Statutory Accounting Principles (E) Working Group
June 28, 2023
Comment Letters Received
INT 23-01T: Net Negative (Disallowed) IMR

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group
Kevin Clark, Vice-Chair of the Statutory Accounting Principles (E) Working Group

FROM: Rachel Hemphill, Chair, Life Actuarial (A) Task Force
Craig Chupp, Vice-Chair, Life Actuarial (A) Task Force

RE: Life Actuarial (A) Task Force Response on Negative IMR

DATE: June 15, 2023

Background

On March 27, 2023 a memorandum from the Statutory Accounting Principles (E) Working Group (SAPWG) was received by the Life Actuarial (A) Task Force (LATF) with a referral for consideration of the Asset Adequacy Testing (AAT) implications of negative IMR. Specifically, the Working Group recommended a referral to the Task Force to consider the following:

1. Development of a template summarizing how IMR (positive and negative) is reflected within AAT.
2. Consideration of the actual amount of negative IMR that is to be used in AAT, noting that as negative IMR is included, there is a greater potential for an AAT liability.
3. Better consideration and documentation of cash flows within AAT, as well as any liquidity stress test considerations.
4. Ensuring that excessive withdrawal considerations are consistent with actual data. (Insurers selling bonds because of excess withdrawals should not use the IMR process.)
5. Ensuring that any guardrails for assumptions in AAT are reasonable and consistent with other financial statement / reserving assumptions.

Recommendation

On its April 27th call, LATF discussed the referral from SAPWG. LATF agreed on the following actions:

Develop IMR Template

LATF is drafting a template with additional disclosures on the reflection of IMR in Principle-Based Reserving (PBR) and AAT. We have requested input from the American Academy of Actuaries and the American Council of Life Insurers on a

potential template. The template's disclosures would aim to support verification of the requirements SAPWG is considering for potential admittance of negative IMR, including confirming:

1. That IMR is appropriately allocated for PBR and AAT,
2. That any negative IMR amounts reflected in starting assets do not generate income and so increase reserves in PBR and/or decrease reserve sufficiency in AAT,
3. That admitted negative IMR does not reflect bonds sold due to historical or anticipated future excess withdrawals, and
4. That admitted negative IMR only reflects bonds sold and replaced with similar bonds.

For items three and four above, we note that while LATF can request verification and justification from companies, this may be difficult for companies to demonstrate. For item three, we can require additional disclosures including actual to expected experience for withdrawals. For item four, it is not yet clear what verification companies could provide.

This template would be optional but recommended starting with 2023 reporting and could be required starting in 2025. Individual regulators could request this information during reviews if warranted before 2025.

Issue Guidance on Consistency

LATF is drafting guidance for year-end 2023 and 2024, consistent with the guidance LATF issued for year-end 2022 but updated for SAPWG's potential admittance of some portion of aggregate negative IMR. That is, LATF continues to affirm that a principle-based, reasonable, and appropriate allocation of IMR for PBR and AAT would be consistent with handling of the IMR asset for statutory reporting. LATF will also consider an Amendment Proposal Form to make changes directly in the Valuation Manual to clarify the treatment of negative IMR starting with the 2025 Valuation Manual. This work continues to address the concern raised that there would be a "double hit" if negative IMR were not admitted while being required to be reflected in PBR and/or AAT.

Recommendation to SAPWG Regarding AAT

LATF recommends to SAPWG that any decision to admit or not admit aggregate negative IMR should not rely on AAT at this time. We wish to clarify that AAT is not formulaic, is heavily judgment-based, and generally does not contain prescriptive guardrails on that judgment, such as the reinvestment guardrail and other guardrails that apply in PBR. In response to specific concerns around a lack of consistency in AAT asset assumptions, Actuarial Guideline (AG) 53 was developed to provide regulators with additional disclosures, but again does not contain guardrails. AG 53 review work is currently under way. Moreover, this is not the only area where concerns could arise regarding the reliability of specific AAT results. We do not believe it would be appropriate to admit negative IMR if doing so was depending on AAT as the sole or primary safeguard for any related solvency concerns.

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May 17, 2023

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Dear Mr. Bruggeman:

Re: Exposure Ref #2022-19 – INT 23-01T Net Negative (Disallowed) IMR

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.

REQUIREMENTS FOR AN EFFECTIVE INTERIM SOLUTION

A. Surplus Considerations

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.

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

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.

B. Derivatives

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.

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.

C. Book Value Guaranteed Separate Accounts

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.

D. <u>Reinvestment and Attestation</u>

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.

[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.

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

> *That this is so 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.

ACLI Recommendation

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.

E. Special Surplus Account

ACLI Recommendation

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.

F. Other Existing Safeguards

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.

G. RBC Sensitivity with and without Admitted Negative IMR

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.

ACLI Recommendation

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.

SUMMARY

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.

If you have any questions regarding this letter, please do not hesitate to contact us.

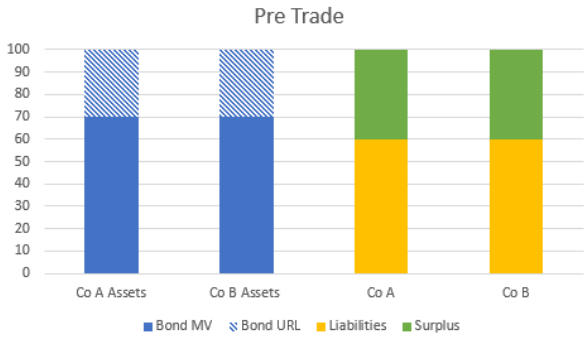
Sincerely,

Mike Monahan
Senior Director, Accounting Policy

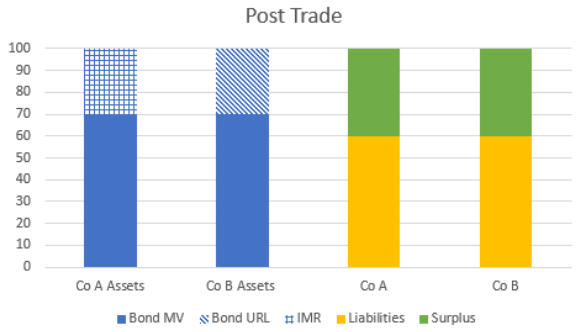
CC: Julie Gann, NAIC

Appendix I

Assume Company A and Company B have each invested their entire portfolios in a single bond. The companies' starting financial position is identical. Both companies have the same locked expected investment return and reserving discount rate assumptions. After interest rates rise, the bond's recorded amortized cost book value ($100) exceeds its market value ($70) and is in an off-Balance Sheet unrealized loss (URL) position.

