

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

ROLL CALL

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

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

Note: This meeting will be recorded for subsequent use.

Hearing Agenda

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

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

Summary:

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

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

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

- b. Draft a referral to the Capital Adequacy (E) Task Force for the consideration of eliminating any admitted net negative IMR from total adjusted capital (TAC) and the consideration of sensitivity testing with and without negative IMR.
- c. Develop guidance for future Working Group consideration that would allow the admission of negative IMR up to 5% of surplus using the type of limitation calculation similar to that used for goodwill admittance. The guidance should also provide for a downward adjustment if RBC ratio is less than 300.
- d. Review and provide updates on any annual statement instructions for excess withdraws, related bond gains/losses and non-effective hedge gains/losses to clarify that those related gains/losses are through asset valuation reserve (AVR), not IMR.
- e. Develop accounting and reporting guidance to require the use of a special surplus (account or line) for net negative IMR.
- f. Develop governance related documentation to ensure sales of bonds are reinvested in other bonds.
- g. Develop a footnote disclosure for quarterly and annual reporting.

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

NAIC Staff Broad Recommendation:

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

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

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

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

ACLI – 21 Pages – Introductory and Conclusion Comments:

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.

ACLI Summary Comments:

It is clear the NAIC wants to be diligent and methodical in determining a long-term solution:

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

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

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

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

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

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

American Academy of Actuaries – 4 Pages

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

IMR in Reserve and Capital Calculations

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

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

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

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

Academy Exposure Comments

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

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

Pros

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

Cons

- In some cases, the non-admission of the IMR may lead to a higher RBC ratio. An illustrative C-3 RBC example is provided in Appendix 1. Similarly in asset adequacy testing, if negative IMR became non-admitted, it may be offset by lower AAT reserves for one company but be a reduction of capital for another company not holding asset adequacy reserves due to the level of margin in reserves.
- There could be inconsistencies caused by the timing of when asset adequacy reserves and/or PBR calculations were performed—e.g., asset adequacy reserves completed as of 9/30 assuming admission of the negative IMR but the admission changes at year-end.

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

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

Pros

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

Cons

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

Admittance of net negative IMR in the separate account

Pros

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

Cons

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

Academy C3 Phase 1 Example

1. Assume \$100 of assets and \$100 liabilities. Assets cover future claims and related expenses (no excess or shortfall in cash flow testing). Assume the company has total adjusted capital of \$15. Taxes are ignored.
2. The C3 Phase 1 modeling results in a \$10 requirement

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

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

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

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

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

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

ACLI Comments:

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

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

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

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

ACLI Recommendation

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

Academy Pros / Cons:

- **Pros:** As intended, this limit would control the portion of a company’s statutory surplus that is made up of negative IMR and would therefore limit the impact that admitting negative IMR could have on evaluating the company’s surplus for RBC purposes.
- **Cons:** A percent of surplus limit would not be needed to ensure the adequacy of reserves and appropriate capital calculations. Instead, reserve and capital adequacy may be better addressed by the inclusion of an appropriate IMR allocation in AAT, PBR, and C-3 RBC calculations.

¹ Barings, “How Life Insurers Account for Realized Losses May Cause Unnecessary Pain”, November, 2022

NAIC Discussion – 5% Limitation on Adjusted Capital and Surplus:

The 5% limitation was directed by the SAPWG during the 2023 Spring National Meeting discussion. The initial regulator-suggested proposal was 1% and while there was discussion on a possible 10% limit, the 5% threshold was determined as a starting point, as it may be used as a materiality threshold by state regulators.

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

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

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

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

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

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

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

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

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

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

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

NAIC Recommendation – 5% Limitation on Adjusted Capital and Surplus:

NAIC staff recommend that the Working Group:

- Provide direction on the percentage limitation for inclusion in the INT.
- Provide direction on the use of adjusted capital and surplus in the INT.
- Provide direction to eliminate the potential for non-interest losses to be captured in the IMR as part of the long-term project and incorporation of guidance within SSAP No. 7.

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

ACLI Comments:

Role of Derivatives in Managing Risk

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

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

Hedge Accounting for Derivatives

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

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

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

Intent of IMR Instructions

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

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

In another excerpt from the E-committee report:

*To insure solvency of a company, its assets should be invested so that the company has a very high probability of paying its contractual liabilities when they become due. In order to assess whether a company is able to fulfill its obligations, it must present its liabilities and assets on a financially integrated basis. Since the accounting practices prescribed for the life insurance annual statement are an important element in this discipline, it is imperative that the accounting practices be consistent for assets and liabilities. **If they are inconsistent, then the annual statement will not reveal whether assets exceed liabilities; more importantly, neither regulators nor management can determine the risk of insolvency for the company.***

The Valuation Actuary’s Opinion includes a statement that the assets backing the liabilities make adequate provision for the company’s liabilities. That is, the Actuary must look beyond the statutory valuation formulas and satisfy himself that the cash flows generated by the assets will probably be sufficient to discharge the liabilities.

Prior to the AVR and IMR, there were many circumstances under which the statutory formula valuation methods gave rise to inappropriate results. Some examples were:

*- **Changes in values due to interest rate swings were recognized inconsistently on the asset and liability sides of the balance sheet. Liabilities are valued using interest rates fixed at issue while some assets may be valued using current interest rates through trading activity.***

*- **When the assets are poorly matched to the liabilities, a significant adverse swing in the interest rates will reduce financial strength and could lead to insolvency even though the balance sheet value of the assets exceeds the balance sheet value of the liabilities. Using long term assets to back demand liabilities is dangerous if there is a significant upswing in interest rates. In addition, individual insurance premiums are received and invested for many years after the issue date on which the reserve interest rate is determined, creating a potential for inadequate yields that is not reflected in standard accounting procedures.***

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

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

The IMR instructions include the following:

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

- *For derivative instruments used in hedging transactions, the determination of whether the capital gains/(losses) are allocable to the IMR or the AVR is based on how the underlying asset is treated. **Realized gains/(losses) on portfolio or general hedging instruments should be included with the hedged asset. Gains/(losses) on hedges used, as specific hedges should be included only if the specific hedged asset is sold or disposed of (emphasis added).***
- *For income generation derivative transactions, the determination of whether the capital gains/(losses) are allocable to the IMR or the AVR is based on how the underlying interest (for a put) or covering asset (for a call, cap or floor) is treated. Realized gains/(losses) should be included in the same sub-component where the realized gains/(losses) of the underlying interest (for a put) or covering asset (for a call, cap or floor) is reported. For a more complete and detailed explanation, refer to SSAP No. 86—Derivatives for accounting guidance.*
- ***Realized gains/(losses), on derivative transactions entered into solely for the purpose of altering the interest rate characteristics of the company’s assets and/or liabilities (hedging transactions) should be allocated to the IMR and amortized over the life of the hedged assets (emphasis added).** Realized gains/(losses), on income generation derivative transactions where the underlying interest (put) or covering asset (call, cap or floor) is subject to IMR, should be allocated to the IMR and amortized over the remaining life of the:*
 - a. underlying interest for a put*
 - b. covering asset for a call*
 - c. derivative contract for a cap or floor*

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

Governance of Derivatives that can apply to use of negative IMR

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

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

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

ACLI Recommendation

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

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

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

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

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

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

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

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

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

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

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

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

- The derivatives do not qualify as effective hedges under SSAP No. 86 and are reported at fair value.
- Each reporting entity is different with regards to how derivatives are used, therefore there are no broad assessments or metrics that can be applied to determine whether these ‘hedging-other’ derivatives are actually effective. In other words, from information received, it would not be possible to codify guidance to allow hedge-effective accounting treatment for these derivatives, as there are no set metrics that can be established / applied for these hedging transactions. Reporting entities consider them to be “effective” if they are in line with their derivative use plans, but that assessment is significant differently from whether a derivative is effective in offsetting changes in fair value or cash flows. From discussions with companies, these are hedges that are anticipatory, in that they are hedging the interest rate risk on future and forecasted bond purchases and sales. These anticipated bond purchases and sales can be many years in the future and may include assets that do not yet exist and cannot be identified at the time the hedge is originated.
- As these derivatives are reported at fair value when they are open, unrealized losses from fair value changes have already reduced surplus. With the ACLI position, at termination and settlement of a realized loss from the derivative, the prior reduction of surplus would be eliminated, resulting in a direct increase in surplus. It is unfathomable to NAIC staff that the original intent of this guidance would require surplus volatility throughout the life of the derivative, only to eliminate that surplus impact at derivative termination, with the impact of the derivative change smoothed into surplus overtime.
- If the intent had been to permit non-effective hedging derivatives to be allocated to IMR, it seems that such derivatives would have been considered for amortized cost treatment from inception. Such an approach would have eliminated the surplus volatility while the derivative was open. (From information received, derivatives identified as “hedging” at inception do not move to “other” derivatives (non-hedging), therefore, there would be no benefit to waiting for derivative termination to remove the surplus volatility.)
- The guidance in SSAP No. 86 for effective hedges only permits derivative allocation to the IMR if the hedged asset is subject to IMR. This results in an essential elimination of IMR impact from the hedged asset and the derivative transaction combined. With the approach being used by industry, there is no IMR offset from any hedged item, therefore the realized losses from derivatives have a direct impact on the IMR balance. This IMR impact appears to be inconsistent with the SSAP No. 86 IMR matching concept that intends to eliminate IMR impact caused by the sale of assets using derivative activity. **As effective hedges are only permitted to go through the IMR if they hedge items subject to IMR, effective derivatives**

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

- The proposal to permit fair value derivatives to flow through IMR at termination, and be admitted assets when net negative, **provides the ability to improve surplus simply by exiting derivative positions and realizing a loss.**
- Although industry has indicated that they have treated derivative gains and losses consistently, with derivative gains increasing IMR, the action is still inconsistent with the provisions of SSAP No. 86.
- Current reporting on Schedule DB cannot be used to identify the ‘hedging-other’ derivatives that industry intends to take to IMR and those that will go through realized losses. From discussion with industry, the treatment for the derivative should be determinable from initial acquisition. If there is support to allow certain fair value derivatives to go through IMR, NAIC staff would recommend reporting revisions to separately identify these derivatives on Schedule DB, as well as to track the recognized gains/losses from termination that are allocated to IMR.
- If there is support for fair value derivatives to be included in IMR, further discussion should occur on the amortization timeframe for those gains/losses in the IMR. From preliminary info from industry, the amortization timeframe currently being used for these derivative losses is based on the average weighted life of the entire asset portfolio (as the derivative is not attributable to a specific asset) and may average around a 10-year amortization timeframe. Comments are requested from regulators on this 10-year amortization timeframe and if a different metric should be utilized.

NAIC Recommendation – Exclusion of Fair Value Derivatives From Determining Net Admitted IMR:

NAIC staff recommend that the Working Group provide direction on whether non-effective hedging derivatives should be included / excluded from the IMR balance permitted to be admitted under the INT.

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

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

3) Book Value Guaranteed Separate Accounts

ACLI Comments:

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

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

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

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

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

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

ACLI Recommendation

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

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

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

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

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

Academy Pros / Cons:

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

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

NAIC Discussion – Book Value Guaranteed Separate Accounts

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

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

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

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

- **Admittance / Nonadmittance is not a separate account concept. There are no separate account reporting columns to nonadmit assets. Disallowed IMR in the separate accounts is not reported as an asset but is taken as a direct reduction to capital.** If the guidance was to permit admittance of the net negative disallowed separate account IMR, consideration would have to occur on how to reflect this within the separate account financial statements. Revisions could permit reporting as a contra-liability, but then the contra-liability reporting would be commingled with the negative IMR that was not disallowed. Another option would be to report the “admitted” SA negative IMR as an aggregate write in for an other-than-invested asset (line 15 of the SA asset page) with the portion that is not permitted as “admitted” continued as a direct reduction to capital. With either of these approaches, if the amount that was permitted to be admitted was changed (due to an increase or decrease of surplus), it may require a reversal of prior entries that eliminated SA negative IMR as a direct reduction to capital.
- **Guidance for determining admittance between the general account and the insulated and non-insulated separate accounts.** For example, if there is a 5% limit on surplus, should the guidance direct that net negative (disallowed) IMR in the general account first be fully admitted? Then, if the reporting entity is still below the 5% limit, they could then admit net negative disallowed IMR in the non-insulated blank, followed by the insulated blank until the admittance limit is reached?

