consistent basis, then the financial statements would not be useful in determining an accurate assessment of solvency or whether there were sufficient assets to pay contractual obligations when they become due.

Amortized cost valuation of fixed income investments reflects the outlook at the time of purchase and amortization reflects the yields available at time of purchase. Policy reserve liabilities are established at the same time, and the interest rate assumptions are consistent with the yields at that time. But if fixed income investments are sold, with the proceeds reinvested in new fixed income investments, a new amortization schedule is established which may be based on an entirely different yield environment, which may be inconsistent with the reserve liabilities when they were established. These concepts were embedded in the development of IMR with the intent that there was symmetrical treatment for both gains and losses with no limits.

The IMR is fundamental to the statutory framework and was developed with the intent of providing an accurate assessment of financial solvency as well as help align the fixed income investment yields to those of the reserve liability assumptions. It is also critical to our ALM and investment and risk management strategies. The original development and documentation of IMR recognized this, both for investment sales with gains and losses, fixed income derivatives transactions, and separate accounts. We encourage LATF feedback on the theoretical appropriateness of symmetrical IMR for the benefit of SAPWG given IMR's actuarial construct. It is important any long-term solution does not change the intent and design of IMR for these reasons.

The ACLI stands ready to continue working with the NAIC to create sufficient, yet practical, safeguards that ensure the most appropriate treatment of IMR can be applied, and a company's surplus and financial strength are properly reflected, while not disincentivizing prudent investment, risk management and ALM practices that are in the best interest of all in any interim and long-term solution.

NAIC Note: The remaining comments, which detail the ACLI "Requirements for an Effective Interim Solution" have been separated by topic to be individually addressed. The ACLI appendices have not been duplicated within his hearing agenda but are available in the comment letter document.

American Academy of Actuaries – 4 Pages

The Life Valuation Committee of the American Academy of Actuaries is pleased to comment on "2023 Net Negative (Disallowed) Interest Maintenance Reserve" (INT 23-01T).

IMR in Reserve and Capital Calculations

Prior to providing specific comments on the exposure, we would like to provide the following background on how the Interest Maintenance Reserve (IMR), whether positive or negative, impacts reserving and capital calculations.

The IMR amortizes interest rate-related gains and losses from the sale of fixed income investments rather than immediately reflecting in statutory surplus. The concept of the IMR reflects that whether a company continues to hold the original fixed income investment or chooses to sell and reinvest in a like fixed income investment, it would maintain the same ability to meet future benefit obligations.

The handling of the IMR is addressed in asset adequacy testing (AAT), model-based risk-based capital calculations (C-3 RBC), and principle-based reserves (PBR). AAT, PBR, and C-3 RBC all specify that an appropriate allocation of IMR (whether positive or negative) should be used to support policyholder liabilities in the calculation. It was affirmed by the year-end 2022 NAIC IMR guidance to LATF that only the portion of IMR that is admitted should be included in AAT. Companies are not required to reflect any non-admitted portion, as this may "double-count losses."

When a negative IMR is included in AAT, PBR, and C-3 RBC calculations, it reduces the amount of interest-earning assets supporting the business. The presence of a negative IMR, however, does not itself cause a reserve inadequacy if the assets sold were reinvested in higher yielding assets. The IMR's impact along with other factors should be an integral part of AAT, PBR, and C-3 RBC calculations.

Academy Exposure Comments

The following provides observations for pros and cons on specific components of INT 23-01T from an actuarial perspective:

Require at least 300% of the Authorized Control Level risk-based capital to admit a negative IMR

Pros

- Use of a risk-based capital (RBC) threshold would allow for regulator or company review of the solvency impacts of the IMR for less capitalized companies.

Cons

- In some cases, the non-admission of the IMR may lead to a higher RBC ratio. An illustrative C-3 RBC example is provided in Appendix 1. Similarly in asset adequacy testing, if negative IMR became non-admitted, it may be offset by lower AAT reserves for one company but be a reduction of capital for another company not holding asset adequacy reserves due to the level of margin in reserves.

- There could be inconsistencies caused by the timing of when asset adequacy reserves and/or PBR calculations were performed—e.g., asset adequacy reserves completed as of 9/30 assuming admission of the negative IMR but the admission changes at year-end.

A disclosure that shows risk-based capital with and without the admitted negative IMR included in Total Adjusted Capital may also give regulators more comparable information about the impact of negative IMR on a company's solvency position.

Limit of 5% of the reporting entity's adjusted surplus

Pros

- As intended, this limit would control the portion of a company's statutory surplus that is made up of negative IMR and would therefore limit the impact that admitting negative IMR could have on evaluating the company's surplus for RBC purposes.

Cons

- A percent of surplus limit would not be needed to ensure the adequacy of reserves and appropriate capital calculations. Instead, reserve and capital adequacy may be better addressed by the inclusion of an appropriate IMR allocation in AAT, PBR, and C-3 RBC calculations.

Admittance of net negative IMR in the separate account

Pros

- INT 23-01T notes that net negative IMR will continue to be disallowed in the separate account. This would accomplish the goal of limiting the admission of negative IMR, in particular for variable products.

Cons

- In cases where the assets in the separate account are held at amortized cost, the IMR should be consistent with handling in the general account.
- Inconsistent treatment may lead to different reserve and capital requirements based on whether a product was held in the general or separate account despite both accounts holding assets at amortized cost. For example, AAT reserves on a product in a separate account would be different than if held in the general account due to whether the negative IMR was admitted and subsequently included in the assets supporting the reserves.

Academy C3 Phase 1 Example

1. Assume $100 of assets and $100 liabilities. Assets cover future claims and related expenses (no excess or shortfall in cash flow testing). Assume the company has total adjusted capital of $15. Taxes are ignored.

2. The C3 Phase 1 modeling results in a $10 requirement

Assets	Liabilities	C3 Phase 1 Amount	Total Adjusted Capital	CAL RBC Ratio	ACL RBC Ratio
$100	$100	$10	$15	150%	300%

3. If market value of assets increases to $104 due to a drop in interest rates and the assets are sold and repurchased, there would be no impact on the C3 Phase 1 requirement, assuming IMR is reflected in this calculation.

Assets	Liabilities	C3 Phase 1 Amount	Total Adjusted Capital	CAL RBC Ratio	ACL RBC Ratio
$104	$100	$10	$15	150%	300%
	IMR: $4				

4. If market value of assets decreases to $96 due to an increase in interest rates and the assets are sold and repurchased and the resulting IMR was non-admitted, Total Adjusted Capital would decrease. If negative IMR was not admitted, it would not be reflected in the C3 Phase 1 requirement, which would result in a higher proportion of interest-earning assets compared to a requirement that includes admitted negative IMR. The higher- earning assets would result in a decrease in the C3 Phase 1 requirement, thereby increasing the RBC ratio.

Assets	Liabilities	C3 Phase 1 Amount	Total Adjusted Capital	CAL RBC Ratio	ACL RBC Ratio
$96	$100	$6	$11	183%	367%
	IMR: $0				

1) Surplus Considerations – 5% Cap on Adjusted Capital and Surplus

ACLI Comments:

The exposure proposes a 5% cap on surplus, which we understand was informed in part by SAPWG consideration of December 31, 2022, negative IMR balances. In establishing a level for the interim cap, we believe it is important for SAPWG to also account for the fact that negative IMR balances for both the G/As and S/As will continue to grow in the elevated rate environment and grow even faster should rates increase more rapidly. Negative IMR already exceeds 10% of surplus for some insurers and will increasingly be the case for the industry over the course of 2023 and beyond. An overly conservative cap would undermine the effectiveness of the statutory framework as once the cap is reached, insurers will be incentivized and pressured to execute risk management and ALM strategies based on statutory accounting outcomes rather than what may be most appropriate from a long-term economic perspective.

Establishing the applicable cap on surplus also should not be thought of in isolation of other elements of the framework. In particular, ACLI believes it is important to also recognize that admitted negative IMR can and should be limited to losses incurred from activities from sound investment, risk management and ALM that promote the long-term claims paying ability of the insurer (versus losses related to asset sales that were done for other purposes such as meeting short-term liquidity demands).