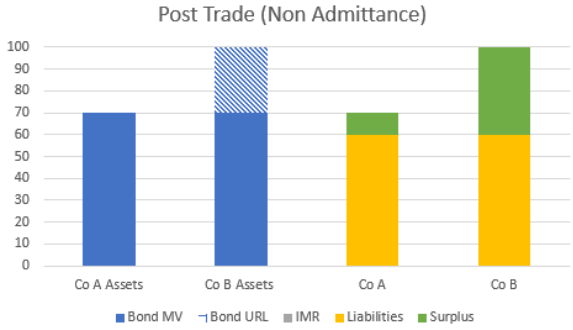


Company A sells its full bond holdings for $70, then immediately reinvests all proceeds into a new bond. The $30 loss is deferred to the IMR. Company B makes no changes to its holdings (no bond sale). Both companies are in the same position of financial strength insofar as having the same total liquid assets available to pay immediate claims, pre and post trade. The market value of both Companies' assets remains $70.



However, if Company A's negative IMR is not allowed, Company A will show an illusory decrease in financial strength, despite no change to its position of financial strength (including total liquid assets available to pay immediate claims) pre and post trade. Company A's IMR equates to the off-Balance Sheet URL embedded in Company B's bond holdings (the difference in the $70 fair market value and $100 amortized cost book value).

The rationale for Company A's trade could be for better ALM (as part of its duration management strategy), to adjust asset allocation, or to otherwise provide more value to its policyholders, which is likely to place it in a better position of true financial strength versus Company B. A cap would disincentivize these actions (see Appendix II).



Appendix II

Assumptions:

- The entire investment portfolio is comprised of zero coupon bonds with time to maturity of 0-10 years and an average portfolio duration of 5.5-6.0 years.
- The book value for these bonds is based on a 3% interest rate.
- Starting interest rates are flat at 3%, equivalent to the book value rate of the bonds in the portfolio.
- Interest rates increase by 250 bps over the course of Year 1 and remain flat for the remainder of the scenario.
- Maturing bonds are reinvested each year into new 10-year zero coupon bonds at current market rate.
- 10% of bonds are sold each year at current market rates and reinvested into new 10-year zero coupon bonds at current market rate.
- No other cash inflows or outflows into portfolio; portfolio duration remains between 5.5 and 6.0 years.
- Company's balance sheet has liabilities at roughly 90% of assets and surplus at roughly 10%.

Figure 1: Impact on portfolio market value (MV) with an interest rate spike

Portfolio market value immediately declines, and the bonds are in an unrealized capital loss position. As rates stabilize, and the portfolio turns over (i.e. through trading or maturity and subsequent reinvestment), the market value recovers.

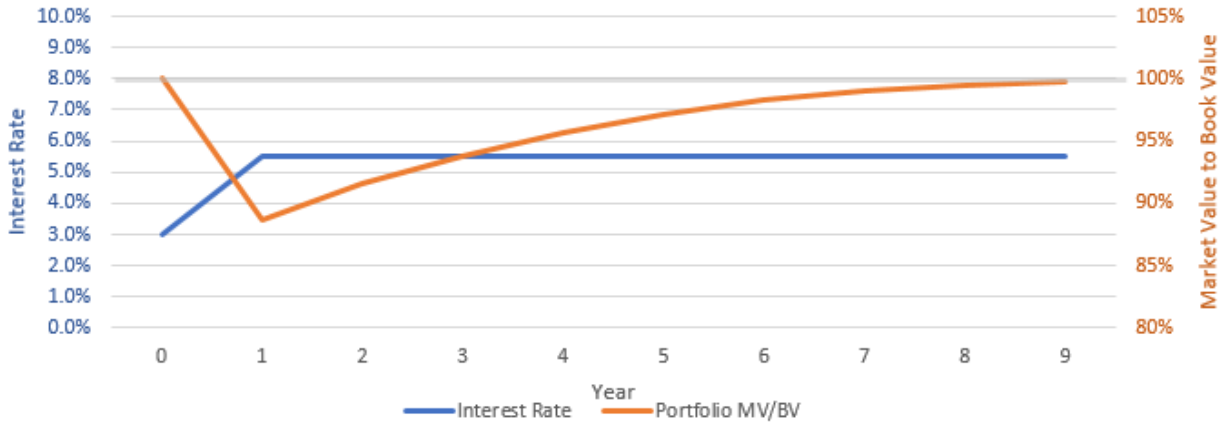


Figure 2: Relationship between portfolio market value, trading assumptions, and IMR

The negative IMR balance, generated by trading, remains below 5% of surplus in year 1 but soon exceeds 10% of surplus in year 2. The balance will continue to grow in years 2-4 even after rates stabilize. (see Fig. 1).