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

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

- **The guidance that determines whether net negative IMR is disallowed (based on a comparison between general and separate account balances) predates the guidance for insulated and non-insulated separate account blanks. The insulated separate account reflects assets that are not available for general account policyholder or creditor claims. As such, as those assets are legally isolated from the general account, it could be perceived as inappropriate to permit an offsetting reporting approach for positive and negative IMR between the general account and insulated separate account financial statements.** This refers to the ‘preferred policyholder concept’ that has been

previously identified when discussing the use of separate accounts. (IMR is not technically offset between the two blanks, but the reporting of whether the IMR is disallowed is contingent on the balance in the other account. If there is negative IMR in the separate account, but the general account has positive IMR, the negative IMR in the SA is only “disallowed” to the extent that the negative balance exceeds the GA positive balance. Negative balances that are not disallowed are reported as contra-liabilities.) Discussion may be warranted as to whether the recognition of IMR should be independent in each reporting blank (general account and insulated / noninsulated separate accounts), rather than the current reporting in which a positive balance in the general account impacts the extent a negative balance in a separate account is permitted as a contra-liability or as a direct reduction of surplus.

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

- The comments received from the ACLI highlight how the use of the SA is an extension of the GA, with the GA ultimately responsible for the payment of claims, as support for “admittance” of disallowed IMR in the SA. However, NAIC staff highlights that the Separate Account reporting was not intended to capture such products. If the intent is to permit the SA as a “segregated general account” then NAIC staff would suggest enhanced reporting in the separate account to ensure these products and assets are subject to the same rigor of products and assets that are reported in the general account. For example:
 - **Requirement of NAIC designations for investments in a manner consistent with the general account asset with application of the underlying SSAP for determining accounting and reporting.** This would require an assessment of credit quality, either from the SVO or CRP (as permitted under the P&P Manual) to be used in asset assessment / measurement / RBC.
 - **Inclusion of separate account assets within the RBC formula in a manner that permits tracing of assets into the formula.** Currently separate account assets are only captured in RBC (LR006) through ‘company records’ in which the company is to calculate the RBC outside of the formula and include their calculated RBC impact. This formula is separated between guaranteed and non-guaranteed separate accounts and from a review of available data, it is not possible to track the assets in the separate account that a company reports as guaranteed in the RBC filing. Although separate accounts are reported by product type in SA General Interrogatory (GI) 1.01 and identified with and without guarantees, the numbers for SA assets with guarantees reported on that GI do not appear to track to the reporting of assets with guarantees in RBC. From a review of limited companies, a significant majority of separate account assets are identified as “with guarantees” in the GI, but most of the assets reported in the RBC formula are reported as without guarantees. The category without guarantees has a much lower RBC requirement than assets with guarantees. (It has been identified that Exhibit 6 – Guaranteed Insurance and Annuity Products also provides info on the guaranteed products, and NAIC staff will review to see if this info tracks to the RBC filing.)
 - **Inclusion of nonadmitted asset concepts to be consistent with the general account.** As noted, nonadmittance is not a current concept in the separate account. This is because the original intent of the SA was to hold assets for which policyholders directed investments and assumed the asset risk. From discussions with limited industry representatives, it was noted that the assets in the separate account would be permitted for admittance if classified within the general account, but it would not be possible to make such an assumption across all industry. The use of the separate account to hold assets for general-account type products, for which the general account is the backstop if those assets do not perform or end up being insufficient to cover the ultimate risks, becomes an even greater concern when the assets are not subject to the same restrictions or safeguards as if they were held in the general account.

- **Inclusion of separate account assets within state investment limits.** The historical exclusion of separate account assets from state investment limits was based on the concept that the assets were being directed by policyholders, with the policyholders bearing the investment risk. If the GA is ultimately responsible for the payment of claims when the SA assets fail to perform or if they are insufficient, then it may be important for the investment mix, risk and concentration to be subject to the same general account investment limit protections.
- **Inclusion of separate account assets in asset adequacy testing.** From a review of the AG53 filing, several companies have been initially identified as likely not including separate account assets. Furthermore there are several instances in which the review of the filing was inconclusive of whether separate accounts assets were included.

NAIC Recommendation – Book Value Guaranteed Separate Accounts

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

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

4) Reinvestment and Allocation

ACLI Comments:

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

Original Concepts on Reinvestments in the Development of IMR

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

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

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

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

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

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

- (a) Although it might be claimed that the theory should encompass unrealized as well as realized gains, the more straightforward applications of the intent of the reserve are to realized gains. Hence the use of the reserve is limited to realized gains (occurring at time of sale, maturity, call, etc.)*
 - (b) Interest-related gains occur on equities, as well as on fixed interest securities, but such gains are much harder to distinguish and analyze. For this reason, equity gains were excluded.*
- 3) The intent of IMR was for symmetrical treatment of both gains and losses, but IMR for losses was never robustly addressed, as intended, subsequent to adoption for gains which was the primary focal point at the time of adoption.

*The basic rationale 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 framework²; rather to prevent misrepresentation of financial strength that could occur within the statutory framework by selling bonds in a declining interest rate environment and recognizing gains.

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

Practical Challenges with Proving Reinvestment

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

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

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

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

That this is demonstrated by the fact that in virtually all cases an insurer who realizes interest-related gains and losses arising from the disposition of securities, will necessarily want to reinvest the proceeds in order to maintain a viable operation that meets its obligation. Such reinvestment will take place in the current interest environment and produce yields consistent with that current environment. The difference in the value of future earnings arising from the reinvestment is roughly equal in magnitude, and opposite in sign, to the Exhibit 4 gains and losses occurring at the time of the transactions; in other words, if an interest-related gain occurs, the insurer is likely to have to reinvest at lower yields; and if an interest-related loss occurs, the insurer will generally be able to reinvest at higher yields. Thus, if the gain or loss is truly interest-related, and not in any way related to a change in circumstances of the issuing entity, no significant change in the ability to meet its obligations or its solvency position of the insurer has occurred.

Hence, the Interest Maintenance Reserve is designed to set aside such gains and losses and prevent them from having an immediate impact on surplus, and to amortize these gains into the Gain from Operations in a manner which reflects the runoff in future yields as closely as possible.

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

Impact of Excess Withdrawals

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

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

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

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.

NAIC Discussion – Reinvestment Allocation

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

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

The ACLI proposes the allowance of a negative IMR balance in statutory accounting. Negative IMR balances are expected to become more prevalent in a higher interest rate environment and their continued disallowance will only serve to project misleading optics on insurers’ financial strength (e.g. inappropriate perception of decreased financial strength through lower surplus and risk-based capital even though higher rates are favorable to an insurer’s financial health) while creating uneconomic incentives for asset-liability management (e.g. discourage prudent investment transactions that are necessary to avoid mismatches between assets and liabilities just to avoid negative IMR).

IMR was created to prevent the timing of the realization of gains or losses on fixed income investments, related to interest rates changes, to affect the immediate financial performance of the insurance company. This recognized that the gains and losses were transitory without any true economic substance since the proceeds would be reinvested at offsetting lower or higher interest rates.

For example, without the IMR, if a company sold all bonds in a declining interest environment (e.g., from 4% to 2%), and reinvested in new bonds, surplus would increase through significant realized gains. The

increased surplus would inappropriately reflect increased financial strength that is illusory, due to a now lower yielding portfolio, as there would be no change to the income needed to support the liabilities.

Likewise, if a company sold all bonds in an increasing interest rate environment (e.g., from 2% to 4%), and reinvested in new bonds, surplus would decrease through significant realized losses. The decreased surplus would inappropriately reflect decreased financial strength that is similarly illusory due to the reinvestment at higher yields relative to when the bonds were originally purchased.

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

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

NAIC Recommendation – Reinvestment and Allocation:

NAIC staff recommend that the Working Group provide direction on what is desired to support / verify the requirement for reinvestment of bond proceeds.

5) 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.

NAIC Discussion – Special Surplus Account

NAIC staff note that the amount allocated to special surplus is the "admitted" net negative (disallowed) IMR. This is correctly reflected in paragraph 10b of the exposed INT. Admittance of the net negative (disallowed) IMR is the exception reflected in the interpretation.

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

NAIC Recommendation – Special Surplus Account

NAIC staff do not believe any modification is necessary to the tentative INT.

6) Other Existing Safeguards

ACLI Recommendation

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

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

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

NAIC Discussion – Other Existing Safeguards

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

- The Life Actuarial (A) Task Force has communicated that asset adequacy testing should not be relied upon for the admittance of net negative (disallowed) IMR.
- Domiciliary state regulators can provide permitted practices for the admittance of net negative (disallowed) IMR based on company-specific situations. Only 2 permitted practices were approved for year-end 2022.
- With regards to the reliance on derivative use plans (DUPs), NAIC staff identify the lack of communication on the termination of fair value derivatives, particularly with how fair value losses, which had previously reduced surplus as unrealized losses, were being reversed to the IMR and not realized losses.

NAIC Recommendation – Other Existing Safeguards:

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

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

7) 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.

NAIC Recommendation – RBC Sensitivity With and Without Admitted Negative IMR

The referral directed from the Spring National Meeting was provided to the Capital Adequacy (E) Task Force in March 2023. NAIC staff request comments from regulators on the ACLI recommendation and the development of additional reporting.

8) Effective Duration / Automatic Nullification Date

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

NAIC Recommendation – Effective Duration / Automatic Nullification Date

NAIC staff request comments from regulators and industry on a proposed nullification date for the INT.

ANY OTHER MATTERS

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

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

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

Interpretation of the Statutory Accounting Principles (E) Working Group

2023 Net Negative (Disallowed) Interest Maintenance Reserve

INT 23-01T Dates Discussed

March 22, 2023

INT 23-01 References

Current:

*SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve
Annual Statement Instructions*

INT 23-01T Issue

1. The statutory accounting guidance for interest maintenance reserve (IMR) and the asset valuation reserve (AVR) is within *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*, but the guidance within *SSAP No. 7* is very limited. It provides a general description, identifies that IMR/AVR shall be calculated and reported per the guidance in the applicable SSAP, and if not explicit in the SSAP, in accordance with the annual statement instructions. The SSAPs most often simply direct allocation to (or between) IMR and AVR, with the bulk of the guidance residing within the annual statement instructions.
2. As detailed in *SSAP No. 7*, paragraph 2, the guidance for IMR and AVR applies to life and accident and health insurance companies and focuses on IMR and AVR liability recognition and distinguishing between IMR and AVR:
 2. Life and accident and health insurance companies shall recognize liabilities for an AVR and an IMR. The AVR is intended to establish a reserve to offset potential credit-related investment losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable. The IMR defers recognition of the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses shall be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses shall be amortized into investment income over the expected remaining life of the liability released.
3. The IMR guidance in the annual statement instructions provides information on the net balance. A positive IMR represents net interest rate realized gains and is reported as a liability on a dedicated reporting line. A negative disallowed IMR represents net interest rate realized losses and is reported as a miscellaneous other-than-invested write-in asset in the general account and nonadmitted.
4. IMR balances between the general account and separate accounts are separate and distinct. Meaning, a net negative IMR in the general account only represents activity that occurred in the general account that was allocated to IMR. However, the net positive or negative balance of the general account influences how the net positive or negative balances are reported in separate account statements (and vice versa). (A net negative IMR balance in the general account may not be disallowed if there is a covering net positive IMR in the separate account. Negative IMR that is not disallowed is reported as a contra-liability.) The instructions for reporting the net negative and positive balances are detailed in the annual statement instructions:

Line 6 – Reserve as of December 31, Current Year

Record any positive or allowable negative balance in the liability line captioned "Interest Maintenance Reserve" on Page 3, Line 9.4 of the General Account Statement and Line 3 of the Separate Accounts Statement. A negative IMR balance may be recorded as a negative liability in either the General Account or the Separate Accounts Statement of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.