Appendix II is an illustrative example that highlights the choice insurers will face between maintaining target duration for prudent ALM and risk management and managing their IMR balances. A surplus cap, especially one that is overly constraining, will disincentivize prudent behaviors that regulators and companies mutually would otherwise encourage for the protection of policyholders.

The example shows how IMR responds to a single 250 basis point interest rate increase (less than occurred in 2022 through year-to-date 2023) with 10% investment portfolio turnover. Note that over the last 15 years, annual portfolio turnover of sales and maturities in the industry has ranged from 17-32%, averaging around 23%[1]. While the percentages include maturities, which would reduce those numbers, the sales are still considerable. We also note that the main component of the illustrative example does not include a further interest rate rise, or more importantly even include derivatives (see next topic), which demonstrates how surplus caps at levels below 10% can be swiftly breached and have negative ramifications for prudent ALM strategies like portfolio duration management.

ACLI Recommendation

To this end, in addition to raising the cap to 10%, ACLI believes net positive goodwill, EDP equipment and operating system software, net deferred tax assets should not be deducted from surplus for purposes of determining the cap. These items are intangible and illiquid and are not relevant for the immediate claims paying ability of the insurer, while the negative IMR resulting from insurer investment, risk management and ALM practices does not change the immediate claims paying ability of an insurer's assets. While this was discussed in our previous letter(s), Appendix I of this letter re-illustrates this important concept.

Academy Pros / Cons:

- Pros: As intended, this limit would control the portion of a company's statutory surplus that is made up of negative IMR and would therefore limit the impact that admitting negative IMR could have on evaluating the company's surplus for RBC purposes.

- Cons: A percent of surplus limit would not be needed to ensure the adequacy of reserves and appropriate capital calculations. Instead, reserve and capital adequacy may be better addressed by the inclusion of an appropriate IMR allocation in AAT, PBR, and C-3 RBC calculations.

[1] Barings, "How Life Insurers Account for Realized Losses May Cause Unnecessary Pain", November, 2022

<u>NAIC Discussion – 5% Limitation on Adjusted Capital and Surplus:</u>
The 5% limitation was directed by the SAPWG during the 2023 Spring National Meeting discussion. The initial regulator-suggested proposal was 1% and while there was discussion on a possible 10% limit, the 5% threshold was determined as a starting point, as it may be used as a materiality threshold by state regulators.

NAIC staff defer to the Working Group on determining the appropriate percentage for this admittance limitation. Fundamentally, net negative (disallowed) IMR represents realized losses in excess of realized gains, which are being delayed and cycled into income over time.

Below are existing limits for other assets within statutory accounting principles:

- EDP Equipment and Operating System Software – 3% of adjusted capital and surplus
- Positive aggregate goodwill – 10% of adjusted capital and surplus
- Deferred tax assets – 15% of adjusted capital and surplus. (This is the maximum percentage under the future realization threshold for companies with greater than 300% RBC. Companies between 200-300% RBC are limited to 10%.)

The use of "adjusted capital and surplus" was also directed by the SAPWG during the 2023 Spring National Meeting discussion. Adjusted capital and surplus, which currently excludes net positive goodwill, EDP equipment and operating system software and net deferred tax assets, is the standard calculation used in the NAIC *Accounting Practices and Procedures Manual* (AP&P Manual) when there is a percentage limitation for admittance. These categories were referred to as "soft assets" during codification. These limitations are used in the following areas in the Manual:

- *SSAP No. 16R—Electronic Data Processing Equipment and Software*
- *SSAP No. 68—Business Combinations and Goodwill*
- *SSAP No. 101R—Income Taxes*

The ACLI comments on the use of adjusted capital and surplus topic is highlighting that the extent an amortized-cost asset could be impaired (FV is less than AC) within the statutory financials is not limited to a percentage of surplus. This is true. However, statutory disclosures are required that detail the extent a bond or LBSS is in an unrealized loss position for which other-than-temporary impairments have not been recognized. Furthermore, the length of time and extent of which fair value has been less than cost is an assessment in determining whether an other-than-temporary impairment (OTTI) should be recognized.

Under existing IMR allocation rules in the Annual Statement Instructions, and the guidance in paragraph 13 of *SSAP No. 26R—Bonds*, realized losses from OTTI are reported entirely to the IMR or AVR based on whether the NAIC designation has moved by more than one designation from the beginning of the holding period to the end of the holding period. **<u>As such, for items captured in scope of SSAP No. 26R, when there is a recognized OTTI reporting entities may recognize that entire realized loss to IMR and not AVR.</u>** This guidance is different for *SSAP No. 43R—Loan-backed and Structured Securities* for which IMR/AVR allocation is required to be allocated for all realized losses between interest and non-interest factors.

As part of the long-term IMR assessment, and the project to incorporate IMR/AVR accounting guidance into SSAP No. 7 as the source of authoritative statutory accounting guidance, **the Working Group may want to consider guidance to ensure only interest-related realized losses are captured in the IMR, similar to the provisions of SSAP No. 43R. Such guidance would eliminate the potential for non-interest (credit) related losses to be realized and reported as admitted assets through the IMR regardless of the extent of NAIC designation changes and regardless of if the investment was sold or recognized as OTTI. This would also eliminate any potential for a reporting entity to sell a security, instead of recognizing an OTTI, to allocate realized losses through the IMR instead of the AVR.**

Ultimately, NAIC staff does not believe that the current ability for assets held at amortized cost to be in an impaired position (fair value is less than amortized cost) has any relation to whether there should be a limit to the extent net negative (disallowed) IMR (realized losses in excess of realized gains) should be admitted in the financial statements. There is an inherent difference between holding an impaired security to maturity, where the reporting entity would receive the full value at maturity and selling a security prior to maturity at a loss and seeking to admit that realized loss as an admitted asset.

If this admittance of realized losses from the sale of impaired assets is permitted, on the premise that reinvestment is beneficial for policyholders, the intent of the capital and surplus adjustment is to reduce the C&S balance for which a percentage is permitted so that assets, which are permitted for admittance but are less liquid and not readily available for policyholder claims, are removed to prevent a compounding effect of those assets when permitting admittance of other such items.

It should also be noted that under U.S. GAAP realized losses do not qualify as assets. A loss is not an asset because there is no future economic benefit associated with it. The loss cannot be exchanged for cash, a financial asset, or a nonfinancial asset used to produce something of value or used to settle liabilities. However, under U.S. GAAP, a gain is not a liability because no obligation exists to sacrifice assets in the future. As such, the current IMR/AVR guidance reflects a variation from U.S. GAAP.

NAIC Recommendation – 5% Limitation on Adjusted Capital and Surplus:
NAIC staff recommend that the Working Group:
- Provide direction on the percentage limitation for inclusion in the INT.
- Provide direction on the use of adjusted capital and surplus in the INT.
- Provide direction to eliminate the potential for non-interest losses to be captured in the IMR as part of the long-term project and incorporation of guidance within SSAP No. 7.

2) Exclusion of Fair Value Derivatives from Determining Admitted Net Negative IMR

ACLI Comments:
Role of Derivatives in Managing Risk
Derivatives play a critical role in enabling insurers to manage interest rate risk associated with issuing long-duration life and retirement liabilities. This interest rate risk may arise in the investment of future premiums, investment income, and proceeds from investment maturities, or for activities like pension-risk transfer. Insurers may take action to pivot an investment portfolio from its current form to their long-term target for supporting the liabilities portfolio, particularly for pension-risk transfers and long-duration liabilities. To the degree these hedges are effective at altering the interest rate characteristics of portfolio of assets, insurers have allocated the realized gains / losses to IMR and subsequently amortized them in a consistent manner with the assets within the hedged portfolio.

Derivatives can be used in the place of fixed income investments, such as for better efficiencies (i.e., lower transaction costs), or in cases where the desired fixed income instrument doesn't exist or isn't readily available. As a result, the gains/losses generated by derivatives and fixed income investments should be consistently eligible for deferral to the IMR. Appendix III illustrates examples of how derivatives can be used to achieve the insurer's objectives and how excluding non-hedge accounting derivatives leads to inappropriate and misleading financial presentation.