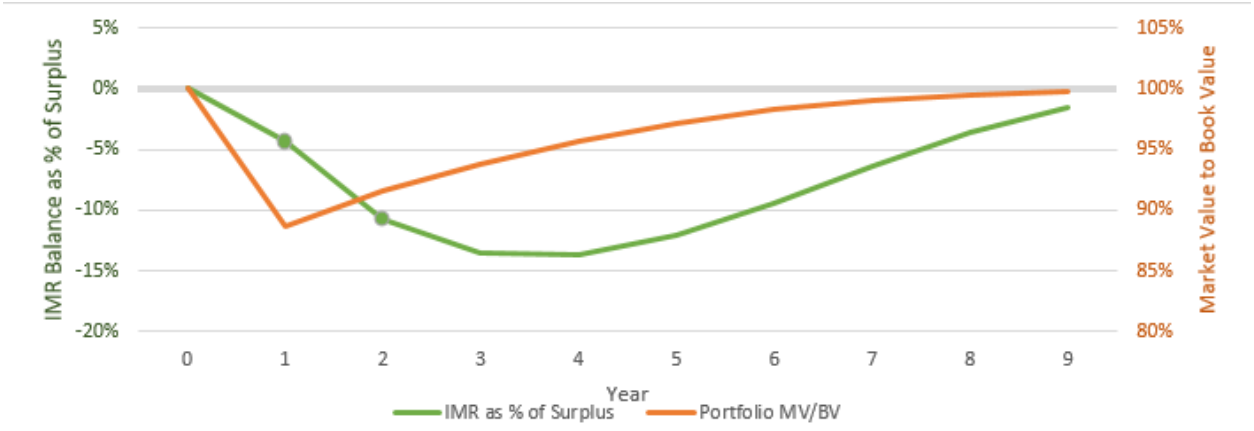


Figure 3: Managing portfolio to a surplus cap
Company will manage so negative IMR doesn't exceed 5% of surplus (0.5% of portfolio value). Bond sales reduced from 10% per year to <5% per year in years 2-5. Company is unable to keep duration in targeted range of 5.5-6.0.

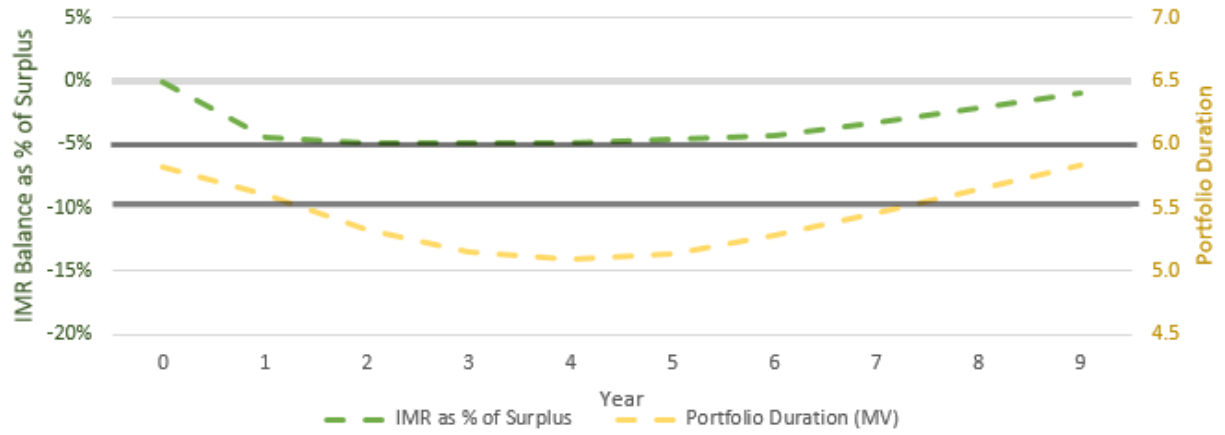


Figure 4: Interest rate sensitivity – rates increase 100 bps over Year 2, then remain level
Using the same initial assumptions, the IMR balance grows more negative than in the original scenario, illustrating that further interest rate increases exacerbate the issue.

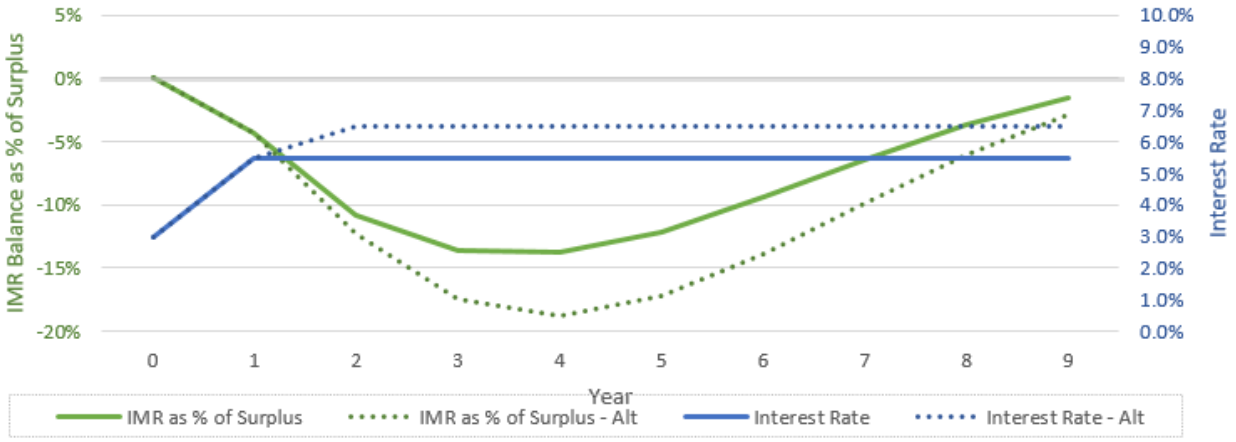
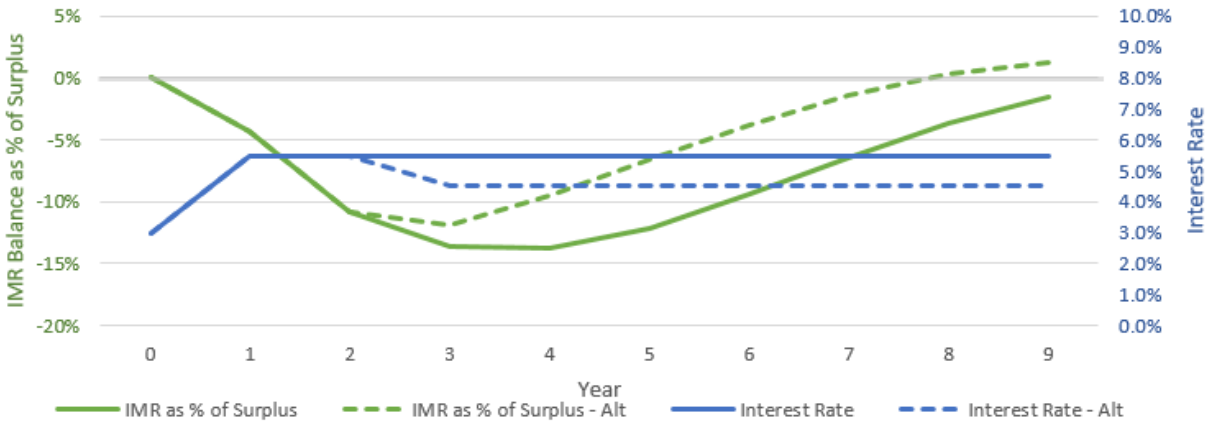


Figure 5: Interest rate sensitivity – rates decrease 100 bps over Year 3, then remain level
The interest rate decline illustrates that negative IMR will recover towards zero slightly faster, however, the issue will still persist for several years.