If there is any disallowed negative IMR balance in the General Account Statement, include the change in the disallowed portion in Page 4, Line 41 so that the change will be appropriately charged or credited to the Capital and Surplus Account on Page 4. If there is any disallowed negative IMR balance in the Separate Accounts Statement, determine the change in the disallowed portion (prior year less current year disallowed portions), and make a direct charge or credit to the surplus account for the "Change in Disallowed Interest Maintenance Reserve" in the write-in line, in the Surplus Account on Page 4 of the Separate Accounts Statement. The following information is presented to assist in determining the proper accounting:

<u>General Account IMR Balance</u>	<u>Separate Account IMR Balance</u>	<u>Net IMR Balance</u>
Positive	Positive	Positive (See rule a)
Negative	Negative	Negative (See rule b)
Positive	Negative	Positive (See rule c)
Positive	Negative	Negative (See rule d)
Negative	Positive	Positive (See rule e)
Negative	Positive	Negative (See rule f)

Rules:

- a. If both balances are positive, then report each as a liability in its respective statement.
 - b. If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement and follow the above instructions for handling disallowed negative IMR balances in each statement.
 - c. If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the Separate Accounts Statement.
 - d. If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the Separate Accounts Statement and follow the above instructions for handling the disallowed portion of negative IMR balances in the Separate Accounts Statement.
 - e. If the general account balance is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the General Account Statement.
 - f. If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the General Account Statement and follow the above instructions for handling the disallowed portion of negative IMR balances in the General Account Statement.
5. In October 2022, the ACLI requested the Statutory Accounting Principles (E) Working Group to reassess the guidance for net negative (disallowed) IMR, with a request to consider admittance of those amounts. The ACLI noted that the nonadmittance of disallowed negative IMR can have adverse negative ramifications for insurers with two key themes:

- a. In general, rising interest rates are favorable to the financial health of the insurance industry and policyholders. However, with negative IMR, there is an inappropriate perception of decreased financial strength through lower surplus and risk-based capital.
 - b. Negative IMR could impact the rating agency view of the industry or incentivize companies to avoid prudent investment transactions that are necessary to avoid mismatches between assets and liabilities. In either scenario, negative IMR encourages short-term non-economic activity that is not in the best long-term interest of a reporting entity's financial health or its policyholders.
6. In considering the request, the Working Group concluded that for year-end 2022, there would be no change to statutory accounting guidance and deviations from statutory accounting principles would need to be approved via a permitted or prescribed practice. The Working Group then held company-specific educational sessions in January 2023 to receive detailed information regarding negative IMR and received a subsequent comment letter from the ACLI.
7. During the 2023 Spring National Meeting, the Working Group further discussed the topic of negative IMR and directed NAIC staff to proceed with drafting guidance for both a 2023 solution and to begin work towards a long-term solution.

INT 23-01T Discussion

8. This tentative interpretation prescribes limited-time, optional, statutory accounting guidance, as an exception to the existing guidance detailed in SSAP No. 7 and the annual statement instructions that requires nonadmittance of net negative (disallowed) IMR in the general account as a short-term solution for 2023. This interpretation is specific for general account treatment only and assessment of possible revisions for the separate account will be considered as part of the long-term solution. Specifically, this interpretation impacts the annual statement instruction rules regarding disallowed negative IMR in the general account, detailed in rules 'b' and 'f' shown in paragraph 4. (As detailed within, admittance in the general account does not impact the determination or reporting of IMR in the separate accounts.) **As this interpretation overrides existing guidance, it will require a 2/3rd vote.**
9. Reporting entities are permitted to admit net negative (disallowed) IMR in the general account with the following restrictions:
- a. Reporting entities with an RBC greater than 300% are permitted to admit net negative (disallowed) IMR, as defined in paragraph 9b, up to 5% of the reporting entity's general account capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, net deferred tax assets and admitted net negative IMR. Reporting entities with a 300% or lower RBC are not permitted to admit net negative (disallowed) IMR.
 - b. Negative (disallowed) IMR admitted pursuant to paragraph 9a is limited to IMR generated from losses incurred from the sale of bonds, or other qualifying fixed income investments, that were reported at amortized cost prior to the sale, and for which the proceeds of the sale were immediately used to acquire bonds, or other qualifying fixed income investments, that will be reported at amortized cost. (This provision intends to explicitly exclude

derivative losses from derivatives reported at fair value that have been allocated to IMR from being admitted under this guidance¹.)

10. Reporting entities that admit net negative disallowed IMR in the general account pursuant to paragraph 9 shall report the admittance in the balance sheet as follows:

- a. Reporting entities shall report the net negative (disallowed) IMR as a write-in to miscellaneous other-than-invested asset (named as “Disallowed IMR”) on the asset page. The net negative (disallowed) IMR shall be admitted to the extent permitted per paragraph 9, with the remaining net negative (disallowed) IMR balance nonadmitted.
- b. Reporting entities shall allocate an amount equal to the general account admitted net negative (disallowed) IMR to special surplus. Although dividends are contingent on state specific statutes and laws, the intent of this reporting is to provide transparency and preclude the ability for admitted negative IMR to be reported as funds available to dividend.

11. Reporting entities admitting net negative (disallowed) IMR are required to complete the following disclosures in the annual and quarterly financial statements for IMR:

- a. Reporting entities that have allocated gains/losses to IMR from derivatives that were reported at fair value prior to the closing / termination / settlement / expiration of the derivative shall disclose the non-amortized impact to IMR from these allocations separately between gains and losses. This disclosure shall illustrate the removal of these balances from the total general account IMR to determine the net negative amount that is permitted to be admitted under paragraph 9b.
- b. Reporting entities shall complete a note disclosure that details the gross negative (disallowed) IMR, the amounts of negative IMR admitted and nonadmitted, adjusted capital and surplus per paragraph 9a and the percentage of adjusted capital and surplus for which the admitted negative IMR represents.

12. The provisions in this interpretation intend to be specific on the following prohibitions:

- a. Negative IMR permitted to be admitted shall not include losses from derivatives that were reported at fair value prior to settlement / termination / expiration / closing of the derivative. (Only derivative losses from derivatives that qualified as effective hedges (and reported under ‘hedge accounting’ as detailed in *SSAP No. 86—Derivatives*), which hedged an item that had offsetting adjustments to IMR, are permitted to be included in the admittance calculation.) The allocation of derivative losses to IMR, for derivatives held at fair value and were not offset by a hedged asset that was also subject to IMR, is not in line with the original intent of the IMR guidance in *SSAP No. 86* or the annual statement instructions. Consideration of this industry interpretation and clarification of derivatives through the IMR will be addressed as part of the long-term proposal.
- b. The admittance of net negative (disallowed) IMR in the general account shall have no impact on the reporting of IMR in the separate account. The comparison of general account

¹ It has been identified that some reporting entities have allocated derivative losses to IMR for derivatives that were reported at fair value throughout the derivative life, as they did not qualify as effective hedges under statutory accounting, and that were not hedging assets with offsetting amounts to the IMR. As detailed in paragraph 9b, these losses shall be removed from the IMR balance in determining the net negative (disallowed) IMR balance permissible for admittance.

and separate account IMR shall occur on the gross positive and negative balances prior to any admittance in the general account. Disallowed negative IMR in the separate account shall continue to be fully disallowed as a direct charge to surplus. The IMR annual statement instructions predate current guidance that requires insulated and non-insulated separate account blanks. Consideration of separate account treatment of IMR will be addressed in a long-term proposal that will assess the concepts of insulated separate accounts and whether the balances of the general account shall have any influence on how IMR shall be reported in those separate account statements.

INT 23-01T Status

13. The consensuses in this interpretation were adopted on _____, to provide limited-time exception guidance to SSAP No. 7 and the annual statement instruction for the reporting of negative (disallowed) IMR in the general account. The provisions within this interpretation are permitted until _____ and will be automatically nullified on _____.

14. Further discussion is planned.

**Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A**

Issue: Negative IMR**Check (applicable entity):**

	P/C	Life	Health
Modification of Existing SSAP	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: This agenda item has been developed to discuss the interest maintenance reserve (IMR) within statutory accounting, specifically the current guidance for the nonadmittance of disallowed negative IMR. Although the statutory accounting guidance has been in place for several years, the rising interest rate environment has created an increased likelihood for reporting entities to move to a negative IMR position. This agenda item intends to provide information on the background of IMR, current accounting guidance, recent discussions of the Life Actuarial (A) Task Force and some broad financial results from year-end 2021 and interim 2022 financial statements. The intent is to provide this information to facilitate Working Group discussion.

The following provides a high-level overview of the use of the terms positive IMR and negative IMR for entities filing the Life, Accident & Health / Fraternal annual statement blank:

- A positive IMR means that the net realized interest related gains which are amortized in the IMR calculation are greater than net realized interest related losses which are being amortized in the IMR calculation. A positive IMR is reported as a statutory liability and amortized to income over time.
- A negative IMR means that net realized interest related losses which are amortized in the IMR calculation are greater than net realized interested related gains which are amortized in the IMR calculation. A disallowed negative IMR is reported as a nonadmitted asset and amortized to income as a loss over time.

As IMR occurs in the general and separate account, there are specific guidelines in determining whether the IMR reflects a net disallowed negative or position in the annual statement instructions. These are on page 5.

A letter from the American Council of Life Insurers (ACLI) dated Oct. 31, 2022, raised concerns with existing statutory accounting requirements on the nonadmittance of disallowed negative IMR noting negative ramifications for insurers. Key summarized positions from this ACLI letter include:

- In general, rising interest rates are favorable to the financial health of the insurance industry and policyholders. However, with negative IMR, there is an inappropriate perception of decreased financial strength through lower surplus and risk-based capital.
- Negative IMR could impact the rating agency view of the industry or incentivize companies to avoid prudent investment transactions that are necessary to avoid mismatches between assets and liabilities. In either scenario, negative IMR encourages short-term non-economic activity that is not in the best long-term interest of a reporting entity's financial health or its policyholders.

Background of IMR

The IMR was first effective in statutory accounting in 1992 and requires that a realized fixed income gains or losses attributable to changes in interest rates (excluding gains/losses that are credit related), be amortized into income over the remaining term to maturity of the fixed-income investments (and related hedging programs) sold rather than being reflected in income immediately.

Minutes, including adopted materials – in the Blue Book (Life Statement), from the 2002 4th Quarter NAIC Proceedings discussing IMR are provided below. Please note the last section that includes “Future Directions” which identifies recognition of negative IMR as a major area of effort.

Description and other components of IMR from the Blue Book, captured in the 2002 4th Quarter NAIC Proceedings, provides the following definition and other details: (*Only key excerpts included.*)

The Interest Maintenance Reserve (IMR): captures for all types of fixed income 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 the interest rate characteristics of assets/liabilities, also are allocated to the IMR and are to be amortized into income over the life of the associated assets/liabilities. Note: certain significant unusual transactions may require immediate recognition of any realized capital gains or losses, as described in a later section. This reserve is not subject to any maximum.

VII. IMR MINIMUMS/MAXIMUMS: A. Minimums: **The IMR can be negative for any line of business as long as the aggregate IMR for the Company is not less than zero. Any otherwise negative IMR value is carried over to subsequent years.** B. Maximums: There is no maximum of the IMR

VIII. BACKGROUND/PERSPECTIVE: 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.

XII. AVR AND IMR BUILT ON AND COMPLEMENT EXISTING VALUATION PRACTICES: The existing framework of asset and liability valuation practices, as augmented by the NAIC Model Standard Valuation Law, played a key role in designing the AVR and IMR, including:

A. Reserve valuation standards should contain a provision for future losses. Although it is well understood that in cash flow testing provision must be made for future asset losses, it may not be as well understood that historically the minimum valuation standards implicitly contained such a provision.

B. Interest assumptions in reserve valuation generally recognize the potential for mismatch. Dynamic valuation rates are lower for ordinary life than for guaranteed investment contracts, for example, because the mismatch is almost inevitable on the former. In addition, it is required in other regulations, and in the NAIC Model Standard Valuation Law, that cash flow testing should be used and may result in the adoption of lower than the dynamic valuation rates if mismatch exists. Hence, with the one exception noted in section (c), there is no need for the IMR reserves to make provision for the risk of mismatch.

C. Asset valuations for fixed interest securities usually reflect the outlook at the time of purchase of an asset. In particular, bond amortization tends to reflect the yields available at time of purchase and the expected cash flow. Liabilities are established at the same time, and the interest rate assumptions on them are those appropriate to the outlook at that time. **But if securities are traded, a new amortization schedule is established that may be based on an entirely different yield environment, which may not be consistent with the liabilities that have been established. Using the IMR to absorb trading gains is desirable and appropriate to eliminate this subsequently created mismatch.**

D. Equities present special valuation problems. Common stocks are valued at market rather than amortized value; hence they require different treatment. Real estate and similar investments, although usually valued at depreciated value, require special consideration because of the great likelihood of major changes in yield and yield expectation after purchase.

XXII. RESERVE MAXIMUM AND MINIMUM LEVELS: No maximum is placed on the Interest Maintenance Reserve. The aggregate minimum value for the IMR for the Company is zero. The IMR may be negative for any Line of Business as long as the aggregate for all lines equals zero. Provision is made in the accounting rules that if an aggregate negative IMR is developed in the absence of the zero minimum, that negative value is carried over to subsequent years.

The basic rationale 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 values of the IMR, the same rationale applies. However, the concept of a negative reserve in the aggregate has not been adopted.