Hedge Accounting for Derivatives
SSAP 86 has three broad categories of derivatives: Hedging (with subcategories accounting hedge and non-accounting hedge), Income Generation, and Replication. Accounting guidance for derivatives defaults with fair value. Only after meeting the additional prescriptive requirements for hedge accounting (or certain types of Replication transactions) can a different accounting basis be used. Derivatives that are entered into for a purpose other than Hedging, Income Generation, or Replication, or are not effective for their originally stated purpose, would be non-admitted under SSAP No. 86.

The fact that these derivatives transactions are reported at fair value has no bearing on whether these transactions are effective hedges. ACLI believes there is an important delineation between qualifying as an effective hedge and meeting the "highly effective hedge" thresholds under SSAP 86 – which many insurers' interest rate risk management derivative activities do – and meeting the requirements to qualify for hedge accounting. Hedge accounting guidance is quite prescriptive, and the specific bond associated with the hedge must be easily and precisely identifiable. The narrow hedge accounting guidance does not recognize the important actions insurers take to not only hedge interest rate risk for specific bonds, but to also "anticipatory hedges" that are used to hedge interest rate risk associated with their asset allocation plans and overall asset portfolio backing insurance liabilities. Such hedging activities are employed within both G/As and S/As.

*(NAIC Staff Note – The reference to the E Committee report from the ACLI letter is the "Asset Valuation Reserves and Interest Maintenance Reserves, Blue Book, December 2002." **It has been included as Attachment 4**.)*

Intent of IMR Instructions
The inclusion of such derivatives within IMR is longstanding and aligns with prior guidance from regulators. The report summarizing the development of IMR to E-committee in 2002 includes the following:

> *The Interest Maintenance Reserve (IMR) captures for all types of investments, all of the realized capital gains and losses which result from changes in the overall level of interest rates as they occur. Once captured, these capital gains or losses are amortized into income over the remaining life (period to maturity) of the investments sold.* ***Realized gains and losses on derivative investments, which alter interest rate characteristics of asset/liabilities, also are allocated to IMR and are to be amortized into income over the life of the associated assets/liabilities (emphasis added)***.

In another excerpt from the E-committee report:

> *To insure solvency of a company, its assets should be invested so that the company has a very high probability of paying its contractual liabilities when they become due. In order to assess whether a company is able to fulfill its obligations, it must present its liabilities and assets on a financially integrated basis. Since the accounting practices prescribed for the life insurance annual statement are an important element in this discipline, it is imperative that the accounting practices be consistent for assets and liabilities.* ***If they are inconsistent, then the annual statement will not reveal whether assets exceed liabilities; more importantly, neither regulators nor management can determine the risk of insolvency for the company.***
>
> *The Valuation Actuary's Opinion includes a statement that the assets backing the liabilities make adequate provision for the company's liabilities. That is, the Actuary must look beyond the statutory valuation formulas and satisfy himself that the cash flows generated by the assets will probably be sufficient to discharge the liabilities.*
>
> *Prior to the AVR and IMR, there were many circumstances under which the statutory formula valuation methods gave rise to inappropriate results. Some examples were:*
>
> > - ***Changes in values due to interest rate swings were recognized inconsistently on the asset and liability sides of the balance sheet. Liabilities are valued using interest rates fixed at issue while some assets may be valued using current interest rates through trading activity.***
> >
> > - *When the assets are poorly matched to the liabilities, a significant adverse swing in the interest rates will reduce financial strength and could lead to insolvency even though the balance sheet value of the assets exceeds the balance sheet value of the liabilities. Using long term assets to back demand liabilities is dangerous if there is a significant upswing in interest rates. In addition, individual insurance premiums are received and invested for many years after the issue date on which the reserve interest rate is determined, creating a potential for inadequate yields that is not reflected in standard accounting procedures.*

- The potential for future asset losses was not well reflected in the balance sheet or earnings statement.

It is desirable that the valuation of the assets and liabilities be made as consistent as possible to (1) minimize the instances where, in order to render a clean opinion, the actuary must establish extra reserves due to interest rate gains or potential for defaults and (2) increase the likelihood that assets supporting liabilities are sufficient even in the absence of an Actuarial Opinion. The development of an AVR and IMR will correct many of these deficiencies in consistency.

The IMR instructions include the following:

The following guidance pertains to instruments in scope of SSAP No. 86—Derivatives:

- *For derivative instruments used in hedging transactions, the determination of whether the capital gains/(losses) are allocable to the IMR or the AVR is based on how the underlying asset is treated.* ***Realized gains/(losses) on portfolio or general hedging instruments should be included with the hedged asset. Gains/(losses) on hedges used, as specific hedges should be included only if the specific hedged asset is sold or disposed of (emphasis added).***

- *For income generation derivative transactions, the determination of whether the capital gains/(losses) are allocable to the IMR or the AVR is based on how the underlying interest (for a put) or covering asset (for a call, cap or floor) is treated. Realized gains/(losses) should be included in the same sub-component where the realized gains/(losses) of the underlying interest (for a put) or covering asset (for a call, cap or floor) is reported. For a more complete and detailed explanation, refer to SSAP No. 86—Derivatives for accounting guidance.*

- ***Realized gains/(losses), on derivative transactions entered into solely for the purpose of altering the interest rate characteristics of the company's assets and/or liabilities (hedging transactions) should be allocated to the IMR and amortized over the life of the hedged assets (emphasis added).*** *Realized gains/(losses), on income generation derivative transactions where the underlying interest (put) or covering asset (call, cap or floor) is subject to IMR, should be allocated to the IMR and amortized over the remaining life of the:*

    a. underlying interest for a put
    b. covering asset for a call
    c. derivative contract for a cap or floor

ACLI believes the intent of IMR, as documented above and within the instructions, is to encompass effective hedging strategies more broadly than solely those derivatives for which an insurer elected hedge accounting. The instructions only discuss hedging transactions and make no reference to "highly effective hedge," "effective hedge," or "hedge accounting." Further, the instructions do not explicitly exclude non-hedge accounting derivatives from inclusion in the IMR calculation. This interpretation has been broadly approved by insurance auditors.

Governance of Derivatives that can apply to use of negative IMR
State regulators are aware of and supportive of insurer use of derivatives to meet these objectives. They also have insight into insurer practices through several tools and resources including DUPs and Schedule DB.

Under Model Regulation 282, insurers must establish written guidelines, i.e., the DUPs, approved by their Commissioner that specify types of derivatives entered into and their desired use (including the risk(s) being hedged), counterparty limits and credit exposures, and compliance with internal control procedures. Insurers are also required to "have a written methodology for determining whether a derivative instrument used for hedging has been effective." DUPs can be subject to annual external auditor review/attestation.

We believe that the governance around the use of derivatives as described above should give both SAPWG and LATF regulators comfort there is additional regulatory review and safeguards built into our derivatives activities.

ACLI Recommendation

The role of derivatives in conjunction with a regulatory framework that appropriately recognizes the vital role they play enables insurers to offer these long-term products at accessible rates for U.S. consumers. ACLI believes it is critical that negative IMR related to interest rate risk management derivatives that are effective hedges should be IMR eligible to avoid creating a strong disincentive for insurers to continue to execute long-standing risk management and ALM practices.

This practice has been consistently employed by the industry for years, including the general declining rate environment we had up until 2022, where insurers were experiencing and deferring gains on such derivatives. In addition to insight insurers provide state regulators on these hedging programs through their DUPs, the interpretation and practice of recording of related gains / losses in IMR of anticipatory hedges that are determined to be effective has broadly been approved by insurer auditors through many years of auditor signoffs of this practice.

Treatment of derivatives is undoubtably a complex topic that will warrant deeper discussion and collaboration between the industry and state regulators. That said, for the reasons noted above, ACLI strongly believes negative IMR related to interest rate risk management derivatives that are effective hedges should be IMR eligible to avoid disincentivizing prudent risk management practices. The interim framework, including the attestation on risk management practices and review of the DUP, should provide state regulators the comfort to admit negative IMR related to effective hedging programs for their insurers. The disclosure of such amounts may help regulators understand the magnitude but moving beyond such a disclosure would be inappropriate, even for an interim solution. We believe the long-standing nature of industry practice across different interest rate environments, auditor support for industry practice, insight regulators have into insurer hedging programs, broader guardrails and reporting requirements that will be part of the framework all provide further support for ACLI's position.

