



EQUITABLE

DATE: January 24, 2022

FROM: Aaron Sarfatti, Chief Risk Officer

SUBJECT: Equitable Comments on the concept of developing an Actuarial Guideline on modeling complex or high-yielding assets in Asset Adequacy Testing (AAT).

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Equitable appreciates the opportunity to further comment on the concept of developing an Actuarial Guideline on the modeling of complex or high-yielding assets in Asset Adequacy Testing (AAT).

As noted in our December 2021 letter, Equitable supports establishing an aggregate credit spread cap of a single-A corporate bond spread plus a modest illiquidity premium (c. 20bps) as a guardrail. The proposed constraint would cap the weighted-average spread across all assets. Our rationale is as follows:

- A. **Harmonization with Principle-Based Reserve (PBR) methodologies:** NAIC has used PBR methodologies to establish liability reserves for life and annuity products, including spread caps on reinvestment and inforce assets. For those products governed under prior valuation rules, a spread constraint would provide a PBR-consistent methodology for liabilities where AAT is the *de facto* reserve in the current rate environment.
- B. **Guardrail on Total Asset Requirements:** Reserve and Capital frameworks adjust to the risk / return profile of investments in their calculations. The lack of a spread constraint within current AAT calculations can facilitate a significant reduction in reserves – which is not accounted for in asset risk capital – and ultimately materially reduces total asset requirements. An aggregate spread constraint applied to all assets, including equities backing general account liabilities, provides a guardrail against overly optimistic reserves that lower the total asset requirement below what is prudent.

Additionally, a spread constraint guardrail serves as a preventative measure against the scenario of a regulator attempting to liquidate an insurer but finding that no buyer will underwrite with the same spread optimism and thus be obligated to take on material impairments. Further, we distinguish a guardrail (“boundary setting”) from prescription (“parameter specification”) and contend guardrails ultimately further long-run PBR adoption by avoiding the type abuses by a minority of companies that undermine confidence in the overall PBR framework.

- C. **Aggregate Spread Constraint is Simpler and More Effective than a Targeted Constraint on Complex or High-yielding Assets:** A spread constraint in aggregate

simplifies the regulatory framework by (a) removing the need to demarcate between complex and high-yielding assets vs. other assets and (b) reducing the regulator burden to “catch” overly optimistic assumptions of spread recognition in the complex and high-yielding assets. It is more effective than a targeted approach because it allows for offsetting levels of optimism and conservatism across a diverse investment portfolio, and because it safeguards the totality of the reserve from overly optimistic spread recognition. Moreover, regulators should take comfort that an aggregate guardrail safeguards against an underlying commercial motivation for optimism in spread recognition in complex or high-yielding assets – lower reserves and greater dividend capacity – which exist across all assets. Nevertheless, if the preference of regulators were to limit the scope of the spread constraint, we believe it could be applied to just the subset of complex and high-yielding assets. In this event, we would propose that the modest illiquidity premium reflected in our proposal could be increased moderately (e.g. an additional c. 20bps) as a result of the narrower scope focused on assets that are inherently more illiquid.

- D. **Constraint is Easier to Monitor than Documentation:** A constraint is a lower burden for regulators to monitor as it reduces the reliance on the regulator to identify and challenge overly optimistic assumptions of spread recognition in complex and high-yielding assets. Documentation can enhance regulator understanding of the basis for spread recognition but does not reliably harmonize reserves or protect the integrity of the total asset requirement.

The remainder of this letter expands the first two arguments.

#### **A. Harmonization with Principle-Based Reserve (PBR) methodologies**

A spread constraint would support harmonization with broader liability governance for principle-based reserves as established in VM-20, VM-21, and VM-22. Equitable supports establishing an aggregate credit spread cap of a single-A corporate bond spread plus a modest illiquidity premium over all assets (not just complex). The single-A curve is recognized in the insurance industry as an appropriate measure of fair value and we believe that adding a modest illiquidity premium is appropriate to reflect the ability of insurers to realize such a premium given the long-dated nature of their liabilities. While harmonization could also be considered for risk free interest rates, it is not necessary to address immediately as part of the implementation of a credit spread guardrail.