XXVIII. EXCESSIVE WITHDRAWALS:

A. Background: Major book-value withdrawals or increases in policy loans can occur at a time of elevated interest rates. If these withdrawals or increases are far in excess of the withdrawals provided for in the company's reserving and cash flow testing, and **if asset sales at this point are, in effect, forced sales to fund liabilities that are no longer on the books, the allocation of a negative amount to the IMR is not correct.**

A company may also experience a "run on the bank" due to adverse publicity. This could occur even during a period of low interest rates, and the sale of assets to meet a run would conceivably produce gains. It is appropriate to register the gains immediately.

If the withdrawals were scheduled payments under a GIC, then there is a presumption that any gains or losses that might occur at the time of withdrawal should be added to the IMR since the gains or losses would be spurious if the company has followed a policy of matching its assets to its liabilities.

Note that many of the situations where an upsurge in withdrawal activity generates real losses arise when a company has a severe mismatch between its assets and its liabilities. Such losses can be present even in the absence of any realized gains or losses. The primary protection as to the adequacy of reserves in these circumstances is the requirement for an actuary's opinion.

- B. IMR Exclusions: All realized interest-related gains or losses which arise from the sale of investments required to meet "Excess Withdrawal Activity" as defined below will be excluded from the IMR and will be reflected in net income.

STANDARDS FOR ACTUARIAL RESERVES WITH AN IMR AND AN AVR

LXX. IMR RESERVE STANDARD The Interest Maintenance Reserve is a true actuarial reserve, and actuaries should use the assets supporting the Interest Maintenance Reserve when opining that the assets supporting the company's reserves make adequate provision for the company's obligations. **In the case of a negative IMR, the actuarial opinion should include an explicit statement that the impact of the negative IMR on reserve adequacy has been considered and that the reserves after deduction of the negative IMR still make adequate provision for the liabilities.**

LXXI. GENERAL EXPLANATION The IMR is designed to work with minimum statutory reserves based on formulas contained in laws or regulations. Where, for example, the valuation rate is based on the interest rate conditions prevailing in the year of deposit, the assets supporting the liabilities will be consistent with the liability assumptions. Disposal of the assets during a period of declining interest rates will produce interest-related gains, but these gains will be needed to support the liabilities that are still valued at the interest rate levels prevailing at time of deposit. Thus, it is appropriate in the case of positive IMR to treat the IMR as an additional reserve requirement above and beyond formula minimums.

In cash-flow-testing actuaries take future cash flows into account from existing assets. In an example such as described above, existing assets may well have been purchased at rates below those prevailing at the time reserves were established. The positive IMR that has been built up has captured the gains and not allowed them to be available for distribution. The IMR is recognized as part of the reserves available to meet future obligation cash flows.

Thus from either point of view a positive IMR is treated as a true actuarial reserve. The same arguments should apply equally well in the case of a negative IMR, but some concern has been expressed that in this case the net reserves are in effect lower than statutory formulas minimums, and therefore special considerations are required.

FUTURE DIRECTIONS

In late 2002, the interested persons (as its name had become) considered refinements of the AVR/IMR for the next several years, from that vantage point, some of the major areas of effort appear to be as follows:

1. **There should be recognition of negative values of the IMR. The group had long recognized that the philosophical basis for the IMR supports negative values of the reserve as well as positive. There is a need to have investment return match the liabilities associated with the investment; and a need to remove the incentive for a company to make investment decisions based on the shortterm balance sheet effect; and these needs exist also on the negative side of the IMR.**

No doubt there are concerns that a negative reserve of this type could somehow lead to an unsound condition, so there has been appended to this report a discussion entitled "Why Are Negative Values For the IMR Necessary?" It also seems as though there should be additional safeguards in the case of a negative IMR. Rather than put arbitrary limits on the amount of the negative reserve, however, consideration is being given to an actuary's statement that an asset adequacy analysis has been carried out that demonstrates the soundness of the reserves.

(Staff Note: The NAIC library does not have a record of the report noted in the above paragraph.)

Current Accounting Guidance

The statutory accounting guidance for IMR (and the Asset Valuation Reserve – AVR) is within *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*, but the guidance within that SSAP is very limited. It provides a general description, identifies that IMR/AVR shall be calculated and reported per the guidance in the applicable SSAP, and if not explicit in the SSAP, in accordance with the Annual Statement Instructions. The SSAPs most often simply direct allocation to (or between) IMR and AVR, with the bulk of the guidance within the Annual Statement Instructions.

The guidance in the Annual Statement instructions provides information on the net IMR balance, which takes into consideration both the positive and negative balances in the general and separate accounts. As detailed, disallowed negative IMR is reported so that it is a direct reduction to surplus on the Summary of Operations, page 4, line 41 change in nonadmitted assets:

Line 6 – Reserve as of December 31, Current Year

Record any positive or allowable negative balance in the liability line captioned “Interest Maintenance Reserve” on Page 3, Line 9.4 of the General Account Statement and Line 3 of the Separate Accounts Statement. A negative IMR balance may be recorded as a negative liability in either the General Account or the Separate Accounts Statement of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.

If there is any disallowed negative IMR balance in the General Account Statement, include the change in the disallowed portion in Page 4, Line 41 so that the change will be appropriately charged or credited to the Capital and Surplus Account on Page 4. If there is any disallowed negative IMR balance in the Separate Accounts Statement, determine the change in the disallowed portion (prior year less current year disallowed portions), and make a direct charge or credit to the surplus account for the “Change in Disallowed Interest Maintenance Reserve” in the write-in line, in the Surplus Account on Page 4 of the Separate Accounts Statement.

The following information is presented to assist in determining the proper accounting:

General Account IMR Balance	Separate Account IMR Balance	Net IMR Balance
Positive	Positive	Positive (See rule a)
Negative	Negative	Negative (See rule b)
Positive	Negative	Positive (See rule c)
Positive	Negative	Negative (See rule d)
Negative	Positive	Positive (See rule e)
Negative	Positive	Negative (See rule f)

Rules:

- a. If both balances are positive, then report each as a liability in its respective statement.
- b. If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement and follow the above instructions for handling disallowed negative IMR balances in each statement.
- c. If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the Separate Accounts Statement.

- d. If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the Separate Accounts Statement and follow the above instructions for handling the disallowed portion of negative IMR balances in the Separate Accounts Statement.
- e. If the general account balance is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the General Account Statement.
- f. If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the General Account Statement and follow the above instructions for handling the disallowed portion of negative IMR balances in the General Account Statement.

The Statutory Accounting Statement of Concepts in the Preamble to the AP&P provides the following on Recognition:

Recognition

35. The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

36. The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

37. Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

Life Actuarial (A) Task Force 2022 Guidance

The Life Actuarial (A) Task Force considered comments from the ACLI that the inclusion of a negative IMR balance in asset adequacy testing, the disallowance of a negative IMR could result in double counting of losses (i.e., through the disallowance on the balance sheet and the potential AAT-related reserve deficiency). The Task Force identified that VM-20 Section 7.D.7.b notes that "...the company shall use a reasonable approach to allocate any portion of the total company balance that is disallowable under statutory accounting procedures (i.e., when the total company balance is an asset rather than a liability)." Question 22 of the AAA's Asset Adequacy Practice Note (Attachment 2) states that "... a negative IMR is not an admitted asset in the annual statement. So, some actuaries do not reflect a negative value of IMR in the liabilities used for asset adequacy analysis." However, Question 22 also notes a 2012 survey data that showed varying practices across companies, including some companies that allocated negative IMR.

On Nov. 17, 2022, in order to assist state regulators in achieving uniform outcomes for year-end 2022, the Task Force exposed guidance until November 30, 2022:

Recommendation In order to assist state regulators in achieving uniform outcomes for year-end 2022, we have the following recommendation: the allocation of IMR in VM-20, VM-21, and VM-30 should be principle-based, "appropriate", and "reasonable". Companies are not required to allocate any non-admitted

portion of IMR (or PIMR, as applicable) for purposes of VM-20, VM-21, and VM-30, as being consistent with the asset handling for the nonadmitted portion of IMR would be part of a principle-based, reasonable and appropriate allocation. However, if a company was granted a permitted practice to admit negative IMR as an asset, the company should allocate the formerly non-admitted portion of negative IMR, as again a principle-based, reasonable and appropriate IMR allocation would be consistent with the handling of the IMR asset. This recommended guidance is for year-end 2022, to address the current uncertainty and concerns with the “double-counting” of losses. This recommended guidance will help ensure consistency between states and between life insurers in this volatile rate environment. Refinement of this guidance may be considered beyond year-end 2022.

The Oct. 31, 2022 ACLI Letter also identified the following references to IMR in the valuation manual and Risk-Based Capital Calculations:

Regulation	Use	IMR references
Actuarial Opinion and Memorandum Regulation (VM-30)	Asset adequacy analysis for annual reserve opinion	An appropriate allocation of assets in the amount of the IMR, whether positive or negative, shall be used in any asset adequacy analysis.
Life principle-based reserves (VM-20)	Calculation of deterministic reserve	Calculate the deterministic reserve equal to the actuarial present value of benefits, expenses, and related amounts less the actuarial present value of premiums and related amounts, less the positive or negative pre-tax IMR balance at the valuation date allocated to the group of one or more policies being modeled
Life principle-based reserves (VM-20)	Calculation of stochastic reserve	Add the CTE amount (D) plus any additional amount (E) less the positive or negative pre-tax IMR balance allocated to the group of one or more policies being modeled
Variable annuities principle-based reserves (VM-21)	Reserving for variable annuities	The IMR shall be handled consistently with the treatment in the company’s cash-flow testing, and the amounts should be adjusted to a pre-tax basis.
C3 Phase 1 (Interest rate risk capital)	RBC for fixed annuities and single premium life	IMR assets should be used for C3 modeling.

Assessment of 2020-2022 IMR Balances:

Note – The following amounts reflect the general account IMR Reserve balance. (This is the amount shown as a liability and shows the decrease in the positive IMR reported since 2020.) This detail does not show the disallowed negative IMR reported as an asset and nonadmitted. Also, information on the separate account IMR, which is a factor in determining in disallowed negative IMR, will not be known until the year-end financial statements are filed (March 1, 2023).

	GA 2022 – Q3	GA 2022 – Q2	GA 2022 – Q1	GA YE – 2021	GA YE – 2020
Aggregate IMR	27,601,001,445	31,859,274,989	37,697,176,149	40,598,068,038	35,229,578,726
Change from Prior	(4,258,273,544)	(5,837,901,160)	(2,900,891,889)	5,368,489,312	
% Change	(13.4%)	(21.5%)	(7.1%)	15.2%	

Review of GA IMR Reserve Decrease:

- From the first quarter (Q1) to second quarter (Q2), 25 companies had decreases in the IMR reserve balance over \$50M totaling \$4,717,657,986, representing 80% of the overall change. 13 of these companies had decreases of IMR over \$100M, totaling \$3,959,569,339, representing 68% of the change. Four of these companies had decreases of IMR over \$400M. One of these companies reported a zero IMR liability and reported a disallowed IMR on the asset page of approx. \$570M.
- From the first quarter (Q1) to second quarter (Q2), 49 companies increased their prior reported positive IMR by \$61,390,564. From the second quarter (Q2) to third quarter (Q3), 56 companies increase their prior reported positive IMR by \$60,316,403
- From the second quarter (Q2) to third quarter (Q3), 16 companies had decreases in the IMR reserve balance over \$50M totaling \$3,161,570,362, representing 74% of the change. 8 of these companies had decreases of IMR over \$100M, totaling \$2,580,832,015, representing 60% of the change. All of these companies were still in a net positive IMR position.
- For the 30 companies that reflected the largest decline in reported IMR between the first to second quarter and then the second to third quarter, the following key details are noted.
 - From the first (Q1) to second quarter (Q2), the top 30 companies reflected a decrease in \$4,923,166,733, which is 84% of the total decrease.
 - From the second (Q2) to third quarter (Q3), the top 30 companies reflected a decrease in \$3,642,088,165, which is 85.5% of the total decrease.
 - 19 companies were noted as being in the population for both periods. 29 of the 30 companies reported a net positive IMR in the third quarter. One company reported a zero IMR in Q3.
- For the 15 companies that had the largest declines between the first quarter (Q1) to second quarter (Q2), eight of those companies also had the largest declines from second quarter (Q2) to third quarter (Q3).
- A limited number of companies are reporting a negative IMR on the liabilities side. Seven companies reported a net negative IMR balance in the third quarter (Q3) for a total of 11,031,998. One company made up \$10.5M of the aggregate balance and this company initially went negative in the second quarter (Q2). Six companies reported a net negative IMR balance for Q2 for a total of \$9,815,594. (The other companies with negative IMR were immaterial amounts.) *(Under the guidance in the A/S instructions, these companies should stop at zero and report the negative as disallowed nonadmitted asset.)*

Review of Disallowed IMR:

Although the assessment of the liability balance shows the decrease in positive IMR, it no longer tracks the decline for companies that go negative, as the reserve balance on the liability page should stop at zero. (This info may be identifiable from the IMR schedule, but not within the quarterly financials from a review of the IMR reported on the liability page.) As such, NAIC staff completed a review of the data to identify the companies that moved to a zero balance (from a prior positive balance) at year-end 2021 or in the 2022 quarters:

Companies that moved from a positive IMR (liability) to a zero balance:

- Initially went to zero in 2022 – Q3: 20 companies
- Initially went to zero in 2022 – Q2: 20 companies
- Initially went to zero in 2022 – Q1: 11 companies
- Initially went to zero YE 2021 – 20 companies (This is a comparison to YE 2020.)