If SAPWG still believes it is necessary to pursue changes to the IMR rules for derivatives, ACLI would recommend against changing their eligibility for deferral for the interim solution. Given the long-standing practice of deferring derivative gains/losses into IMR and the role derivatives play in prudent investment risk management, making sudden changes would pose significant operational challenges and would require insurers to completely rethink their current risk management strategies. Instead, proposals to change the IMR rules for derivatives should be reviewed holistically as part of the long-term solution to understand the potentially far-reaching ramifications of such changes.

NAIC Discussion – Exclusion of Fair Value Derivatives from Determining Admitted Net Negative IMR

As detailed by the ACLI, the tentative interpretation that permits admittance of net negative (disallowed) IMR proposes to exclude the impact of derivatives that were held at fair value throughout the life of the derivative (as the derivative did not qualify as an effective hedge under *SSAP No. 86R—Derivatives*), but for which the loss at termination was taken through IMR and not through realized loss. **This exclusion was proposed as this accounting treatment is not consistent with the guidance in SSAP No. 86 and, from information received, appears inconsistent with what regulators were expecting to occur when a fair value derivative was terminated.**

The guidance in SSAP No. 86, paragraph 24 is explicit on the use of IMR for derivatives that qualify as effective hedges and **only if the hedged item is subject to IMR**:

24. For those derivatives **which qualify for hedge accounting**, the change in the carrying value or cash flow of the derivative shall be recorded consistently with how the changes in the carrying value or cash flow of the hedged asset, liability, firm commitment or forecasted transaction are recorded. Upon termination of a derivative that qualified for hedge accounting, the gain or loss shall adjust the basis of the hedged item and be recognized in income in a manner that is consistent with the hedged item **(alternatively, if the item being hedged is subject to Interest Maintenance Reserve (IMR), the gain or loss on the hedging**

derivative may be realized and shall be subject to IMR upon termination.) Entities who choose the alternative method shall apply it consistently thereafter.

With the SSAP No. 86 guidance for effective-hedge derivatives, there is a matching concept between the hedged asset and the hedging derivative through IMR. As such, if a bond was hedged and resulted in a realized gain, the offsetting realized loss from the effective-hedging derivative would be matched through IMR. This would prevent the gain from the bond going through IMR, and the loss of the derivative going directly against surplus.

Although the ACLI has provided comments citing the Annual Statement Instructions and their interpretation for "hedging" derivatives to encompass both effective-hedging and hedging-other, **there is no guidance in *SSAP No. 86—Derivatives* that indicates for derivatives held at fair value to be realized through IMR. *SSAP No. 86, Exhibit B – Specific Hedge Accounting Procedures for Derivatives*, only identifies recognition of fair value changes through earnings for derivatives that are not held at amortized cost. Furthermore, the guidance in Exhibit B is explicit that the hedged item must be allocated to IMR for the derivative to be allocated to IMR. Pursuant to the Statutory Hierarchy detailed in the Preamble, the SSAPs are Level 1, and the highest level of authoritative statutory guidance. The Annual Statement instructions are Level 3.**

With regards to this fair value derivative discussion, NAIC staff highlight the following key points:

- The derivatives do not qualify as effective hedges under SSAP No. 86 and are reported at fair value.

- Each reporting entity is different with regards to how derivatives are used, therefore there are no broad assessments or metrics that can be applied to determine whether these 'hedging-other' derivatives are actually effective. In other words, from information received, it would not be possible to codify guidance to allow hedge-effective accounting treatment for these derivatives, as there are no set metrics that can be established / applied for these hedging transactions. Reporting entities consider them to be "effective" if they are in line with their derivative use plans, but that assessment is significant differently from whether a derivative is effective in offsetting changes in fair value or cash flows. From discussions with companies, these are hedges that are anticipatory, in that they are hedging the interest rate risk on future and forecasted bond purchases and sales. These anticipated bond purchases and sales can be many years in the future and may include assets that do not yet exist and cannot be identified at the time the hedge is originated.

- As these derivatives are reported at fair value when they are open, unrealized losses from fair value changes have already reduced surplus. With the ACLI position, at termination and settlement of a realized loss from the derivative, the prior reduction of surplus would be eliminated, resulting in a direct increase in surplus. It is unfathomable to NAIC staff that the original intent of this guidance would require surplus volatility throughout the life of the derivative, only to eliminate that surplus impact at derivative termination, with the impact of the derivative change smoothed into surplus overtime.

- If the intent had been to permit non-effective hedging derivatives to be allocated to IMR, it seems that such derivatives would have been considered for amortized cost treatment from inception. Such an approach would have eliminated the surplus volatility while the derivative was open. (From information received, derivatives identified as "hedging" at inception do not move to "other" derivatives (non-hedging), therefore, there would be no benefit to waiting for derivative termination to remove the surplus volatility.)

- The guidance in SSAP No. 86 for effective hedges only permits derivative allocation to the IMR if the hedged asset is subject to IMR. This results in an essential elimination of IMR impact from the hedged asset and the derivative transaction combined. With the approach being used by industry, there is no IMR offset from any hedged item, therefore the realized losses from derivatives have a direct impact on the IMR balance. This IMR impact appears to be inconsistent with the SSAP No. 86 IMR matching concept that intends to eliminate IMR impact caused by the sale of assets using derivative activity. **As effective hedges are only permitted to go through the IMR if they hedge items subject to IMR, effective derivatives**

have a more stringent requirement than the industry interpretation to take all non-effective derivatives deemed to hedge interest rate risk through the IMR. This could result with companies electing not to designate derivatives as effective, as the resulting treatment, particularly if realized losses from derivatives in the IMR can be reported as admitted assets, would be more beneficial for non-effective hedging derivatives.

- The proposal to permit fair value derivatives to flow through IMR at termination, and be admitted assets when net negative, **provides the ability to improve surplus simply by exiting derivative positions and realizing a loss.**

- Although industry has indicated that they have treated derivative gains and losses consistently, with derivative gains increasing IMR, the action is still inconsistent with the provisions of SSAP No. 86.

- Current reporting on Schedule DB cannot be used to identify the 'hedging-other' derivatives that industry intends to take to IMR and those that will go through realized losses. From discussion with industry, the treatment for the derivative should be determinable from initial acquisition. If there is support to allow certain fair value derivatives to go through IMR, NAIC staff would recommend reporting revisions to separately identify these derivatives on Schedule DB, as well as to track the recognized gains/losses from termination that are allocated to IMR.

- If there is support for fair value derivatives to be included in IMR, further discussion should occur on the amortization timeframe for those gains/losses in the IMR. From preliminary info from industry, the amortization timeframe currently being used for these derivative losses is based on the average weighted life of the entire asset portfolio (as the derivative is not attributable to a specific asset) and may average around a 10-year amortization timeframe. Comments are requested from regulators on this 10-year amortization timeframe and if a different metric should be utilized.

NAIC Recommendation – Exclusion of Fair Value Derivatives From Determining Net Admitted IMR:
NAIC staff recommend that the Working Group provide direction on whether non-effective hedging derivatives should be included / excluded from the IMR balance permitted to be admitted under the INT.

For this item, it is NAIC staff's recommendation to exclude realized losses from fair valued derivatives until sufficient discussion and assessment by regulators can occur.

Ultimately, the initial ACLI discussion from Oct. 2022 on the urgent need to address net negative (disallowed) IMR was focused on the rising interest rate environment impacting the sale and reinvestment of fixed-income instruments. This initial request focused on the ability to sale bonds (with depressed fair values due to higher interest rates), for which the reinvestment would benefit from a higher-interest rate item. The tentative interpretation intends to address that initial goal. The inclusion of derivative realized losses as an admitted assets, for derivatives that do not qualify as effective hedges and that do not offset any hedged item that goes through the IMR, could be discussed as part of a longer-term project, but NAIC staff do not believe the inclusion of these losses should occur until sufficient regulator discussion. This concept seems beyond the original request to address bond sales / reinvestment from the rising interest rate environment.