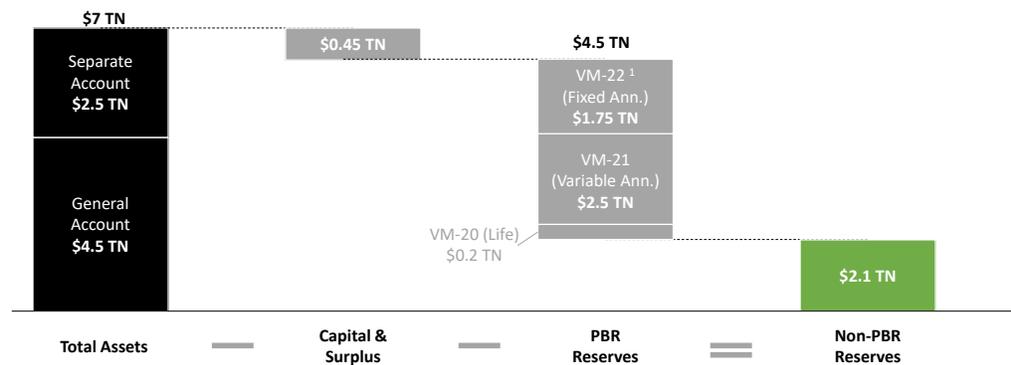
While we support full harmonization of credit constraints across PBR and AAT frameworks, we modify narrowly the approach to VM-20 and VM-21. The *inforce* asset guardrail under VM-20 and VM-21 are primarily based on corporate bond defaults – not net yields – and thus do not sufficiently guardrail complex, high-yielding assets that can exhibit significantly higher defaults in stress environments. The *reinvestment* spread guardrails (50% ‘A’/50% ‘AA’ spreads, no illiquidity premium) are likely too restrictive. We therefore suggest applying a construct similar to the VM-20 and VM-21 reinvestment cap on such *inforce* assets but based on the current ‘A’ spreads with a modest (c.20bps) illiquidity premium. Such a spread constraint works similarly to the caps already contained with VM-20/VM-21 and thus would not be difficult to implement.

The chart below compares the spread constraints within VM-20, VM-21, the proposed VM-22 framework, and the NY Special Considerations Letter (NY SCL) to Equitable’s proposed AAT guardrail:

Reserve Regime	Inforce Asset Requirements	Reinvestment Asset Requirements
<b>Proposed AAT guardrail</b>	Spreads on all assets capped at current ‘A’ spreads plus a modest illiquidity premium (c.20bps) in aggregate	Same as Inforce requirement
<b>VM-20 and VM-21</b>	Inforce assets subject to 85 <sup>th</sup> percentile defaults and temporary (<4yr) aggregate cap at BBB corporate spreads	Reinvestment spreads subject to a 50% ‘A’ / 50% ‘AA’ aggregate corporate bond spread cap without illiquidity premium
<b>VM-22</b>	Same as VM-20/VM-21	Reinvestment assets subject to aggregate cap based on 5% Treasury, 15% AA, 40% A, 40% BBB corporate spread mix
<b>NY SCL (AAT)</b>	Inforce assets subject to a spread cap based on long term averages of 50% A / 50% AA, and spread cap applied on an asset-by-asset basis	Same as Inforce requirement

Of the c.\$6.5 TN in life insurance assets (excluding capital & surplus) at YE 2020 in the below chart, PBR approaches will govern approximately 70% by 2025<sup>1</sup>. The remaining 30% of reserves under non-PBR approaches are primarily grandfathered business which would have otherwise been subject to VM-20 and secondarily other types of liabilities. This material block of non-PBR liabilities relies on the AAT reserving requirement when establishing reserves given the current low rate environment (where market rates are materially below the historical Statutory Valuation Law rates commonly in the range of 4-6%).