Appendix III

Background

For simplicity, only one derivative type is shown within each example, but gains and losses from all interest rate derivatives are equally applicable if used to achieve the same ends. Interest rate-related derivatives generate gains/losses when terminated or sold prior to maturity, similar to bonds. Additionally, certain derivative types, such as futures, bond forwards, and total return swaps, have contractual periodic settlements which generate a realized gain/loss. These events are outside the control of the insurance company, but may happen multiple times over the life of the hedging strategy. This document is not intended to be an exhaustive list of all derivative strategies that may be used to manage interest rate risk and examples are simplified to best illustrate the salient points. Any example utilizing a single bond and corresponding derivative can also be similarly extended to a portfolio of bonds and single derivative, or portfolio of both.

Example 1: Floating rate bond(s) paired with an interest rate swap

An insurer may choose to purchase floating rate bonds because of attractive relative value to fixed rate bonds when considering spread, structural protections, and other factors. Alternatively, the desired fixed rate bond may not be readily available in the market. In either case, the insurer may wish to have fixed rate exposure to better match liability objectives, and for example pairs a 5 year floating rate bond with a 5 year receive-fixed swap to mimic the desired fixed rate bond. If both instruments' critical terms match, or if cash flows or fair value (depending on the type of hedge elected) remained within the prescribed effectiveness range from SSAP 86, an insurer could elect hedge accounting. However, an insurer may not desire or seek hedge accounting for a number of reasons, such as wanting flexibility to trade the position (ie. trade the bond and terminate the swap), which could taint the overall hedge accounting strategy.

The interest rate swap could also be utilized to change the duration of the bond, for example, pairing a 5-year floating rate bond with a 10-year receive-fixed interest rate swap mimics investment in a longer duration fixed rate bond. This is often more efficient (for example, with reduced transaction costs, especially when applied to a portfolio of bonds) than buying and selling only bonds to affect duration (see more discussion in Example 3). The longer swap tenor would likely cause difficulties in achieving hedge accounting, as the critical terms wouldn't match and the cash flows or fair values would likely not fall within the SSAP 86 prescribed effectiveness range.

These strategies could also be completed using various derivative instruments as alternatives to interest rate swaps. The derivative gains/losses could come from either aforementioned contractual settlements or the company choosing to terminate the derivative. The company could terminate the derivative for a number of reasons, depending on strategy or other changes in circumstance. In either scenario, the hedge would still be considered highly effective, even though the non-accounting hedge derivative is held at fair value. In both cases, if the insurer sold the bond and terminated the derivative, it is most appropriate to offset the gains/losses from each instrument in the IMR. The accounting hedge election should not cause a recognition mismatch. If the gain/loss on the bond is deferred to the IMR, but the derivative gain/loss is not, there is a mismatch between the economics of the transaction that actually occurred, and the long-term financial statement presentation.

Example 2: Hedging Future Investment Risk

An insurer may have future cash flows to invest, whether from premiums on level-pay policies, reinvestment of bond coupons and principal repayments, or a combination thereof. Product pricing may have assumed a certain investable yield over the life of a product. Hedging future investable rates can provide for more certainty of attaining those assumptions and reduce risk associated with low interest rates and product guarantees.

In this example, an insurer could lock in the targeted yield using Treasury bond forwards or forward-starting interest rate swaps to protect against declining rates and better ensure the assumed investment yield is achieved, therefore helping ensure liabilities can be paid. In the event that interest rates decline, the derivative will generate a gain that supplements yields of bonds subsequently

purchased in that lower rate environment. Alternatively, if interest rates rise, the derivative will generate a loss, but is economically offset by being able to invest future cash flows in that higher rate environment.

It is generally difficult to qualify for hedge accounting for these strategies, as the bond in the forecasted purchase is not easily and precisely identifiable, which is required to achieve hedge accounting under SSAP 86. It would require either hedging the purchase price of an existing specific bond/portfolio of bonds the insurer will purchase, or hedging the future cash flow stream of a newly issued bond/portfolio of bonds not yet in the market. Both are operationally burdensome and difficult to show under SSAP 86's prescriptive requirements. However, if the gain/loss on the derivative is not deferred to the IMR, the total yield on the bond(s) ultimately purchased will not align with the company's expectations, potentially leading to ALM or other risk concerns. A disallowed negative IMR and the ability to defer gains and losses from non-accounting hedges may disincentivize hedging and risk management behaviors helping to back policyowner value. Not deferring the losses would show a worse economic position when in fact it was a prudent risk management transaction and the insurer is likely in a better financial position.

Example 3: Hedging Duration Risk on Long Duration Liabilities (like Pension Risk Transfer, or PRT)
An insurer may have long duration liabilities with cash flows longer than the typical investable universe. For example, liabilities with 50 year cash flows do not readily match available asset tenors (often 30 years or less). The insurer would have reinvestment risk (e.g. in 30 years available yields could be too low to support the existing liabilities).

In this case, companies could sell shorter duration assets and purchase longer duration assets, to extend the asset durations, but there may not be desirable longer-term assets available or significant transaction costs. However, derivatives could be used to help manage the duration gap, as the asset duration may be shorter than the liability duration, transactions costs are cheaper, and asset availability is not an issue. Similarly, it could be that an insurer took on a block of business, such as in a PRT, and uses derivatives over the initial transition period until they can invest to match the desired liability characteristics. An insurer could similarly invest in US Treasury bonds at the prevailing market rate, then sell them as more appropriate assets are identified.