For these 71 companies, NAIC staff has completed a manual review to the 2022 third quarter financial statements to determine if a disallowed IMR was reported as an aggregate write-in on the asset page. For these companies, 60 were identified with a disallowed IMR for a total of \$1 Billion as of the third quarter 2022.

Existing Authoritative Literature:

SSAP Authoritative Guidance:

- *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- Life Annual Statement Instructions

(Guidance included as part of discussion.)

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

- Nov. 17, 2022, Discussion by Life Actuarial (A) Task Force as discussed above.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:
None

Convergence with International Financial Reporting Standards (IFRS): NA

Recommendation:

NAIC staff recommend that the Working Group include this item on their maintenance agenda as a New SAP Concept for discussion to assess the current guidance for disallowed negative IMR. NAIC staff recommend that at the Working Group's conclusion, documentation of the discussion, and resulting decisions, be captured for historical purposes in an Issue Paper.

Staff Review Completed by: Julie Gann - NAIC Staff, November 2022

Status:

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

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

- a. Draft a referral to the Life Actuarial (A) Task Force on further consideration of the asset adequacy implications of negative IMR. Items to include: 1) developing a template for reporting within asset adequacy testing (AAT); 2) considering the actual amount of negative IMR that is admitted to be used in the AAT; 3) better consideration of cash flows within AAT (and documentation), as well as any liquidity stress test (LST) considerations; 4) ensuring that excessive withdrawal considerations are consistent with actual data (sales of bonds because of excess withdrawals should not use the IMR process); and 5) ensuring that any guardrails for assumptions in the AAT are reasonable and consistent with other aspects.
- b. Draft a referral to the Capital Adequacy (E) Task Force for the consideration of eliminating any admitted net negative IMR from total adjusted capital (TAC) and the consideration of sensitivity testing with and without negative IMR.
- c. Develop guidance for future Working Group consideration that would allow the admission of negative IMR up to 5% of surplus using the type of limitation calculation similar to that used for goodwill admittance. The guidance should also provide for a downward adjustment if RBC ratio is less than 300.
- d. Review and provide updates on any annual statement instructions for excess withdraws, related bond gains/losses and non-effective hedge gains/losses to clarify that those related gains/losses are through asset valuation reserve (AVR), not IMR.
- e. Develop accounting and reporting guidance to require the use of a special surplus (account or line) for net negative IMR.
- f. Develop governance related documentation to ensure sales of bonds are reinvested in other bonds.
- g. Develop a footnote disclosure for quarterly and annual reporting.

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

<https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2023/3-22-23-Spring/Exposures/22-19-NegativeIMR.docx>

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

TABLE OF CONTENTS

COMMENTS / DOCUMENT	PAGE REFERENCE
Included in Attachment 3:	
<ul style="list-style-type: none"> • Life Actuarial (A) Task Force – June 15, 2023 	1
<ul style="list-style-type: none"> • ACLI – May 17, 2023 	3
<ul style="list-style-type: none"> • ACLI – Responses to NAIC Questions – June 7, 2023 	24
<ul style="list-style-type: none"> • ACLI – Hedge Examples – June 7, 2023 	30
<ul style="list-style-type: none"> • Life Valuation Committee of the American Academy of Actuaries – June 7, 2023 	33
Included as Attachment 4 – 59 Pages:	
ACLI Referenced “AVR/IMR Report to NAIC” -- Asset Valuation Reserves and Interest Maintenance Reserves, Blue Book, Dec. 2002	1

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.

Mike Monahan

Senior Director, Accounting Policy

202-624-2324 t

mikemonahan@acli.com

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).

American Council of Life Insurers | 101 Constitution Ave, NW, Suite 700 | Washington, DC 20001-2133

The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

- 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 undoubtedly 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. Reinvestment and Attestation

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 rationale 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 framework²; 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,

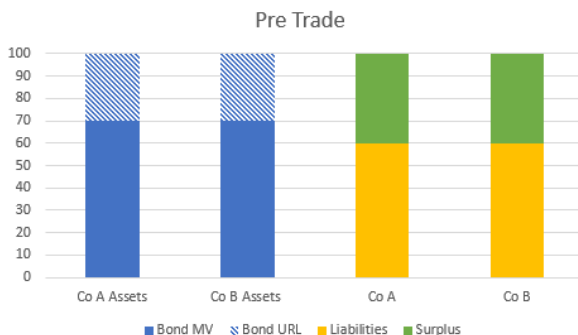
A handwritten signature in black ink, appearing to read "M Monahan". The signature is fluid and cursive, with a large initial "M" and a trailing flourish.

Mike Monahan
Senior Director, Accounting Policy

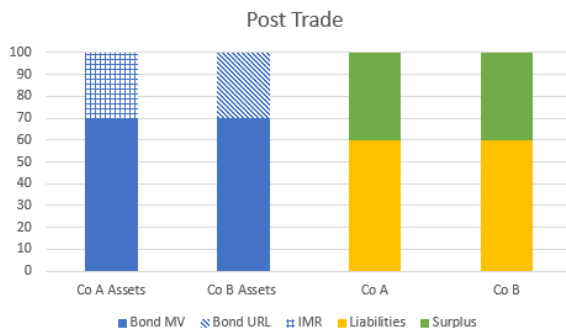
CC: Julie Gann, NAIC

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.

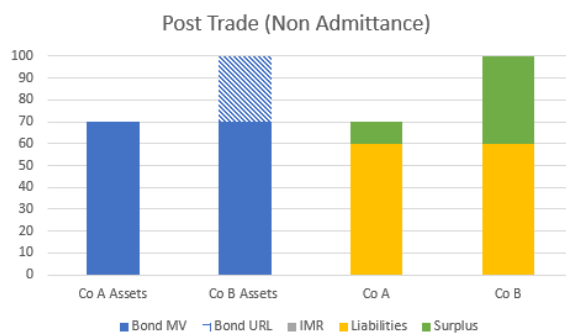


Company A sells its full bond holdings for \$70, then immediately reinvests all proceeds into a new bond. The \$30 loss is deferred to the IMR. Company B makes no changes to its holdings (no bond sale). Both companies are in the same position of financial strength insofar as having the same total liquid 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.

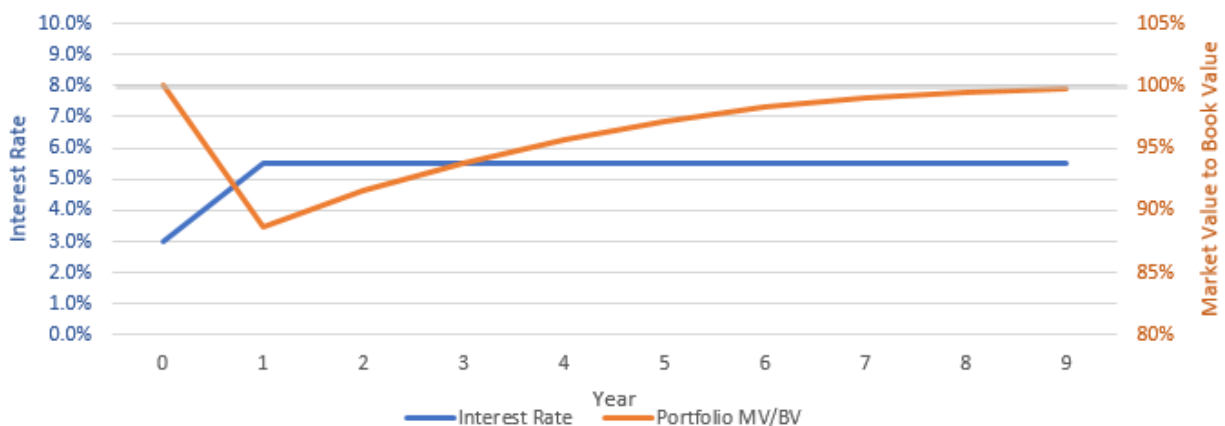


Figure 2: Relationship between portfolio market value, trading assumptions, and IMR

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).

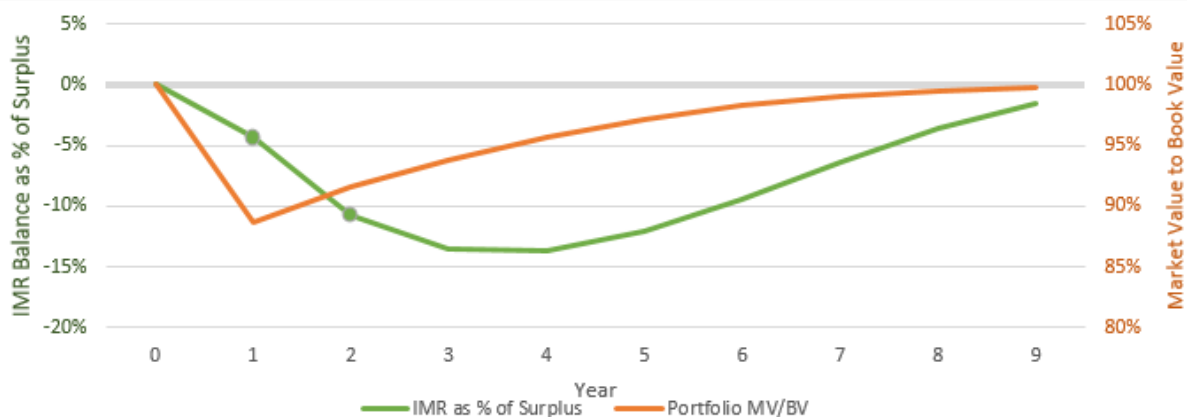


Figure 3: Managing portfolio to a surplus cap

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.

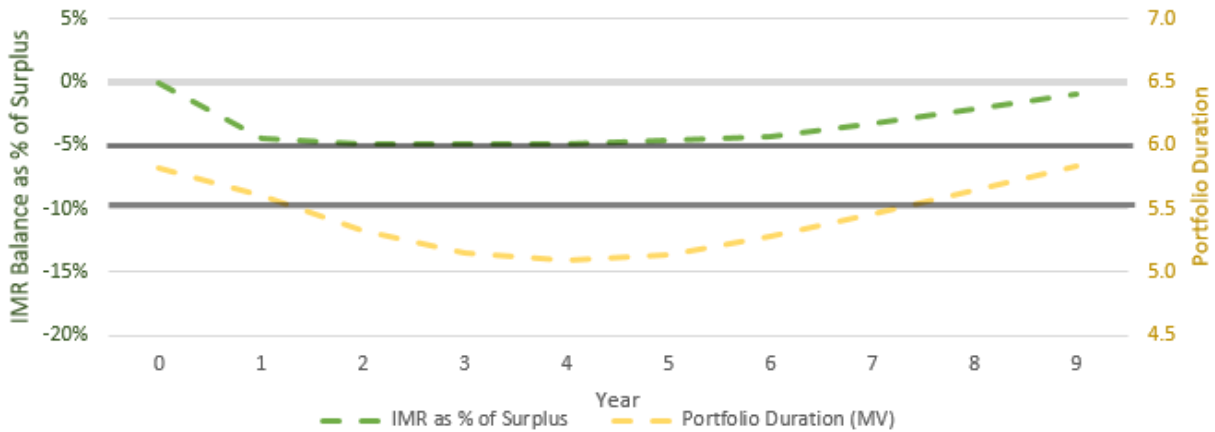


Figure 4: Interest rate sensitivity – rates increase 100 bps over Year 2, then remain level

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.