3) Book Value Guaranteed Separate Accounts

ACLI Comments:

Background: Book-value separate accounts, whether insulated or non-insulated, are in many ways extensions of an insurer's general account. Insulated BVG S/As are primarily comprised of guaranteed investment contracts (GIC) and funded pension risk transfer products and policies. Non-insulated BVG S/As can be made up of activities such as registered index-linked annuities, among others.

The drivers of net negative IMR for BVG S/As are the same as the G/A. The BVG S/A assets that are managed in support of policyholder liabilities require a level of active portfolio management to ensure that assets are well positioned to pay obligations. For BVG S/As – particularly those supporting pension risk transfer products – there is significant trading activity upon transfer of pension obligations to the insurance company. Assets and cash received are transitioned into the targeted asset mix of the insurance company, which may take time. The cash is not held, rather invested into U.S. Treasuries or other short-term assets and/or hedged with an anticipatory derivative, while waiting for appropriate target assets. The sales of these assets or turn-over of the derivatives could generate negative IMR. This can take up to 18 months and, if contemporaneous with a rising rate environment, can lead to substantial realized losses that can significantly increase BVG S/A negative IMR while proceeds are reinvested in higher yielding assets.

BVG S/As are often intertwined with the G/A and/or parent holding company.

- First, the guarantees associated with these policies ultimately fall to the G/A should the investment results of the BVG S/As fall short of the guaranteed returns. If a BVG S/A does not perform as guaranteed, it is incumbent on the G/A to meet any additional claims and payouts associated with the account.
- Second, the financial results related to these S/As are understood to contribute to the overall financial position of the insurance company. Current statutory accounting guidance provides for this in both the Net Gains from Operations (SOP line 5) and as direct benefits/charges to the Capital & Surplus Account (SOP line 37). Investment income, insurance margins, and gains/losses in the S/A ultimately inure to the G/A. Disallowing the admittance of net negative IMR distorts the financial statements and surplus position of BVG S/As and, therefore, the B/A, as those realized losses would inure to the surplus of the G/A (through NGO, SOP line 5) while the net negative IMR in the BVG S/As is left non-admitted. Please see Appendix IV for an illustrated example.
- Third, BVG S/As that produce IMR balances follow the same RBC requirements as assets and liabilities in the G/A. In many cases, the Capital & Surplus supporting these RBC requirements is managed in the G/A, so trading activity that impacts the insurance company cannot be easily bifurcated between BVG S/As and G/A.
- Current IMR admissibility rules recognize the interdependency of the G/A and BVG S/A IMR balances, as discussed more below.

Current IMR Treatment: The current IMR rules appropriately recognize that net negative IMR in the S/A is relevant to overall IMR position of the insurance company. Contributions to the IMR calculation are produced by both insulated and non-insulated BVG S/As.

The IMR instructions contain provisions which state that net negative IMR in the BVG S/As can offset net positive IMR in the G/A. This correctly recognizes that surplus is transferrable between the BVG S/As (whether insulated or not) and G/A. It is clear from the current guidance and the historical record that only the admittance of net negative G/A and BVG S/As IMR was to be disallowed, as the recognition of contra-liabilities as assets was not adopted.

ACLI Recommendation

Negative IMR related to relevant insulated and non-insulated BVG S/A's should be IMR admissible. Excluding negative IMR generated within BVG S/As from the interim solution:

- Disincentivizes prudent ALM and risk management activities;
- Inappropriately distorts the financial statements and surplus position of the BVG S/As and the G/A;
- Runs contrary to the regulatory goals of the proposed interpretation; and
- Could ultimately harm both companies and policyholders in the long run.

Further, the concepts of insulated versus non-insulated S/As are not relevant to the IMR issue. Even with revised statutory guidance on insulated versus non-insulated S/As introduced a little over a decade ago, both insulated and non-insulated S/A financial statements are still consolidated with the G/A for overall statutory surplus reporting.

It is imperative the admissibility of both accounts is treated the same for statutory accounting purposes, to preserve the integrity of the financial statements, and avoid disruptions to the invest and capital management frameworks in both the interim and long-term solutions.

If SAPWG is contemplating changes to the IMR rules that would further distinguish between the BVG S/As and the G/A, they should be given proper study as part of the long-term solution to understand the potential ramifications of departing from the current guidance that allows for the combination of BVG S/As and G/A surplus.

Academy Pros / Cons:

Pro: INT 23-01T notes that net negative IMR will continue to be disallowed in the separate account. This would accomplish the goal of limiting the admission of negative IMR, in particular for variable products.

Cons: In cases where the assets in the separate account are held at amortized cost, the IMR should be consistent with handling in the general account. Inconsistent treatment may lead to different reserve and capital requirements based on whether a product was held in the general or separate account despite both accounts holding assets at amortized cost. For example, AAT reserves on a product in a separate account would be different than if held in the general account due to whether the negative IMR was admitted and subsequently included in the assets supporting the reserves.

NAIC Discussion – Book Value Guaranteed Separate Accounts

As detailed by the ACLI, the tentative interpretation that permits admittance of net negative (disallowed) IMR proposes to exclude net negative (disallowed) IMR that is captured in the separate account (both insulated and non-insulated). **This exclusion was proposed as the separate account reporting is not designed be a 'segregated general account' and there are several accounting and reporting questions that arise with the use of separate accounts in this manner. To be fair, these are issues that currently exist because of how separate accounts are being used and could be perceived as not directly related or caused by the reporting of IMR. Concerns continue to exist that examiners / auditors perceive and evaluate the assets and obligations of the separate account as "policyholder risks", when the products (and assets that back those products) are actually reflective of general account products, and the general account serves as a backstop if the separate account assets fail to perform sufficient to cover the product obligations.**

The initial INT proposal to limit the admittance of net negative IMR to the general account for the short-term interpretation provides time to assess the accounting and reporting in the separate account and establish a guidance to ensure appropriate regulator tools and oversight for when the separate account is used as an extension of the general account (which is different than the original intent of separate accounts). If preferred by the Working Group, an alternative approach could be used to allow net negative (disallowed) SA IMR to be captured in the admittance calculation initially, while guidance and reporting changes are incorporated to reflect the current dynamic of separate account products. If that approach is taken,

consideration will need to occur on how the "admittance" of IMR will be reflected in the separate account statement and how the admittance determination will occur between the general account and the insulated and non-insulated separate account statements.

Items to Consider if Permitting SA Net Negative (Disallowed) IMR to be Admitted in the Initial INT:

- **Admittance / Nonadmittance is not a separate account concept. There are no separate account reporting columns to nonadmit assets. Disallowed IMR in the separate accounts is not reported as an asset but is taken as a direct reduction to capital.** If the guidance was to permit admittance of the net negative disallowed separate account IMR, consideration would have to occur on how to reflect this within the separate account financial statements. Revisions could permit reporting as a contra-liability, but then the contra-liability reporting would be commingled with the negative IMR that was not disallowed. Another option would be to report the "admitted" SA negative IMR as an aggregate write in for an other-than-invested asset (line 15 of the SA asset page) with the portion that is not permitted as "admitted" continued as a direct reduction to capital. With either of these approaches, if the amount that was permitted to be admitted was changed (due to an increase or decrease of surplus), it may require a reversal of prior entries that eliminated SA negative IMR as a direct reduction to capital.

- **Guidance for determining admittance between the general account and the insulated and non-insulated separate accounts.** For example, if there is a 5% limit on surplus, should the guidance direct that net negative (disallowed) IMR in the general account first be fully admitted? Then, if the reporting entity is still below the 5% limit, they could then admit net negative disallowed IMR in the non-insulated blank, followed by the insulated blank until the admittance limit is reached?