The insurer could use Treasury futures or other derivatives to cover these gaps between the assets and liabilities (i.e., lock in yields to protect against declining rates to ensure the assumed investment yield is achieved and therefore help ensure liabilities can be paid). In the event that interest rates decline, the derivatives/US Treasurys would increase in value, helping to match the assumed earning in pricing the liability. Alternatively, if interest rates rise, the derivatives/US Treasurys would generate a loss, but that loss would be offset by the ability to invest in higher yielding assets.

In combination, the bonds and derivatives/US Treasurys are intended to earn the yield needed to support the liabilities. Without these transactions, the total yield on assets would not be aligned with the presumed yield required to meet product obligations over the entire life of the product. Not deferring the losses would show a worse economic position when in fact it was a prudent risk management transaction and the insurer is in better financial position.

These scenarios further illustrate the interchangeable nature of bonds and derivatives to hedge interest rates. However, by using derivatives, and insurer can be more efficient by reducing transaction costs associated with trading in and out of US Treasurys. Similar to Examples 1 and 2, hedge accounting requirements are difficult to obtain, leading many insurers to consider these non-accounting hedges. However, again, the long-term financial statement presentation is again misaligned with the economics of the hedging transaction (to align expected asset yields to those required by the liabilities or assumed in their reserves) and the accounting hedge election should not cause recognition mismatch. Insurers could be more focused on managing the misrepresented short-term financial position (due to disallowed negative IMR) and choose not to enter into the derivative transaction(s), leading to potential asset and liability duration misalignment, retention of interest rate risk and insufficient asset yield to meet policy obligations.

Appendix IV

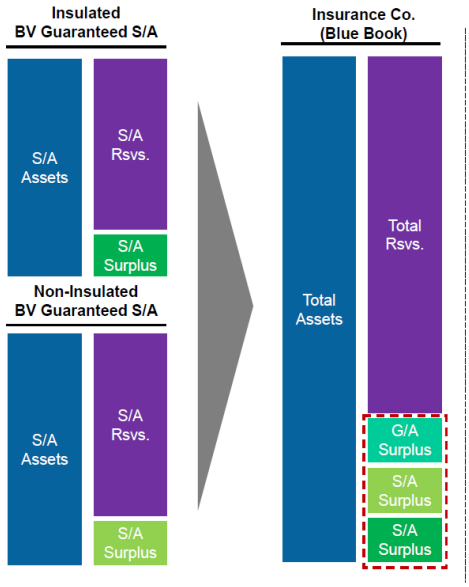
Inclusion of Separate Accounts ("S/A") in Admittance of Negative IMR

	Insulated vs Non-insulated	Included in IMR	Product Examples	Considerations
Book Value Guaranteed S/A	Insulated	Yes	Pensions GICs MVA Annuity	• Assets in insulated S/A are protected from General Account ("G/A") creditors • Income and Surplus is consolidated with G/A
Other BV S/As	Non-insulated	Yes	RILA	• Assets in non-insulated S/A are not protected from G/A creditors • Alignment that Income and Surplus, including negative IMR is relevant for G/A consolidation
Market Value Non-Guaranteed S/A	Insulated and Non-insulated	No (SSAP 56-22)	Variable Annuity Variable Life	• N/A – not relevant for IMR as MV non-guaranteed S/A is not included in IMR

- Book Value Guaranteed S/A, even when "legally insulated", still consolidate surplus with the G/A
- The insulation of the S/A provides protections for the policyholders within the S/A from the creditors of the G/A in cases of insolvency – it does not preclude or reduce the transfer of surplus from the S/A to the G/A
- The G/A effectively "guarantees" the surplus of an insulated S/A and ensures that S/A surplus is never negative

1

All S/A Surplus is relevant to the Surplus of the General Account



"Assets held in separate accounts are owned by the insurer" – SSAP 56-3

"The general account shall include the…surplus, if any, of its separate account business" – SSAP 56-6

- Admissible Negative IMR is a form of surplus generated by the activities of both insulated and non-insulated S/As. Surplus is not differentiated based on insulation status within SSAP 56
- When the S/A has a realized loss, and the proceeds are reinvested into higher yielding assets – both the realized loss and higher net investment income on the new assets will inure to the General Account ("G/A")
- It is therefore prudent and aligned with the initial intent of the IMR and SSAP 56 for negative IMR attributable to the S/A to be reflected in the G/A. Current IMR instructions recognize this condition
- As the admissible negative IMR of the S/A amortizes as a charge against surplus, it will offset the higher net investment income on the higher yielding assets, providing stability and accuracy in total surplus
- This treatment best preserves the intent of G/A surplus to reflect the full economic condition of the insurance company, both at the time of the realized loss and over the remaining life of the assets

2

ACLI Responses to NAIC Questions
June 7, 2023

Background: Following a presentation of net negative (disallowed) IMR, NAIC staff submitted seven questions for additional information. The questions and ACLI responses are detailed within.

Question 1 – Derivative Loss Amortization in the IMR:

NAIC Question: Per the presentation, it was heard that the derivative losses in IMR were being amortized in accordance with life of the assets in the hedged portfolio. However, the impression is that the derivative losses in IMR are likely from hedges of liabilities. **As such, how is the amortization duration determined for derivative losses in IMR that were from liability hedges?**

ACLI Response: The IMR instructions state that realized gains/losses associated with "derivative transaction 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." [1]

Companies generally either amortize over: (1) the average life of the investment portfolio whose interest rate characteristics have been altered or (2) consistent with the maturity of the hedging derivative or its referenced underlying asset. These two methods are most prevalent in industry, and the difference in amortization period is due to differences in each specific hedge/hedge program. Both methods have auditor support and are reasonable interpretations of the guidance as discussed further in #3.

As detailed in the ACLI comment letter in Appendix III, the hedging transactions we enter into are in service of ensuring proper interest rate risk management. Because these hedges protect against the change in valuation and yield of the assets we currently own or will ultimately purchase once all liability (premiums, fees) and asset (principal, interest) cash flows have been received and become investable, they are effective in mitigating interest rate risk and could be viewed as hedging the assets or the liabilities.