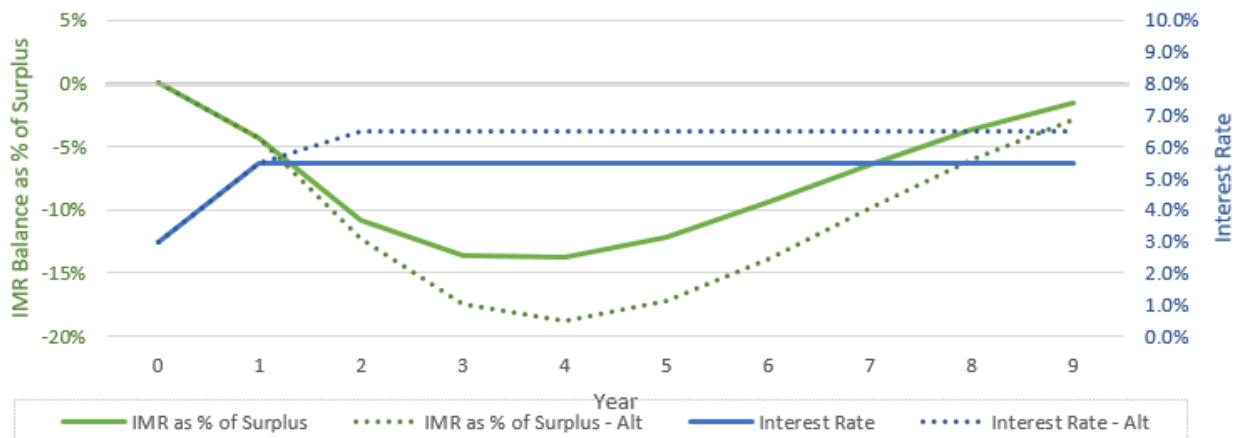
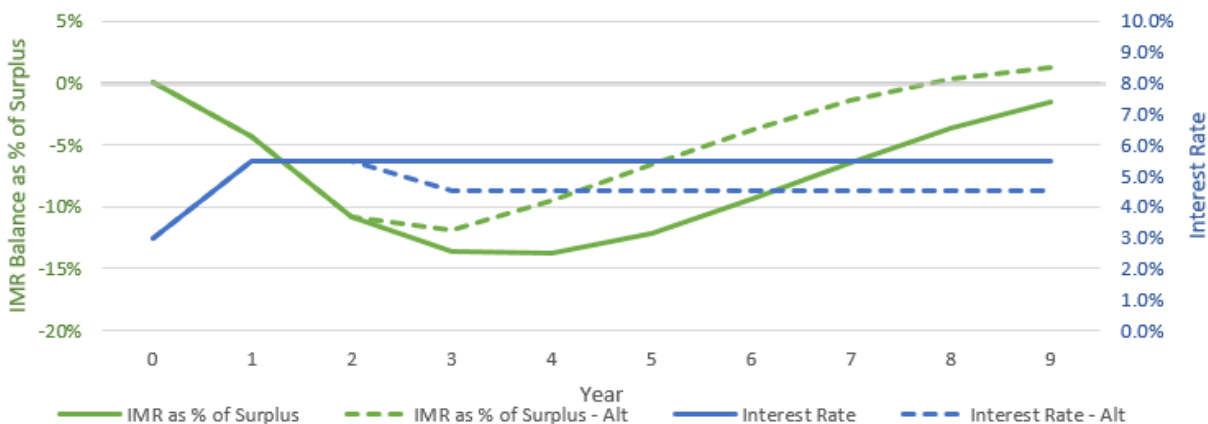


Figure 5: Interest rate sensitivity – rates decrease 100 bps over Year 3, then remain level

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 Treasuries would increase in value, helping to match the assumed earning in pricing the liability. Alternatively, if interest rates rise, the derivatives/US Treasuries 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 Treasuries 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 Treasuries. 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.

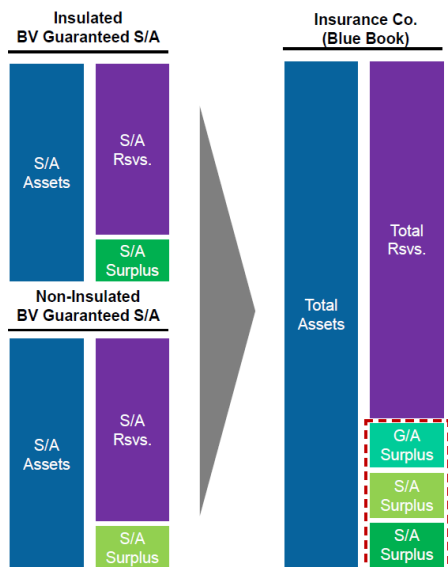
Inclusion of Separate Accounts (“S/A”) in Admittance of Negative IMR

	Insulated vs Non-insulated	Included in IMR	Product Examples	Considerations
Book Value Guaranteed S/A	Insulated	Yes ✓	Pensions GICs MVA Annuity	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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 chooses 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 amortized over 10 years
 Amortization of IMR creates stable earnings and surplus 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										
		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	5%	Interest Income										
Deriv G/L at t=1 (EOP)	0.0	IMR Amort										
		Total Investment Income										
		Crediting										
		Net Income										
<u>Balance Sheet</u>												
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	10.0

		End of Year										
		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	4%	Interest Income										
Deriv G/L at t=1 (EOP)	10.0	IMR Amort										
		Total Investment Income										
		Crediting										
		Net Income										
<u>Balance Sheet</u>												
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	10.0

		End of Year										
		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	6%	Interest Income										
Deriv G/L at t=1 (EOP)	-10.0	IMR Amort										
		Total Investment Income										
		Crediting										
		Net Income										
<u>Balance Sheet</u>												
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	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	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	5%											
Deriv G/L at t=1 (EOP)	0.0											
	Interest Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
	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
<u>Balance Sheet</u>												
	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	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	4%											
Deriv G/L at t=1 (EOP)	10.0											
	Interest Income		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
	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	-	-	-	-	-	-	-	-	-
<u>Balance Sheet</u>												
	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	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	6%											
Deriv G/L at t=1 (EOP)	-10.0											
	Interest Income		6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
	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
<u>Balance Sheet</u>												
	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		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	5%											
Deriv G/L at t=1 (EOP)												
	Interest Income		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
	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
<u>Balance Sheet</u>												
	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		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	4%											
Deriv G/L at t=1 (EOP)												
	Interest Income		4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
	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		-	-	-	-	-	-	-	-	-	-
<u>Balance Sheet</u>												
	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		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Bond Yield at t=1 (EOP)	6%											
Deriv G/L at t=1 (EOP)												
	Interest Income		6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
	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
<u>Balance Sheet</u>												
	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 Actuaries¹ 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 (AAT²), 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 surplus³

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

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				

**ASSET VALUATION RESERVES
AND
INTEREST MAINTENANCE RESERVES**

**BLUE BOOK
DECEMBER, 2002**

**REPORT TO THE NATIONAL ASSOCIATION
OF INSURANCE COMMISSIONERS (NAIC)**

**FINANCIAL CONDITION
(E COMMITTEE)**

TABLE OF CONTENTS

I.	Asset Valuation Process-Primary Functions	5
II.	Objectives	5
III.	Description of Interest Maintenance Reserve	5
IV.	Description of Asset Valuation Reserve	5
V.	Asset Valuation Reserve Components/Formula	6
VI.	AVR Basic Contributions, Reserve Objectives and Maximums	7
VII.	IMR Minimums/Maximums	7
VIII.	Background/Perspective	8
IX.	Actuarial Responsibilities	8
X.	Key Assumptions	9
XI.	Level of Conservatism	9
XII.	AVR and IMR Built on and Complement Existing Valuation Practices	10
 <u>ROLE AND PURPOSE OF THE INTERST MAINTENANCE RESERVES</u>		 11
XIII.	Summary	11
 <u>INTEREST MAINTENANCE RESERVES</u>		 11
XIV.	Interest-Related vs. Credit Related Capital Gains and Losses	11
XV.	IMR Structure	12
XVI.	Fixed Interest Investments Applications	13
XVII.	Distinguishing Interest Related Gains from Credit-Related Gains	13
XVIII.	IMR Amortization	14
XIX.	Negative Yield Adjustments	16
XX.	Expected Maturity Date	16
XXI.	Capital Gains Taxes	17
XXII.	Reserve Maximum and Minimum Levels	18
XXIII.	Initialization in 1992	18
XXIV.	Treatment of Market Value Adjustments	18
XXV.	Equity Linked Products Participating Business	18
XXVI.	Reinsurance of a Block of Business	19
XXVII.	Sale, Transfer or Reinsurance of Liabilities	19
XXVIII.	Excessive Withdrawals	20
XXIX.	Recapture of Reinsurance Ceded (10/99)	20
XXX.	Withdrawable Reserves	21
XXXI.	Effective Withdrawals	21
XXXII.	Preferred Stock	22
XXXIII.	Replications (Synthetic Assets)	22
XXXIV.	Capital and Surplus Notes (1998)	22
XXXV.	Appendix: Grouped Amortization Schedules	23
 <u>ROLE AND PURPOSE OF THE ASSET VALUATION RESERVES</u>		 24
XXXVI.	Purpose	24
XXXVII.	Summary	24
XXXVIII.	Determination of Numerical Values for AVR Factors	25

XXXIX.	Criteria/Timing for Future Change of Factors	25
<u>THE DEFAULT COMPONENT OF THE ASSET VALUATION RESERVE</u>		25
XL.	General Description	25
XLI.	The Bond and Preferred Stock Sub-Component	26
XLII.	Basic Contribution	27
XLIII.	Additional Contributions	27
XLIV.	Transfer Rules for Sub-Components	28
XLV.	Negative Sub-Components after Additional Contribution	28
XLVI.	Voluntary Contributions	28
XLVII.	Mortgage Sub-component	28
XLVIII.	Experience Adjustment Factor (EAF)	29
XLIX.	Application of EAF to Farm and Other Than Guaranteed/Insured Commercial Mortgages	30
L.	Mortgage Loan Factors	30
LI.	Other Mortgage Category's Factors	30
LII.	US Government Securities	31
LIII.	Federal Agricultural Mortgage Cooperations (3/99)	31
LIV.	Mutual Funds	31
<u>THE EQUITY COMPONENT OF THE ASSET VALUATION RESERVE</u>		31
LV.	AVR Equity Component	32
LVI.	Basic Contribution, Reserve Objectives, Maximums	32
LVII.	Voluntary Contributions/Negative	33
LVIII.	Replications (6/98)	33
LIX.	Derivative Instruments	33
<u>THE COMMON STOCK SUB-COMPONENT</u>		33
LX.	Convertible Bonds or Preferred Stock (including FHLB Stock)	34
LXI.	Summary - Reserve Objectives and Maximum	34
LXII.	Real Estate Sub-Component	34
LXIII.	Schedule BA Assets	36
<u>SEPARATE ACCOUNTS</u>		38
LXIV.	IMR for Book Value Separate Accounts	38
LXV.	Determination of Capital Gains (Losses)	39
<u>FEDERAL INCOME TAXATION ASSUMPTIONS</u>		40
LXVI.	General	40
LXVII.	IMR-Fixed Income Related Capital Gains	40
LXVIII.	Asset Valuation Reserve	40
LXIX.	AVR Tax Recognition Assumptions	41
<u>STANDARDS FOR ACTUARIAL RESERVES WITH AN IMR AND AVR</u>		42
LXX.	IMR Reserve Standard	42
LXXI.	General Explanation	42
LXXII.	AVR Reserve Standard	42

<u>ACCOUNTING TREATMENT</u>	43
LXXIII. Interest Maintenance Reserve	43
LXXIV. AVRTreatment of Capital Gains	43
LXXV. Asset Valuation Reserve	43
LXXVI. Alternate Treatments Considered	43
APPENDIX A Transition from MSVR to AVR in 1992	45
APPENDIX B Future Directions	46
APPENDIX C Changes approved in 1995/96	48
APPENDIX D Justification for the AVR Common Stock Factor	50
APPENDIX E_Justification of the 20% Common Stock factor	52
APPENDIX F_Additional Historical perspectives	56

I. ASSET VALUATION PROCESS - PRIMARY FUNCTIONS

- A. Assure that all assets and liabilities are reported on as consistent a financial basis as is practical.
- B. Minimize the impact that capital gains and losses arising from movements in interest rates have upon provisions for credit related losses. That is, distinguish capital gains/losses arising from changes in interest rates from capital gains/losses arising from changes in the assets credit worthiness.
- C. Provide a reserve consistent with valuation actuary standards that adequately provides for future volatile increasing incidence of asset losses.
- D. Provide appropriate recognition of long-term expected returns for equity type investments.

II. OBJECTIVES

- A. To develop an asset valuation reserve, which recognizes current actual default or credit experience, and also potential future adverse (and favorable) experience in the value of assets.
- B. The basis for this reserve should be consistent with that used to determine the value of liabilities for statutory purposes, and
- C. Be consistent with the accounting basis used to determine the statutory balance sheet value of assets.
- D. Capital gains and losses arising from changes in interest rates should be reserved in a manner consistent with cash flow testing done by a valuation actuary. Gains or losses should be gradually released over time as no economic changes have occurred as measured on an ongoing valuation basis.