Additional Items to Consider on the Broad Application of Separate Accounts if Permitting Net Negative (Disallowed) IMR: ***(These items could be subsequent to the initial INT based on Working Group feedback.)***

***Under SSAP No. 56—Separate Accounts*, assets are to be reported at fair value. There is a limited exception in SSAP No. 56, paragraph 17 for GICs that do not participate in underlying portfolio experience with a fixed interest rate guarantee**. From discussions with companies, the pension risk transfer (PRT) assets reported in the SA at book value (which seem to be a main driver of negative IMR in the SA), as well as other products where the general account bears the investment risk, are outside of this SSAP No. 56 book value exception but are permitted in accordance with state law or with state approval to classify specific products in the separate account. Although the reporting in the SA statement shows the 'book value' assets separate from the 'fair value' assets and there are disclosures in the general interrogatory for amortized cost assets, **most reporting entities do not identify these state-specific exceptions to SAP in the separate account.** When there is a state exception to SAP in the general account, it is detailed in Note 1. For year-end 2022, only three reporting entities detailed the use of "book value / amortized cost" for products outside the current provisions of SSAP No. 56 in Note 1 of the general account. Additionally, only one state has a prescribed practice for SSAP No. 56 detailed in the "States' Prescribed Differences from NAIC Statutory Accounting Principles" That prescribed difference does not detail use of amortized cost / book value for certain products. **Ultimately, either SSAP No. 56 needs to be revised to permit more usage of book value / amortized cost, or there should be explicit direction for detailing state specific exceptions in the SA within Note 1 of the general account.**

- **The guidance that determines whether net negative IMR is disallowed (based on a comparison between general and separate account balances) predates the guidance for insulated and non-insulated separate account blanks. The insulated separate account reflects assets that are not available for general account policyholder or creditor claims. As such, as those assets are legally isolated from the general account, it could be perceived as inappropriate to permit an offsetting reporting approach for positive and negative IMR between the general account and insulated separate account financial statements.** This refers to the 'preferred policyholder concept' that has been previously identified when discussing the use of separate accounts. (IMR is not technically offset between the two blanks, but the reporting of whether the IMR is disallowed is contingent on the balance in the other account. If there is negative IMR in the separate account, but the general account has positive IMR, the negative IMR in the SA is only "disallowed" to the extent that the negative balance exceeds the GA positive balance. Negative balances that are not disallowed are reported as contra-liabilities.) Discussion may be warranted as to whether the recognition of IMR should be independent in each reporting blank (general account and insulated / noninsulated separate accounts), rather than the current reporting in which a positive balance in the general account impacts the extent a negative balance in a separate account is permitted as a contra-liability or as a direct reduction of surplus.

Discussion on the Use of Separate Accounts as an Extension of the General Account. If the Working Group agrees with these components, further revision / revisions could be directed in a separate agenda topic:

- The comments received from the ACLI highlight how the use of the SA is an extension of the GA, with the GA ultimately responsible for the payment of claims, as support for "admittance" of disallowed IMR in the SA. However, NAIC staff highlights that the Separate Account reporting was not intended to capture such products. If the intent is to permit the SA as a "segregated general account" then NAIC staff would suggest enhanced reporting in the separate account to ensure these products and assets are subject to the same rigor of products and assets that are reported in the general account. For example:

    - **Requirement of NAIC designations for investments in a manner consistent with the general account asset with application of the underlying SSAP for determining accounting and reporting.** This would require an assessment of credit quality, either from the SVO or CRP (as permitted under the P&P Manual) to be used in asset assessment / measurement / RBC.

    - **Inclusion of separate account assets within the RBC formula in a manner that permits tracing of assets into the formula.** Currently separate account assets are only captured in RBC (LR006) through 'company records' in which the company is to calculate the RBC outside of the formula and include their calculated RBC impact. This formula is separated between guaranteed and non-guaranteed separate accounts and from a review of available data, it is not possible to track the assets in the separate account that a company reports as guaranteed in the RBC filing. Although separate accounts are reported by product type in SA General Interrogatory (GI) 1.01 and identified with and without guarantees, the numbers for SA assets with guarantees reported on that GI do not appear to track to the reporting of assets with guarantees in RBC. From a review of limited companies, a significant majority of separate account assets are identified as "with guarantees" in the GI, but most of the assets reported in the RBC formula are reported as without guarantees. The category without guarantees has a much lower RBC requirement then assets with guarantees. (It has been identified that Exhibit 6 – Guaranteed Insurance and Annuity Products also provides info on the guaranteed products, and NAIC staff will review to see if this info tracks to the RBC filing.)

    - **Inclusion of nonadmitted asset concepts to be consistent with the general account.** As noted, nonadmittance is not a current concept in the separate account. This is because the original intent of the SA was to hold assets for which policyholders directed investments and assumed the asset risk. From discussions with limited industry representatives, it was noted that the assets in the separate account would be permitted for admittance if classified within the general account, but it would not be possible to make such an assumption across all industry. The use of the separate account to hold assets for general-account type products, for which the general account is the backstop if those assets do not perform or end up being insufficient to cover the ultimate risks, becomes an even greater concern when the assets are not subject to the same restrictions or safeguards as if they were held in the general account.

- **Inclusion of separate account assets within state investment limits.** The historical exclusion of separate account assets from state investment limits was based on the concept that the assets were being directed by policyholders, with the policyholders bearing the investment risk. If the GA is ultimately responsible for the payment of claims when the SA assets fail to perform or if they are insufficient, then it may be important for the investment mix, risk and concentration to be subject to the same general account investment limit protections.

- **Inclusion of separate account assets in asset adequacy testing.** From a review of the AG53 filing, several companies have been initially identified as likely not including separate account assets. Furthermore there are several instances in which the review of the filing was inconclusive of whether separate accounts assets were included.

NAIC Recommendation – Book Value Guaranteed Separate Accounts
NAIC staff recommend that the Working Group provide direction on whether net negative (disallowed) IMR in the separate account should be included for admittance within the INT. If supported, comments are welcome on the desired approach for reporting and allocation between insulated and non-insulated blanks.

NAIC staff also recommend comments / direction by the Working Group broader revisions to address IMR in the separate account (products permitted for book value / state exceptions and reporting determinations based on the positive/negative balances in the general account / other separate accounts). Comments are also requested on whether a separate agenda item should be developed to address the use of the separate account as an extension of the general account, to ensure reporting requirements consistent with the general account.

4) Reinvestment and Allocation

ACLI Comments:
This section of our letter will focus solely on the requirement in paragraph 9b to require the proceeds of the sale of fixed income investment to be immediately used to acquire another fixed income investment.

Original Concepts on Reinvestments in the Development of IMR
There were a number of considerations that were made in the development of IMR as it pertains to the reinvestments of proceeds from sale of fixed income instruments. Several of those considerations included in the excerpts from the E-committee reports are summarized below:

1) It is important to distinguish between capital gains and losses which arise because of changes in the general level of interest rates, and capital gains and losses which are a result of the changing circumstances of the issuer.

> ***It is important to distinguish between capital gains and losses which arise because of changes in the general level of interest rates, and capital gains and losses which are a result of the changing circumstances of the issuer.*** *Those which arise because of changes in the general level of interest rates (interest-related gains and losses), although defined as capital gains and losses for financial reporting purposes of Capital Gain and Loss Exhibit,* ***are in reality purely transitory gains and losses without any true economic substance on an ongoing basis.***

Gains and losses which arise because of changes in the general level of interest rates, are in reality purely transitory gains and losses without any true change to the company's position of financial strength. The ACLI has illustrated this in our previous letters and in Appendix I to this letter.

2) It could be claimed that in theory IMR should be applied to both unrealized and realized gains and losses (i.e., one is in the same position of financial strength whether one sells a fixed income investment and reinvests in another fixed income investment or just has off balance sheet unrealized gains or losses).

In practical application of these concepts, certain modifications occurred. An effort was made to keep compromises and exceptions to a minimum in order to maintain the objectives of the IMR. Among such modifications were the following:

(a) ***Although it might be claimed that the theory should encompass unrealized as well as realized gains, the more straightforward applications of the intent of the reserve are to realized gains. Hence the use of the reserve is limited to realized gains (occurring at time of sale, maturity, call, etc.)***

(b) Interest-related gains occur on equities, as well as on fixed interest securities, but such gains are much harder to distinguish and analyze. For this reason, equity gains were excluded.

3) The intent of IMR was for symmetrical treatment of both gains and losses, but IMR for losses was never robustly addressed, as intended, subsequent to adoption for gains which was the primary focal point at the time of adoption.