In the case of Examples 2 and 3 in Appendix III of the ACLI comment letter, the insurer could use either the average duration of their investment portfolio or the referenced underlying asset associated with the hedging derivative that realized a gain/loss (e.g., a 30-year UST bond in the case of a Treasury forward/future).

Footnote (1): 2022 LAH Instructions, Interest Maintenance Reserve, Line 2

Question 2 – Identification of Hedging-Other Derivatives that Hedge Interest Rate Risk

NAIC Question: One of the noted safeguards on the derivative presentation slides was Schedule DB. However, there is the impression that it is not possible to identify from Schedule DB the 'hedging-other' derivatives that could / would be allocated to IMR. Is this correct? **Is there a way to identify the derivatives that were classified as 'hedging-other' that are specifically hedging interest-rate risk that an entity intends to allocate to IMR upon termination? (Or, is there a way to identify whether the derivative gain/loss was allocated to IMR from the Schedule DB terminated schedules?)**

ACLI Response: Schedule DB Part A and B, Sections 1 and 2 classifies derivatives by line numbers aligned with SSAP 86 accounting classification (Hedging Effective, Hedging Other, Replication, Income Generation). In both sections, Columns 2 and 3 require a description of the item hedged and, if applicable, the item's Blanks schedule, respectively. Column 4 requires an identification of the risk(s) hedged (e.g., "Interest Rate"). This provides detail around insurer hedging programs currently in use and the risks they are hedging. SSAP 86 also requires disclosure on Section 2 for any terminated derivative where the gain/loss was used to adjust the basis of the hedged item (SSAP 86 Exhibit B).

Industry notes it is not currently disclosed in Schedule DB which derivatives would be eligible for IMR if terminated (Section 1) or after termination (Section 2). However, industry would be supportive of adding disclosures to Schedule DB to better identify, or adding prescriptive requirements within one of the description columns (similar to the requirement for a basis adjustment).

Question 3 – E Committee Report Referenced in Comment Letter

NAIC Question: The comment letter identifies a report to E Committee at the time of IMR development – **Can you provide this memo or provide more detail as to the name / source of this memo?**

ACLI Response: Provided pdf of the report "Asset Valuation Reserves and Interest Maintenance Reserves, Blue Book, December 2002." The report is labeled as "AVR/IMR Blue Book" and included link to Attachment One-A in the Valuation of Securities (E) Task Force December 8, 2002 Minutes.

Additional NAIC Comments:

The minutes excerpt is included below, noting receipt of the Blue Book during the meeting.

> 3. Blue Book Mr. Gorski noted that the primary work over the preceding three conference calls was to review and edit the draft Blue Book. Mr. Gorski noted that during the Nov. 19, 2002, interim call, Jim Reiskytl (Northwestern Mutual Life) noted that any future changes and revisions were to be managed by Alan Close (Northwestern Mutual Life). Mr. Gorski asked Mr. Close to review and describe the latest draft of the Blue Book (Attachment One-A). Mr. Close noted that this draft had been made available on the SVO/NAIC web site and that copies were in the back of the room. Mr. Close recommended that the working group receive the Blue Book in its current form. Mr. Gorski asked for a motion to receive the Blue Book. Tennessee moved to receive the Blue Book, Delaware seconded and the motion passed.

Question 4 – SSAP No. 86 Guidance for IMR

NAIC Question: The comment letter and the presentation did not address the existing SSAP No. 86 guidance for IMR. 2Was that intentional? SSAP No. 86 provides guidance in 4 locations for the treatment through IMR, and all of them are specific to derivatives that follow hedge accounting (effective hedges). (In paragraph 24 and then 3 instances in the Exhibit B for the specific hedge accounting procedures.)

ACLI Response: SSAP 86 paragraph 24 only provides guidance for how to treat gains/losses on derivatives that receive hedge accounting, as those derivatives are often carried at amortized cost (ie. not at the "default" fair value). Exhibit B, in addition to similar language as paragraph 24, contains additional guidance for realized gain/loss treatment for derivatives that cease eligibility for hedge accounting (the realized gains/losses will be recognized currently in income). SSAP 86 offers no guidance on the IMR

treatment of hedging transactions that do not receive hedge accounting at inception or at any point during the life of the hedge, and therefore industry follows the IMR instructions.

The IMR instructions are broader and cover both hedges that do and do not receive hedge accounting – collectively "hedging transactions." The instructions also separately reference "income generation" and "replication transactions" and do not note that hedge accounting is a precondition for inclusion in IMR. The derivatives section within the IMR instructions providing guidance begins by referencing "the following guidance pertains to instruments in Scope of SSAP No. 86–Derivatives," with no further qualifiers on limitations.

For hedging transactions, the IMR instructions indicate treatment of the hedging derivative aligns with the hedged asset(s). Since the hedged asset(s) are IMR eligible bonds/portfolios of bonds, the instructions state that the hedging derivatives are also IMR eligible. Auditors and industry have consistently applied this interpretation of the IMR instructions and SSAP 86.

Further, we wanted to address the perception that hedging transactions that have not received the hedge accounting designation should not be IMR eligible given the potential for the "unwinding" of prior unrealized gain/losses from having impacted surplus. For the avoidance of doubt, the changes in fair value of non-hedge accounting derivatives are recorded as unrealized gains/losses and are reflected as a change in the statutory surplus of the company.

Despite this treatment – there is still no justification for excluding the realized gains/losses on non-hedging accounting hedging transactions from the admittance of negative IMR.

Rather than there being an unwarranted "unwinding" of a prior gain/loss – the deferral and amortization through IMR appropriately reflects the transaction that occurred and the overall financial condition of the company. When derivatives are terminated or settle – the realized loss is effectively matched against the hedged investments (that are subject to IMR and whose income or realized gain/loss IMR amortization is what the derivative IMR is amortized against). The IMR instructions clearly state that realized gains/losses on hedging transactions should be amortized along with the hedged item.