III. DESCRIPTION OF INTEREST MAINTENANCE RESERVE

The Interest Maintenance Reserve (IMR) - captures for all types of fixed income 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 the interest rate characteristics of assets/liabilities, also are allocated to the IMR and are to be amortized into income over the life of the associated assets/liabilities.

Note: certain significant unusual transactions may require immediate recognition of any realized capital gains or losses, as described in a later section.

This reserve is not subject to any maximum.

IV. DESCRIPTION OF ASSET VALUATION RESERVE

The Asset Valuation Reserve (AVR) - consists of two major components and a number of sub-components each designed to address specific asset risk areas:

- a) The Default Component - provides for future credit-related losses on fixed income investments. The default component has two sub-components:

- i) The Bond and Preferred Stock Sub-component - contains the default provisions for corporate debt securities, preferred stock, mortgage backed securities, and counter-party exposure arising from derivatives transactions.
 - ii) The Mortgage Sub-component - contains the default provisions for farm, commercial, and residential mortgages.
- b) The Equity Component - provides for all types of equity investments. The size of the provisions depends to some extent on the market value for those investments. For real estate the market value is determined by using appraisals net of selling expense. The equity component has two sub-components:
- i) The Common Stock Sub-component - contains provision for both affiliated and unaffiliated common stock and other investments in the nature of common stock.
 - ii) The Real Estate and Other Invested Asset Sub-component - contains provision for real estate.

Note: The provision for Schedule BA assets is established in accordance with the true nature of the particular assets to the greatest extent possible, by allocating these assets to the appropriate sub-component.

The Asset Valuation Reserve captures all recognized credit-related capital gains and losses in the appropriate sub-component. In addition, a basic contribution and an annual contribution are made to each sub-component.

Credit gains and losses captured in the Asset Valuation Reserve include realized gains or losses, net of capital gains taxes, any other recognized capital gains and losses net of deferred taxes. Unrealized gains and losses on hedging instruments not related to interest rate changes should be included with the hedged asset. Gains or losses, net of capital gains tax, on specific hedges should be included only if the hedged asset is sold or disposed.

Voluntary contributions and limited transfers between sub-components are permitted.

V. ASSET VALUATION RESERVE COMPONENTS/FORMULA

A. The AVR is determined separately for each sub-component as (1) the Accumulated Balance + (2) the Additional Contribution, but not less than zero nor more than the maximum, where:

- (1) the Accumulated Balance = Beginning Balance
 - + Capital Gains, net of taxes
 - Capital Losses, net of taxes
 - + Basic Contribution
- (2) the Additional Contribution = 20% (Reserve Objective - Accumulated Balance)

The Additional Contribution amortizes the difference between the Reserve Objective and the Accumulated Balance.

If a sub-component is at a maximum, then transfers are made to the other sub-component within a major component. If both sub-components are at a maximum, transfers to the other major component are not required.

The book adjusted carrying value is used for all AVR calculations.

B. Quarterly Calculations

The AVR calculations are done in accordance with the Annual Statement Instructions, quarterly, with full recognition of credit losses to the end of that quarter. However, only a proportionate part (25%, 50%, 75%) of:

- (1) the Basic Contribution, and
- (2) 20% of the Reserve objective less the Accumulated Balance is used on 3/31, 6/30 and 9/30.

C. Determination of Reserve Objectives, Contributions and Maximums

The Reserve Objective, the Basic Contribution, and the AVR Maximums are determined by applying specifically defined factors for each asset type to the corresponding statement values for that asset.

VI. AVR BASIC CONTRIBUTIONS, RESERVE OBJECTIVES AND MAXIMUMSA. Basic Contributions

1. Fixed Income Investments: Basic contributions are set equal to expected net capital losses arising from default or credit events. They were refined as part of codification in 2002.
2. Equity Investments: Basic contributions are set equal to zero.
Note: no changes were made to the equity component. Possibly under some future consideration is a draft proposal to bring them into line with the fixed income components structure.

B. Reserve Objectives

1. Fixed Income: developed factors to provide the same level of conservatism as that of all valuation reserves (about 85%).
2. Equity Investments: set equal to maximums prior to 1997, adjusted where necessary for deferred taxes. Real Estate factors were already fully tax adjusted.

Common Stock 20% with an adjustment for the volatility of the portfolio.

Real Estate 7.5%

C. Maximums

1. Fixed Income: maximums are set equal to the post-tax Risk Based Capital factors for each asset type.
2. Equity Investments: 20% for Common Stock and 7.5% for Real Estate maximums selected to keep reserves close to objectives. Risk Based Capital factor maximums would have created excessive AVR reserves.

VII. IMR MINIMUMS/MAXIMUMS

- A. Minimums: The IMR can be negative for any line of business as long as the aggregate IMR for the Company is not less than zero.

Any otherwise negative IMR value is carried over to subsequent years.

B. Maximums: There is no maximum of the IMR.

VIII. BACKGROUND/PERSPECTIVE

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.

IX. ACTUARIAL RESPONSIBILITIES

It is clear that the responsibilities of the actuary were an important part in establishing both the AVR and the IMR. Valuation Actuaries must not only know valuation standards and the appropriate mortality and other tables to use when determining the liabilities of their company, but must also recognize and calculate the impacts of changing interest rate environments and potential asset defaults as they establish reserves. The "asset Adequacy test" undertakes to show that the assets, which fund the reserves, are adequate to carry out the promises of the company.

The appointed actuary may use and must disclose reliance upon any portion of the assets supporting the Asset Valuation Reserve (AVR), Interest Maintenance Reserve (IMR) or other mandatory or voluntary statement of reserves for asset adequacy analysis. The Actuary can either reflect default losses directly in the asset adequacy testing or the actuary can use the Default Component Reserve Objective amount of the AVR directly as the appropriate (present value) measure of credit losses. This measure becomes part of the obligations to be met in the cash flow testing of the reserves.

X. KEY ASSUMPTIONS

A. Insurance Policy and Contract Valuations Will Not Be Changed.

Recognizing the importance of consistent treatment of assets and liabilities, it is very important to determine the value of assets consistent with that used to determine the value of the liabilities. The development of the AVR and IMR assume that the present methods for valuing policy reserves for statutory purposes remains substantially unchanged.

Any material change in insurance valuation methodology will require reexamining the appropriateness of the AVR and IMR.

B. The Primary Focus Of The Statutory Statements Is Solvency.

The most important and fundamental purpose of the Statutory Statements is to provide basic financial information focusing on solvency. Other accounting objectives, such as accurate measures of earnings, are considered to be less important. Development of the AVR and the IMR is consistent with this objective.

C. AVR and IMR Only Apply To Life Insurers.

The AVR and IMR resolve issues associated with life insurer and fraternal insurer asset and liability valuations. These issues may not exist or the AVR and IMR methods may be inappropriate for other types of insurers or financial service organizations due to different reserve structures, length of obligations, no direct tie of assets to liabilities, etc.

D. Going Concern Basis of Valuation

The valuation of assets and liabilities proceeds on the assumption that the insurer is a going concern. Valuation is not done on a liquidation basis.

XI. LEVEL OF CONSERVATISM

The level of conservatism for statutory reserves and, therefore, the AVR and IMR has not changed over the years.

A. Pre-Codification (Prior to 2001)

The N.A.I.C. Accounting Practices and Procedures Manual described statutory accounting practices as follows:

"Statutory accounting practices may be conservative in some respect, but they are not unreasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. They attempt to determine the company's ability to satisfy its obligations

to its policyholders and creditors at all time. Because of the conservatism generally associated with these accounting principles, the statutory balance sheet is sometimes viewed as being presented on a solvency basis inasmuch as some assets are either valued conservatively or given no value at all. Many liabilities are valued on an equally conservative basis." (Introduction, page ii)

As currently required to meet the solvency objective, policy reserves should be sufficient to cover reasonable deviations from expected experience, including the ups and downs of economic cycles. The objective of the NAIC Model Standard Valuation Law is to meet this criterion. In the environment of such standards, technical insolvency (where assets are less than liabilities) is not necessarily an indicator of policyholder loss. An insolvent company may still meet all of their obligations in an orderly and complete manner. Also, the standards take no account of a company's ability to take corrective action when solvency is threatened (for example, by reducing new business volume or lowering interest-crediting rates).

In addition, companies hold capital and surplus in order to be able to absorb more extreme events not anticipated in this reserve criterion. In assessing financial condition, considerable emphasis is placed on the size of a company's surplus relative to its risks, as well as the adequacy of the underlying reserves.

One of the objectives of the Asset Valuation Reserve is that it should have the same strength as all other components or types of statutory reserves; that is, it should have the same level of confidence that it will survive over reasonably adverse economic cycles.

B. Post-Codification 2001

Statutory accounting practice (SAP) is conservative in some respects but not unreasonably conservative over the span of economic cycles or in recognition of the primary statutory responsibility to regulate for financial solvency. SAP attempts to determine at the financial statement date an insurer's ability to satisfy its obligations to its policyholders and creditors." (Preamble par. 9)

Nothing of substance in the level of conservatism was changed with codification.

XII. AVR AND IMR BUILT ON AND COMPLEMENT EXISTING VALUATION PRACTICES

The existing framework of asset and liability valuation practices, as augmented by the NAIC Model Standard Valuation Law, played a key role in designing the AVR and IMR, including:

- (a) Reserve valuation standards should contain a provision for future losses. Although it is well understood that in cash flow testing provision must be made for future asset losses, it may not be as well understood that historically the minimum valuation standards implicitly contained such a provision.
- (b) Interest assumptions in reserve valuation generally recognize the potential for mismatch. Dynamic valuation rates are lower for ordinary life than for guaranteed investment contracts, for example, because the mismatch is almost inevitable on the former. In addition, it is required in other regulations, and in the NAIC Model Standard Valuation Law, that cash flow testing should be used and may result in the adoption of lower than the dynamic valuation rates if mismatch exists. Hence, with the one exception noted in section (c), there is no need for the IMR reserves to make provision for the risk of mismatch.
- (c) Asset valuations for fixed interest securities usually reflect the outlook at the time of purchase of an asset. In particular, bond amortization tends to reflect the yields available at time of purchase and the

expected cash flow. Liabilities are established at the same time, and the interest rate assumptions on them are those appropriate to the outlook at that time. But if securities are traded, a new amortization schedule is established that may be based on an entirely different yield environment, which may not be consistent with the liabilities that have been established.

Using the IMR to absorb trading gains is desirable and appropriate to eliminate this subsequently created mismatch.

- (d) Equities present special valuation problems. Common stocks are valued at market rather than amortized value; hence they require different treatment. Real estate and similar investments, although usually valued at depreciated value, require special consideration because of the great likelihood of major changes in yield and yield expectation after purchase.

ROLE AND PURPOSE OF THE INTEREST MAINTENANCE RESERVES

XIII. SUMMARY

Trading gains on fixed-income assets (i.e., capital gains or losses due primarily to the sale of an asset before maturity in an interest rate environment different from that at the time of purchase) should be treated differently from all other gains and losses. Although it would have been less complicated to treat trading gains within the framework of the AVR that handles other gains and losses, such treatment would not have achieved the desired consistency between the reporting basis for assets and the reporting basis for liabilities. To accomplish this objective most effectively, a separate reserve had to be established - the Interest Maintenance Reserve.

INTEREST MAINTENANCE RESERVES

XIV. INTEREST-RELATED VS. CREDIT RELATED CAPITAL GAINS AND LOSSES

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.

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.

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.
- (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."

Serious consideration was given during the development of the IMR to exempting the assets supporting certain lines of business, such as Ordinary Life, and/or the assets supporting surplus. The argument was that such assets do not have a close correspondence to a set of liabilities with characteristics similar to the assets. However, it was felt that despite the more obvious case that can be made for an IMR in "matched" accounts, the same basic motivations apply to those other accounts; gains tend to be transitory and spurious, and such a telescoping of future yields into the current balance sheet should not be permitted. In addition, the concern was expressed that "gains trading" would occur if certain portions of operations were exempted. For example, the company could choose to trade assets that were in an exempt or a non-exempt account, depending on the balance sheet effect, and thus would be able to manipulate results.

XV. IMR STRUCTURE

All realized capital gains and losses on fixed income investments are to be distinguished as to whether they are identified as arising from changes in the level of interest rates. If they are, they should be treated as contributions to the Interest Maintenance Reserve, and amortized into surplus over a period of time.

A. Quarterly Calculations

The IMR should be computed in accordance with the Annual Statement Worksheets except that only a proportionate part (25% in March, 50% in June, and 75% in September) of the current years amortization is released to the gain from operations.