**Life insurance assets and reserves (with PBR fully in place by 2025)**  
High-level estimation using YE 2020, \$TN



1. Currently Fixed Annuities are non-PBR, but will be implemented with PBR in VM-22 by 2025 (expected)  
Source: ACLI

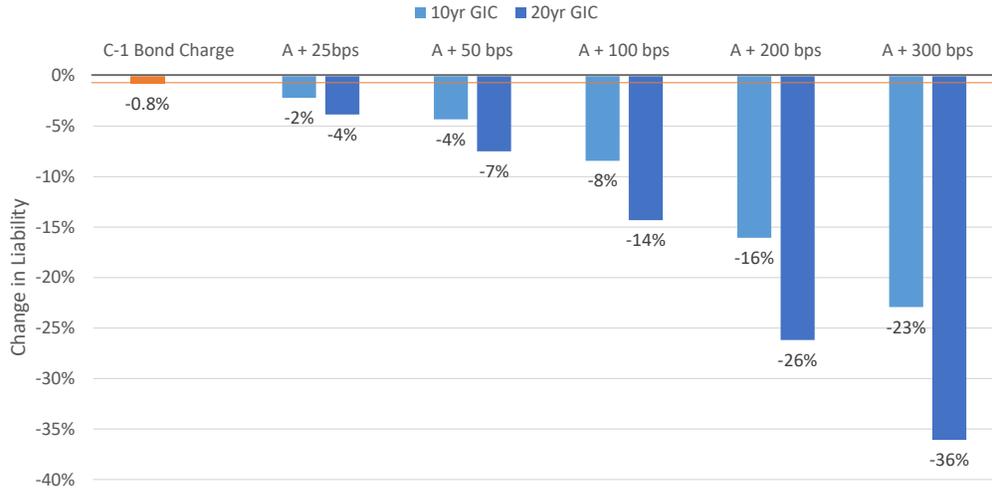
An aggregate spread guardrail for these \$2.1 TN in non-PBR reserves would harmonize the regulatory liability governance framework, at least for assumed underlying investment returns, across all life insurance reserves.

<sup>1</sup> This figure assumes VM-22 is implemented in 2025 and with no grandfathering of liabilities. All figures shown in chart are as of 12/31/20.

## B. Guardrail on Total Asset Requirements

Higher spread assumptions under AAT reduce reserves – with a 175 bp increase in spread assumption on a 20yr GIC<sup>2</sup> reducing reserves by 22% as of December 2020 as shown in the below chart. Structurally, this reserve reduction creates surplus which will only grow with investment optimism.

**Decrease in GIC Liability relative to A-rated credit curve**

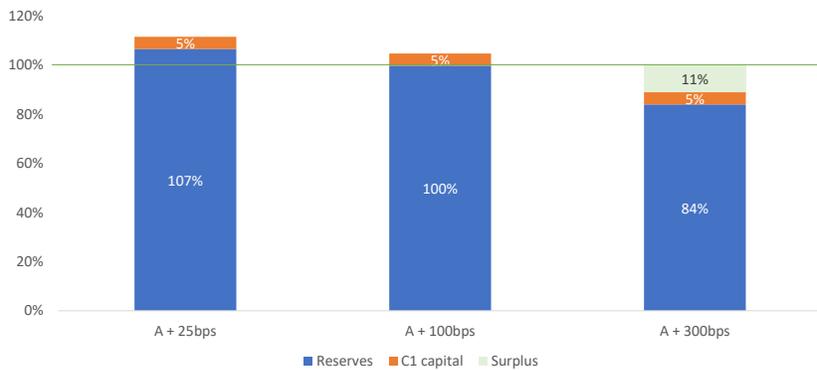


Source: Liability cashflow model with treasury assumptions as of 12/30/2020

The below chart illustrates how increased spread assumptions can generate surplus in excess of the C-1 capital. If higher than expected defaults or lower reinvestment yields in the future eroded this spread, it is apparent that the C-1 capital could be insufficient to support policyholder claims.

**Total asset requirement by spread assumption**

10yr GIC, % of assets



Source: Liability cashflow model with treasury assumptions as of 12/30/2020  
C1 capital is estimated as undiversified bond factor for NAIC 2 rated asset at 1.26% at 400% RBC ratio

<sup>2</sup> The illustrated GICs in the two following charts are hypothetical, plain vanilla GICs maturing at initial principal with a 2.5% minimum guaranteed annual interest rate.

The above chart illustrates the relative impact of appropriately reflecting investment risk/return profiles in reserving. While capital can offset some of the investment risk, the current latitude in AAT could facilitate reductions in total assets which are multiples of the investment risk capital. Credit spread limits are an important part of a principle-based framework. Such limits ensure reserves do not rely on excessive amounts of credit spread in excess of industry investment and pricing practices.

NAIC observations of current practices – e.g., high spreads and reinvestment yield assumed to persist over 30 years, corporate bond defaults applied to other complex assets – support the need for a guardrail. However, the constraint would be designed to maintain the industry’s ability to compete based on investment strategies and differentiation in investment sourcing, illiquidity premium, etc. An effective constraint addresses the excessive optimism but does not infringe on competitive investment strategies.

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Equitable appreciates the opportunity to comment on this exposed proposal and looks forward to working with regulators to reach an appropriate framework for modeling of complex and other assets within the Asset Adequacy Testing framework. We are available to discuss our comments further as desired.

Sincerely,



Aaron Sarfatti, ASA

Chief Risk Officer, Equitable