The basic rational for the IMR would conclude that neither a maximum nor a minimum is appropriate. If the liability values are based on the assumption that the assets were purchased at about the same time as the liabilities were established, then there should be no bounds to the reserve ***which corrects for departures from that assumption****;* ***if a company has to set up a large reserve because of trading gains, it is in no worse position than if it had held the original assets. As for negative value of the IMR, the same rationale applies.*** *However, the concept of a negative reserve in the aggregate has not been adopted.*

The concepts above recognize that IMR was not developed to replace the statutory framework with a market consistent framework[2]; rather to prevent misrepresentation of financial strength that could occur within the statutory framework by selling bonds in a declining interest rate environment and recognizing gains.

It is imperative that transitory interest related gains and losses be treated similarly with off-balance sheet unrealized gains and losses so financial strength is comparatively reflective and so prudent risk management transactions are not disincentivized. Otherwise, financially strong companies could be shown comparatively weaker, and financially weak companies could be shown as comparatively stronger, or worse, companies will not engage in prudent investment and risk management behavior due to regulatory dis-incentivization.

Practical Challenges with Proving Reinvestment

Certain regulators and ACLI have discussed this concept with understanding of this macro view, and in fact are concerned that proving the reinvestment of any individual fixed income investment comes with two practical problems related to the fungibility of cash. We share those concerns.

First, because of the fungibility of cash, it is likely impossible to prove the proceeds were immediately reinvested. Relatedly, it is unclear how the exposure would require demonstration of this proof. Second, and more importantly, such proof if it were able to be attained, would potentially give regulators a false sense of certainty that significant reinvestment was actually occurring. For example, if a company sold a bond, proved it reinvested the proceeds immediately and directly in another bond, due to the fungibility of cash the purchased bond could be meant for new business written, and all or a significant majority of maturities and new premiums were invested in equity securities. Thus, while proving such reinvestment actually occurred, it would provide little assurance if any, that broad level

[2] We strongly support the NAIC framework, with its built-in conservatism, as it facilitates the issuance of long-term insurance products in the US market by not overly focusing on current market fluctuations. This is unlike many market valuation regimes where over-reliance or misapplication of current market conditions often distorts the financial solvency of insurance companies and can lead, and has led to, the decrease or elimination of such long-term product issuances in those regimes. Not allowing for net interest rate losses, as was the original intent of IMR, is not conservative, it potentially disincentives the exact type of prudent behavior insurance companies should be engaging in.

reinvestment was actually occurring as presumed. The important point is to prove reinvestment is occurring on a macro basis.

> *That this is demonstrated by the fact that in virtually all cases* ***an insurer who realizes interest-related gains and losses arising from the disposition of securities, will necessarily want to reinvest the proceeds in order to maintain a viable operation that meets its obligation. Such reinvestment will take place in the current interest environment and produce yields consistent with that current environment.*** *The difference in the value of future earnings arising from the reinvestment is roughly equal in magnitude, and opposite in sign, to the Exhibit 4 gains and losses occurring at the time of the transactions; in other words, if an interest-related gain occurs, the insurer is likely to have to reinvest at lower yields; and if an interest-related loss occurs, the insurer will generally be able to reinvest at higher yields.* ***Thus, if the gain or loss is truly interest-related, and not in any way related to a change in circumstances of the issuing entity, no significant change in the ability to meet its obligations or its solvency position of the insurer has occurred.***
>
> ***Hence, the Interest Maintenance Reserve is designed to set aside such gains and losses and prevent them from having an immediate impact on surplus, and to amortize these gains into the Gain from Operations in a manner which reflects the runoff in future yields as closely as possible.***

An insurer will necessarily want to reinvest the proceeds in order to maintain a viable operation that meets its obligation as noted in the E-Committee report above. Implicit within the concept of IMR is also that such reinvestment will occur in fixed income investments. This concept was discussed at the LATF meeting on April 27th. Notwithstanding if a company re-invested in equity securities, for example, RBC would require a materially higher capital charge, the implicit reinvestment assumption is certainly meant to occur on a macro basis.

Impact of Excess Withdrawals

We recognize that assets may be sold in an environment when an insurer experiences elevated withdrawal activity and may not subsequently reinvest the proceeds of those sales. The Excess Withdrawal safeguard referred to in E-Committee excerpt below was specifically designed to address these situations to avoid capital gains and losses from asset sales used to pay for excess withdrawal activity to be deferred into IMR.

> *(c) Within the category of fixed interest gains, practical methods were developed to distinguish between interest-related and credit-related gains and losses (see section on "How To Distinguish Gains").*
>
> *(d) Special provision is made for liabilities with Market Value Adjustments (see section on "Market Value Adjustments").*
>
> *(e)* ***There are certain circumstances where the sale of securities is not accompanied by a reinvestment because of a significant reduction in liabilities. Special rules to handle these situations are described in the sections on "Reinsurance Transactions" and "Excessive Withdrawals."***

We believe this safeguard is both appropriate and well designed for the intended purpose. We also support regulators in their desire to re-evaluate this safeguard in the context of the current environment to ensure it achieves the objective for which it was designed. We stand ready to work with regulators in that regards, if desired, in development the longer-term permanent solution.

<u>ACLI Recommendation</u>

We agree with regulators that some macro level of proof of reinvestment is warranted to align with the original theory. We believe this proof should be designed to be practical while not disincentivizing prudent investment, derivative and ALM behavior that corrects for the assumption that assets were purchased at the same time as liabilities were established (i.e., assumed yield required for satisfying liabilities by ensuring any explicit guarantees and disintermediation risks are addressed as well as ensuring subsequent premiums, coupon payments, and maturities can be invested at the appropriate yield).

This could be done, for example, by generally requiring the sum of the proceeds from the sale and maturity of bonds (line 12.1) and mortgage loans (line 12.3) are less than the sum of the cost of bonds acquired bonds (line 13.1) and mortgage loans (line 13.3) from the cash flow statement ultimately submitted to regulators in the annual statement. ACLI notes that maturities are included within lines 12.1 and 12.3, and similarly, there may be acquisitions funded by new premiums or other cash inflows within lines 13.1 and 13.3. However, the fungibility of insurer cash flows produces difficulty in bifurcating the source of the acquisition cash flows, as well as which proceeds were reinvested and which were used for other business purposes.

Despite these items, such a requirement would provide the following benefits:

1) It is objective, easily verifiable, and ultimately rolls up into the audited financial statements,
2) It eliminates the issue surrounding the "fungibility of cash",
3) It demonstrates on a macro basis significant reinvestment is occurring.

This could be coupled with a disclosure in the financial statements showing this proof explicitly and an attestation that:

1) Fixed income investments generating IMR losses comply with the company's documented investment or liability management policies,
2) IMR losses for fixed income related derivatives are all in accordance with prudent and documented risk management procedures and in accordance with a company's DUP, and
3) Any deviation to 1) above was either because of a temporary and transitory timing issue or related to a specific event, such as a reinsurance transaction, that mechanically made the proof not reflective of reinvestment activities.

We believe that the above demonstrations and disclosures, coupled with the Excess Withdrawal safeguard previously mentioned would ensure that the appropriate level of capital gains and losses are deferred into IMR.

NAIC Discussion – Reinvestment Allocation

NAIC staff agree with comments made by the ACLI on the practicability challenges and fungibility of cash in determining reinvestment. However, NAIC staff are aware that regulators are looking for more verification that the sale of fixed-income investments is being reinvested, as that is the premise for the original ACLI request to permit admittance of net negative (disallowed) IMR.

Excerpts from the ACLI letter dated Oct. 31, 2022:

> The ACLI proposes the allowance of a negative IMR balance in statutory accounting. Negative IMR balances are expected to become more prevalent in a higher interest rate environment and their continued disallowance will only serve to project misleading optics on insurers' financial strength (e.g. inappropriate perception of decreased financial strength through lower surplus and risk-based capital even though higher rates are favorable to an insurer's financial health) while creating uneconomic incentives for asset-liability management (e.g. discourage prudent investment transactions that are necessary to avoid mismatches between assets and liabilities just to avoid negative IMR).
>
> IMR was created to prevent the timing of the realization of gains or losses on fixed income investments, related to interest rates changes, to affect the immediate financial performance of the insurance company. This recognized that the gains and losses were transitory without any true economic substance since the proceeds would be reinvested at offsetting lower or higher interest rates.
>
> For example, without the IMR, if a company sold all bonds in a declining interest environment (e.g., from 4% to 2%), and reinvested in new bonds, surplus would increase through significant realized gains. The

> increased surplus would inappropriately reflect increased financial strength that is illusory, due to a now lower yielding portfolio, as there would be no change to the income needed to support the liabilities.
>
> Likewise, if a company sold all bonds in an increasing interest rate environment (e.g., from 2% to 4%), and reinvested in new bonds, surplus would decrease through significant realized losses. The decreased surplus would inappropriately reflect decreased financial strength that is similarly illusory due to the reinvestment at higher yields relative to when the bonds were originally purchased.