Additionally, the current recognition that IMR is relevant for hedging transaction correctly and symmetrically recognizes that realized gains should be deferred and amortized. In the periods of low and declining interest rates that followed the 2007-2008 Financial Crisis insurance companies following prudent ALM practices realized significant gains on their hedging transactions that, absent the deferral and amortization through IMR, would have inappropriately reflected increased financial strength. While the current interest rate environment following the pandemic is markedly different, the industry is requesting that IMR remains symmetrical for both realized gains and losses. 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 due to the potentially far-reaching ramifications of such changes.

Lastly, hedge accounting is not easily achieved for significant portions of many insurers' usage of hedging transactions. Hedging transactions that are "anticipatory" in nature, that is, hedging the interest rate risk on future and forecasted bond purchases or sales, often do not receive hedge accounting. This is not because they lack the requisite "effectiveness" qualifications (hedge assets move within 80-125% of the hedged item) but rather the interpretation that the "anticipated" bond to be purchased or sold must be

identified at the hedge's inception. Many of the anticipated bond purchases or potential sales are many years in the future and may include assets that do not yet exist in the primary or secondary markets (e.g., future on-the-run US government bond issues or public or privately originated bonds) or can otherwise not be readily identified at the time the hedge is originated. These conditions make it difficult for these hedging transactions to receive hedge accounting treatment. While hedge accounting would be an acceptable method of recognizing the financial condition of using hedging transaction, its application is not available to many insurers.

The following scenarios help illustrate the importance of including hedging transaction gains/losses in any negative IMR admittance proposal (see additional scenarios in the attachment):

Scenario Assumptions:

- Company expects to receive $100 in future premium in 1 year
- Company needs to invest in 10Y US treasury bond
    - Current 10Y treasury bond yield is 5%
- Liability crediting rate is locked-in today at 4%
- Company choses to hedge the interest rate risk on the future investment (except Scenario D)
    - Company enters into 1Y total return swap on 10Y US treasury bond

Scenario A:

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	5%	Interest Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Deriv G/L at t=1 (EOP)	0.0	IMR Amort		-	-	-	-	-	-	-	-	-	-
		Total Investment Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	**10.0**

Scenario A Observations:

- Interest rates stay constant at 5% over the first year
- When the $100 premium is received it is invested at 5% yield
- The derivative is terminated with no gain/loss
- There is no impact to IMR
- Ultimately the insurance company accumulates **+$10** in surplus

Scenario B:

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	6%	Interest Income		6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Deriv G/L at t=1 (EOP)	-10.0	IMR Amort		(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)
		Total Investment Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Balance Sheet													
IMR			-10.0	-9.0	-8.0	-7.0	-6.0	-5.0	-4.0	-3.0	-2.0	-1.0	0.0
Surplus (Retained earnings)				1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	**10.0**

Scenario B Observations:

- Interest rates rise to 6% over the first year
- When the $100 premium is received it is invested at 6% yield
- The derivative is terminated with **a -$10 realized loss**

- Under ACLI proposal for negative IMR admittance, **the -$10 loss is deferred and amortized** against the investment income over 10 years (aligned with the derivative's referenced asset)
- Ultimately the insurance company accumulates **+$10 in surplus – as they locked in an effective 5% yield as intended**
- The financial statements appropriately reflect the company's financial condition

Scenario C:

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	6%	Interest Income		6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Deriv G/L at t=1 (EOP)	-10.0	Realized G/L		(10.0)									
		Total Investment Income		(4.0)	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		(8.0)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				(8.0)	(6.0)	(4.0)	(2.0)	-	2.0	4.0	6.0	8.0	**10.0**

Scenario C Observations:

- Interest rates rise to 6% over the first year
- When the $100 premium is received it is invested at 6% yield
- The derivative is terminated with **a -$10 realized loss**
- If the derivative is not eligible for IMR, the **-$10 realized loss is recognized immediately through income**
- Ultimately the insurance company **accumulates +$10 in surplus – as they locked in an effective 5% yield as intended**
- However, the financial statements inappropriately reflect the company's financial condition in the early years, implying a significant insolvency event, and may lead to significant and punitive unintended consequences

Scenario D:

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	3%	Interest Income		3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Deriv G/L at t=1 (EOP)	n/a	IMR Amort		-	-	-	-	-	-	-	-	-	-
		Total Investment Income		3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				(1.0)	(2.0)	(3.0)	(4.0)	(5.0)	(6.0)	(7.0)	(8.0)	(9.0)	**(10.0)**

Scenario D Observations:

- Interest rates fall to 3% over the first year
- When the $100 premium is received it is invested at 3% yield
- The company did not hedge its interest rate risk as it was concerned with the surplus volatility stemming from the SAPWG IMR proposal to exclude hedging transactions from negative IMR admittance
- Ultimately the insurance company accumulates **-$10 in surplus – as their investment income couldn't cover the interest credited on their liabilities**
- The SAPWG proposal disincentivizes prudent risk management in favor of managing statutory accounting volatility. The surplus strain in Scenario C (prudent ALM) is worse in year 1 alone than for the first 8 years of Scenario D (no prudent ALM)

- The financial statement differences between Scenario C and Scenario D belie the underlying financial conditions of the two risk management strategies

Question 5 – Separate Accounts in RBC

NAIC Question: With the discussion, it was noted that there is inclusion in the RBC calculation for SA assets. The RBC provisions rely on company records and separates RBC for SA products with guarantees. It is uncertain whether that guidance is applied consistently, particularly with the guarantee definition included in SSAP No. 56. Are there thoughts on how companies are interpreting that guidance? Using PRT as a simple example, is it presumed that PRT assets reported in the SA blank would be reported as 'assets in the SA with guarantees' in RBC?

ACLI Response: Guaranteed Separate Accounts can be held at either Fair Value or Book Value, but only those S/A held at Book Value are applicable to IMR accounting. Industry believes there is consistent application that Separate Accounts held at Book Value are reported as Guaranteed and assessed RBC risk consistent with General Account risk.

Question 6 – Separate Accounts in Asset Adequacy Testing

NAIC Question: With the discussion of Asset Adequacy Testing, and its use of a safeguard, are there thoughts to ensure that SA assets (and admitted SA negative IMR) are properly reflected in AAT? If SA IMR was admitted, should this be captured as part of the GA AAT to ensure its reflected?

ACLI Response: Book Value Separate Accounts is AAT tested so any admitted Separate Account negative IMR would also be captured in AAT. Industry believes the LATF instructions for negative IMR inclusion in AAT calculations to capture both Separate Account and General Account negative IMR. All AAT is booked to the General Account (Blue Book)

Question 7 – Separate Account Nonadmitted Assets

NAIC Question: Unrelated to the IMR discussion, but something that came to mind with the comments, with the use of the SA as an extension of the GA, **how do companies address SA assets that don't qualify for admittance under the SSAPs?** (For example, if a company held a SSAP No. 48 investment in the SA that wasn't audited.)

ACLI Response: Book Value Separate Accounts tend to be invested in simple, more conservative portfolios consistent with General Account investment portfolios. Industry believes General Account admissibility requirements are consistently applied to Book Value Separate Account portfolios.

Situation:
Company will receive $100 premium/cash flow in 1 year
Company needs to invest $100 into 10y UST bond (at year 1)
10y UST is currently at 5%
Liability will need to be credited 4%
Company wants to hedge reinvestment risk on future 10y UST purchase to economically lock in 5% yield
Company enters into 1 year total return swap on 5% 10y UST
Company will realize gain/loss at t=1 if 10y UST rate has changed
G/L will be amorized over 10 years
Amorization of IMR creates stable earnings and suplus profile across various rate scenarios
Surplus grows consistent with economic earnings of the transaction

Calculation of derivative G/L has been simplified to make example intuitive
IMR amortization has been simplified to straight line

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	5%	Interest Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Deriv G/L at t=1 (EOP)	0.0	IMR Amort		-	-	-	-	-	-	-	-	-	-
		Total Investment Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	**10.0**

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	4%	Interest Income		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Deriv G/L at t=1 (EOP)	10.0	IMR Amort		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
		Total Investment Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Balance Sheet													
IMR			10.0	9.0	8.0	7.0	6.0	5.0	4.0	3.0	2.0	1.0	0.0
Surplus (Retained earnings)				1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	**10.0**

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	6%	Interest Income		6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Deriv G/L at t=1 (EOP)	-10.0	IMR Amort		(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)	(1.0)
		Total Investment Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Balance Sheet													
IMR			-10.0	-9.0	-8.0	-7.0	-6.0	-5.0	-4.0	-3.0	-2.0	-1.0	0.0
Surplus (Retained earnings)				1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	**10.0**

Situation:
Company will receive $100 premium/cash flow in 1 year
Company needs to invest $100 into 10y UST bond (at year 1)
10y UST is currently at 5%
Liability will need to be credited 4%
Company wants to hedge reinvestment risk on future 10y UST purchase to economically lock in 5% yield
Company enters into 1 year total return swap on 5% 10y UST
Company will realize gain/loss at t=1 if 10y UST rate has changed
G/L will be recognized in income
Recognition will create unstable earnings and surplus profile across various rate scenarios
Surplus does not grows consistent with economic earnings of the transaction

Calculation of derivative G/L has been simplified to make example intuitive

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	5%	Interest Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Deriv G/L at t=1 (EOP)	0.0	Realized G/L		-	-	-	-	-	-	-	-	-	-
		Total Investment Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	**10.0**

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	4%	Interest Income		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Deriv G/L at t=1 (EOP)	10.0	Realized G/L		10.0									
		Total Investment Income		14.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		10.0	-	-	-	-	-	-	-	-	-
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	**10.0**

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	6%	Interest Income		6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Deriv G/L at t=1 (EOP)	-10.0	Realized G/L		(10.0)									
		Total Investment Income		(4.0)	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		(8.0)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				(8.0)	(6.0)	(4.0)	(2.0)	-	2.0	4.0	6.0	8.0	**10.0**

Situation:
Company will receive premium/cash flow in 1 year
Company needs to invest into 10y UST bond (at year 1)
10y UST is currently at 5%
Liability will need to be credited 4%

Earnings and surplus profiles vary across scenarios
- lower earnings, lower surplus when rates fall; higher earnings, higher surplus when rates rise

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	5%	Interest Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Deriv G/L at t=1 (EOP)		IMR Amort		-	-	-	-	-	-	-	-	-	-
		Total Investment Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	**10.0**

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	4%	Interest Income		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Deriv G/L at t=1 (EOP)		IMR Amort		-	-	-	-	-	-	-	-	-	-
		Total Investment Income		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		-	-	-	-	-	-	-	-	-	-
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				-	-	-	-	-	-	-	-	-	**-**

		End of Year	1	2	3	4	5	6	7	8	9	10	11
Bond Yield at t=1 (EOP)	6%	Interest Income		6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Deriv G/L at t=1 (EOP)		IMR Amort		-	-	-	-	-	-	-	-	-	-
		Total Investment Income		6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
		Crediting		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
		Net Income		2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Balance Sheet													
IMR			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Surplus (Retained earnings)				2.0	4.0	6.0	8.0	10.0	12.0	14.0	16.0	18.0	**20.0**

June 7, 2023

Dale Bruggeman,
Chair, Statutory Accounting Principles Working Group (SAPWG)
National Association of Insurance Commissioners (NAIC)

Re: 2023 Net Negative (Disallowed) Interest Maintenance Reserve (INT 23-01T)

Dear Chair Bruggeman,

The Life Valuation Committee of the American Academy of Actuaries[1] 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[2]), 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

[1] The American Academy of Actuaries is a 19,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
[2] An analysis of the adequacy of reserves and other liabilities, in light of the assets supporting such reserves and liabilities, performed in support of the actuarial opinion.

yielding assets. The IMR's impact along with other factors should be an integral part of AAT, PBR, and C-3 RBC calculations.

SAPWG 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[3]

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.

[3] Surplus is adjusted for any net positive goodwill, electronic data processing equipment and operating system software, net deferred tax assets and admitted net negative IMR.

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.

The Academy Life Valuation Committee would be willing to provide additional input as this exposure is being considered. Please contact Academy life policy analyst Amanda Barry-Moilanen (barrymoilanen@actuary.org) with any questions.

Sincerely,

Life Valuation Committee, American Academy of Actuaries

Appendix 1

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				