NAIC staff agree that a broad comparison of sales/maturities of bonds and mortgage loans to the acquisition of bonds and mortgage loans from the cash flow statement could be used as a minimum assessment. However, that approach is faulty as new investments continue to occur as premiums are received. As such, that metric only really works if a reporting entity was no longer receiving premiums / making new investments. With new investments reflected in the cost of bonds/mortgage loans, significant sale activities without reinvestment could still occur and not be identified through that comparison.

NAIC staff also do not oppose the inclusion of a new disclosure / attestation on the reporting entity's policy for the sale / reinvestment of assets and what has been included in IMR. NAIC staff note that the reference in paragraph 9b of the proposed INT, referencing an "immediate" usage of sale proceeds to acquire bonds or other qualifying fixed income securities was intended to not necessarily require a trackable metric, but rather reflect a general concept on how proceeds are used. The term "immediate" was not defined, as it is recognized that such actions may not be instantaneous, but that it should not be permitted for proceeds from the sale of bonds to sit as cash, or used for other purposes, with an ultimate reinvestment in the future and to have those actions qualify for admitted IMR reporting. Direction or suggestions for revised language to better reflect this concept are welcome.

<u>NAIC Recommendation – Reinvestment and Allocation:</u>
NAIC staff recommend that the Working Group provide direction on what is desired to support / verify the requirement for reinvestment of bond proceeds.

5) <u>Special Surplus Account</u>

<u>ACLI Recommendation</u>
We do not object to reporting net negative IMR to special surplus. However, we presume it is the regulatory intent for this to be allowed rather than disallowed IMR that is to be shown in special surplus.

<u>NAIC Discussion – Special Surplus Account</u>
NAIC staff note that the amount allocated to special surplus is the "admitted" net negative (disallowed) IMR. This is correctly reflected in paragraph 10b of the exposed INT. Admittance of the net negative (disallowed) IMR is the exception reflected in the interpretation.

Net negative IMR that is not disallowed is already permitted to be shown as a contra-liability. This would reflect negative IMR in the GA that is offset by a positive IMR in the SA, or vice versa. The net negative IMR that is not disallowed is not proposed to be captured in the special surplus reporting.

<u>NAIC Recommendation – Special Surplus Account</u>
NAIC staff do not believe any modification is necessary to the tentative INT.

6) <u>Other Existing Safeguards</u>

ACLI Recommendation

While ACLI believes an appropriate interim package of safeguards for IMR admittance includes the requirements in the SAPWG's exposure with ACLI's recommended changes, we also wanted to acknowledge the role played by other safeguards that are operational today. These existing safeguards include:

- AAT
- Excess Withdrawal Safeguard
- Domicile regulator review and approval of DUPs, which can be subject to auditing procedures

These existing safeguards enhance the protections provided by the interim package of safeguards. For example, AAT, though not relied upon as the sole safeguard, continues to play a very significant role as a safeguard for ensuring adequate reinvestment, which was illustrated in ACLI's February 16, 2023 letter. AAT also ensures that claims-paying ability is ultimately preserved even as the admitted negative IMR amortizes away. Inadequate (due to surrender activity) or inappropriate reinvestment that jeopardizes claims-paying ability of a company would get picked up by AAT and result in reserve strengthening, which immediately reduces surplus. Furthermore, LATF confirmed on their April 27, 2023 call that their year-end 2022 guidance requires that all admitted net negative IMR be reflected in AAT (i.e., admitted negative IMR cannot be assumed to back surplus). This clarification further strengthens the AAT safeguard and is consistent with ACLI's recommendation for AAT enhancements in our February 16, 2023 letter.

<u>NAIC Discussion – Other Existing Safeguards</u>

NAIC staff note the following with regards to the ACLI noted additional safeguards:

- The Life Actuarial (A) Task Force has communicated that asset adequacy testing should not be relied upon for the admittance of net negative (disallowed) IMR.

- Domiciliary state regulators can provide permitted practices for the admittance of net negative (disallowed) IMR based on company-specific situations. Only 2 permitted practices were approved for year-end 2022.

- With regards to the reliance on derivative use plans (DUPs), NAIC staff identify the lack of communication on the termination of fair value derivatives, particularly with how fair value losses, which had previously reduced surplus as unrealized losses, were being reversed to the IMR and not realized losses.

<u>NAIC Recommendation – Other Existing Safeguards:</u>

NAIC staff request feedback from the Working Group on whether these safeguards should be identified in the tentative INT and/or if other safeguards should be considered for the long-term assessment.

NAIC staff have the impression that additional safeguards are desired by regulators, and requests comments and feedback on additional elements that can be included.

7) <u>RBC Sensitivity With and Without Admitted Negative IMR</u>

The idea of an RBC sensitivity with and without admitted negative IMR was included in the referral to the Capital Adequacy Task Force (CATF). This RBC sensitivity would provide regulators additional insight on RBC (e.g., relative to RBC action levels). Although the ACLI does not support a direct adjustment to TAC because it puts companies in the same spot as today with regards to disincentivizing prudent investment, risk management, and ALM strategies, as articulated throughout this letter, the ACLI would support the aforementioned sensitivity analysis.

<u>ACLI Recommendation</u>
ACLI would therefore recommend that industry offer this sensitivity as part of the interim solution to give regulators greater comfort with the full interim package of safeguards. We would recommend that such a sensitivity be reported confidentially (i.e., regulator-only) to avoid confusion among other users associated with two calculations of RBC while still providing regulators with the necessary transparency. ACLI would be happy to work with the NAIC to develop appropriate reporting for this sensitivity.

<u>NAIC Recommendation – RBC Sensitivity With and Without Admitted Negative IMR</u>
The referral directed from the Spring National Meeting was provided to the Capital Adequacy (E) Task Force in March 2023. NAIC staff request comments from regulators on the ACLI recommendation and the development of additional reporting.

8) <u>Effective Duration / Automatic Nullification Date</u>

The tentative INT was exposed as a limited-time, optional, exception to SSAP No. 7 and the Annual Statement Instructions. The draft included language that it would be automatically nullified, but the date was left blank.

<u>NAIC Recommendation – Effective Duration / Automatic Nullification Date</u>
NAIC staff request comments from regulators and industry on a proposed nullification date for the INT.

<u>ANY OTHER MATTERS</u>

a. **VOSTF Referral (Julie) (Attachment 5):** On June 1, 2023, the Working Group received a referral from the Valuation of Securities (E) Task Force with a request that the Working Group review the proposed revised definition of an NAIC designation within the Purposes and Procedures Manual of the NAIC Investment Analysis Office. The referral requests an informal response if the NAIC designation meets the Working Group's needs. If the definition does not meet the Working Group's needs, the referral requests a response with this indication by June 29, with a later deadline of July 31st to submit proposed modifications to the definition.

   To allow ample time to review the definition, NAIC staff have requested an extension of the initial time. Working Group members that have comments on the proposed definition are requested to send their thoughts to NAIC staff by July 7. If there are comments with what is proposed, NAIC staff will inform the Task Force by July 10. We will plan to propose any needed modifications to the definition by July 31.

b. **ICP 14 / ICP 17 (Julie):** On June 23, 2023, the International Association of Insurance Supervisors (IAIS) released for public consultation two draft revised Insurance Core Principles (ICPs): *ICP 14: Valuation and ICP 17: Capital Adequacy*. Comments on the ICPs are due to the IAIS by Sept. 21, 2023. (In addition to the ICPs, the IAIS released for public consultation the candidate Insurance Capital Standard (ICS) as a prescribed capital requirement for Internationally Active Insurance Groups (IAIGs.) The consultation documents are available on the IAIS website: https://www.iaisweb.org.