XVI. FIXED INTEREST INVESTMENTS APPLICATIONS

The categories of assets to which the Interest Maintenance Reserve applies (fixed interest investments) are described below.

- corporate debt securities,
- preferred stock,
- government obligations (direct and guaranteed),
- obligations of states, territories, and possessions (direct and guaranteed),
- Obligations of political subdivisions of states, territories, and possessions (direct and guaranteed),
- special revenue and special assessment obligations and all non-guaranteed obligations of agencies and authorities of governments and their political subdivisions,
- mortgages,
- mortgage backed securities,
- money market funds,
- other investments in the nature of debt instruments, and
- derivative instruments hedging these assets
-
- some realized foreign exchange related capital gains/losses.

XVII. DISTINGUISHING INTEREST RELATED GAINS FROM CREDIT-RELATED GAINS

Although one could theoretically determine an interest rate portion and a credit or default risk portion for each capital gain or loss, for administrative simplicity the following rules were adopted to distinguish the two types of gains. These definitions are used since they are easily implemented with the information that is currently available. Gains or losses that do not occur on the disposition of an asset are automatically classified as credit related.

- A. Realized capital gains or losses (net of capital gains tax) on corporate debt securities, preferred stock, mortgage backed securities and derivatives transactions hedging those assets are to be classified as interest rate gains or losses provided such gains or losses were on issues which have not changed by more than one SVO rating classifications between the purchase date, (or December 31, 1990 if purchased prior to that date), and the date of sale, or has not been rated "G" during that period. Capital gains or losses relating to changes in foreign exchange rates should follow this same guidance. All other gains or losses on corporate debt securities, preferred stocks, and mortgage backed securities, including realized capital gains or losses (net of capital gains tax) on derivatives transactions hedging those assets are to be classified as credit gains or losses.
- B. Capital gains or losses (net of taxes) on the disposition of mortgage loans which are not in process of foreclosure or in course of voluntary conveyance, where interest is not more than 90 days past due, and

where such loans have not had restructured terms over the prior two years, are to be classified as interest rate gains or losses. All other gains or losses on mortgage loans would be classified as credit related gains or losses.

Note: Slight variations in the treatment of preferred stock and convertible assets are described in subsequent sections.

XVIII. IMR AMORTIZATION

The amortization procedures used in the Interest Maintenance Reserve assume that the gains or losses arise from sale and repurchase of the same asset. In practice of course, the repurchase may be of different duration or quality than the original asset. But it is neither practical nor theoretically correct to let the disposition of the proceeds affect the reserve calculation.

Procedure - Each realized capital gain or loss, net of capital gains tax, due to changes in the level of interest rates should be amortized by establishing a liability (in case of gain) or asset (in case of loss) that is equal to the excess of the value of the original asset (as if it had not been sold) over the value of the same asset as if it had been repurchased at the sale date. This includes derivative transactions entered into solely for the purpose of altering the interest rate characteristics of the company's assets and/or liabilities (hedging transactions). Capital gains or losses on these transactions should be credited or charged to the Interest Maintenance Reserve and amortized using the amortization method elected by the company.

In other words, a specific amortization schedule is established for each asset on which an interest rate gain or loss is recognized, with such schedule being individually designed to reflect the characteristics of that asset. Since this requirement may impose an administrative burden on some companies, companies are allowed to use alternative methods that reasonably approximate this amortization method. This includes reasonable approximations of the described method as approved by the domiciliary state insurance department. A "simplified method" that will be deemed to satisfy this criteria will group all capital gains and losses according to the number of calendar years to expected maturity. The groupings will be in bands of 5 calendar years. The assumptions used to develop the amortization schedule for these groupings are set forth in the Appendix to this section.

The groupings are as follows:

- 0 calendar years to expected maturity,
- 1 calendar year to expected maturity,
- 2 to 5 calendar years to expected maturity,
- 6 to 10 calendar years to expected maturity,
- 11 to 15 calendar years to expected maturity,
- 16 to 20 calendar years to expected maturity,
- 21 to 25 calendar years to expected maturity,
- 26 to 30 calendar years to expected maturity, and
- over 30 calendar years to expected maturity.

Where "Calendar years to expected maturity" means the calendar year of expected maturity minus the calendar year of disposition, so that a bond sold in 2002 that would have matured in 2007 has five calendar years to expected maturity.

Simplified Method

Under the simplified method, the capital gains and losses due to interest rate changes on fixed income investments should be amortized according to the amortization schedules derived from the formulas in the Appendix to this section, using the current Reference Interest Rate (R) specified in the Standard Valuation Law for single premium immediate annuities rounded to the nearest one percent. The accompanying table displays the rates, which are being used for year-end 2002.

The presence of sinking fund payments, principal repayment schedules, expected prepayments, and adjustable interest rates, complicate the determination of the number of calendar years to expected maturity. The simplifying rules designed for these cases are:

In the case of convertible bonds, convertible preferred stocks, and callable bonds purchased at a premium, the expected maturity date is defined as the contractual retirement date that produced the lowest amortization value for annual statement purposes. Potential retirement dates include all possible call dates, and the contractual maturity date. When the instrument's contractual terms include scheduled sinking fund payments of fixed amounts, an additional calculation of yield to average life should be included in the analysis where average life is defined as the date at which the instrument is 50% repaid. For puttable instruments, expected maturity is the put date. For perpetual instruments, the expected maturity is 30 years from the current date. However, where a callable bond purchased at a premium is called or sold after the expected maturity date, there should be no amortization of the call premium or interest related gain or loss. Similarly, there should be no amortization of any interest-related gain or loss arising if a convertible bond or preferred stock is disposed of after the expected maturity date.

For residential mortgages and residential mortgage pass-through other than Real Estate Mortgage Investment Conduits (REMICs), the number of calendar years to expected maturity is defined to be one-half the number of calendar year to final maturity (Note that in the table for the simplified method, the parenthetical references to number of years provide for residential mortgages.)

For REMICs and other asset-backed investments purchased at the time of original issuance, the calendar year of expected maturity is the calendar year of issue plus the "weighted average life" (rounded to the nearest whole number) as stated in the Offering circular, using the prepayment assumption stated in the Circular to be used for Federal Income Taxation. For REMICs and other asset backed investments purchased after the original issuance, it is permissible for the company to recompute the weighted average life of the investment based on the same prepayment assumptions used to compute the purchase price, provided that this re-computation is done in a consistent manner for all similar asset backed investments.

For bonds and preferred stock without a maturity date, and for which an expected maturity date is not determinable by the above rules, a maturity date 30 years from the year of disposition should be used.

For loan-backed bonds and structured securities that are valued using currently anticipated prepayments

- a) Under the Seriatim or General Method, use an amortization schedule developed using the anticipated future cash flows of the security sold consistent with the prepayment assumptions that would have been used to value the security had the security been purchased at its sales price.

- b) Under the Grouped Alternative Method, use the remaining weighted average life of principal and interest payments consistent with the prepayment assumptions that would have been used to value the security had the securities been repurchased at its sale price.

Prior to 1994

In 1994, only loan-backed and structured securities that met the following definition were required to be valued using currently anticipated prepayments:

Loan-backed and structured securities that have potential for loss of a significant portion of the original investment due to changes in interest rates or the prepayment rate of the underlying loans supporting the security. These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over par value.

For loan-backed bonds and other structured securities that are **not** valued using currently anticipated prepayments (pre 1995 only):

- a) Under the Seriatim or General Method, the amount amortized in a given year is the excess of the amount of income which would have been reported in that year, had the asset not been disposed of, over the amount of income which would have been reported had the asset been repurchased at its sale price.
- b) Under the Grouped Alternative Method, use the weighted average life of the investment based on the same prepayment assumptions used to compute the purchase price to determine the amount to be amortized in any given year.

Beginning in 1995, all loan-backed and other structured securities are valued using currently anticipated prepayments.

XIX. NEGATIVE YIELD ADJUSTMENTS:

Losses recognized on loan-backed bonds and other structured securities that have a negative effective yield at the date of valuation should be treated as realized losses and included in the reserve as if the security had been sold and the loss considered an interest rate loss. If the security is valued using the prospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of anticipated future cash flows of the security is less than the current book value of the security at the date of valuation. If the security is valued using the retrospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of actual and anticipated cash flows is less than the original cost of the investment.

XX. EXPECTED MATURITY DATE

For a convertible bond or preferred stock purchased while its conversion value exceeds its par value, any gain or loss realized from its sale before conversion must be excluded from the IMR and included in the AVR. Conversion value is defined to mean the number of shares available currently or at next conversion date, multiplied by the stock's current market price.

Grouped Amortization Schedules
Interest Maintenance Reserve for 2002 Gains and Losses
Interest Rate = 7.00%

Calendar Years to Maturity
(Residential Mortgages)

<u>Year end</u>	<u>26-30</u>	<u>21-25</u>	<u>16-20</u>	<u>11-15</u> (21-30)	<u>6-10</u> (11-20)	<u>2-5</u> (3-10)	<u>1</u> (1-2)	<u>0</u> (0)
2002	0.6 %	0.9%	1.4%	2.4 %	4.8%	13.0%	49.1%	100.0%
2003	1.3%	1.9%	3.1%	5.2%	10.2%	27.5%	50.9%	
2004	1.3%	2.1%	3.2%	5.5%	10.9%	25.3%		
2005	1.5%	2.2%	3.5%	5.9%	11.6%	18.6%		
2006	1.5%	2.3%	3.7%	6.3%	12.5%	11.6%		
2007	1.7%	2.6%	4.0%	6.8%	13.4%	4.0%		
2008	1.8%	2.7%	4.3%	7.2%	12.7%			
2009	1.9%	2.9%	4.5%	7.8%	10.1%			
2010	2.0%	3.1%	5.0%	8.3%	7.5%			
2011	2.2%	3.3%	5.2%	8.9%	4.7%			
2012	2.4%	3.6%	5.6%	9.6%	1.6%			
2013	2.5%	3.8%	6.1%	9.0%				
2014	2.7%	4.1%	6.4%	7.3%				
2015	2.9%	4.4%	6.9%	5.3%				
2016	3.1%	4.6%	7.4%	3.4%				
2017	3.3%	5.1%	8.0%	1.1%				
2018	3.5%	5.4%	7.5%					
2019	3.8%	5.7%	6.0%					
2020	4.1%	6.2%	4.5%					
2021	4.3%	6.6%	2.8%					
2022	4.7%	7.1%	0.9%					
2023	5.0%	6.7%						
2024	5.4%	5.4%						
2025	5.7%	4.0%						
2026	6.2%	2.5%						
2027	6.6%	0.8%						
2028	6.2%							
2029	5.0%							
2030	3.7%							
2031	2.3%							
2032	0.8%							

NOTE: “Calendar Years to Expected Maturity” is defined in the preceding text. In the case of residential mortgages, where one-half the number of years to final maturity should be used, the parenthetical headings apply.

XXI. CAPITAL GAINS TAXES

The capital gains taxes incurred or recognized as the result of capital gains or losses due to interest rate changes, should be charged or credited to the Interest Maintenance Reserve and amortized in proportion to the before-tax amortization.

This amortization achieves the desired parity between holding and selling the bond except in the case of certain bonds for which the tax basis differs substantially from the statement basis.

Capital gains tax is determined using the documented company’s method of allocating taxes for statutory financial reporting.

XXII. RESERVE MAXIMUM AND MINIMUM LEVELS

No maximum is placed on the Interest Maintenance Reserve. The aggregate minimum value for the IMR for the Company is zero. The IMR may be negative for any Line of Business as long as the aggregate for all lines equals zero. Provision is made in the accounting rules that if an aggregate negative IMR is developed in the absence of the zero minimum, that negative value is carried over to subsequent years.

The basic rationale 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 values of the IMR, the same rationale applies. However, the concept of a negative reserve in the aggregate has not been adopted.

IMR CALCULATED QUARTERLY

The IMR calculations are done quarterly. Only a proportionate part of the reserve is released to the operating gain each quarter (25%, 50%, 75% on 3/31, 6/30, and 9/30 respectively).

XXIII. INITIALIZATION IN 1992

The initial value of the IMR at the beginning of 1992 was set equal to zero.

XXIV. TREATMENT OF MARKET VALUE ADJUSTMENTS

Certain policies and contracts issued by insurance companies provide for a market value adjustment should the policyholder or contractholder surrender the policy or contract before its maturity. The adjustments are distinguished by the fact that they are keyed to the current level of interest rates. Current accounting reports the excess of the liability released over the payment to the contractholder as a gain or loss in the year of surrender. This gain or loss should not be booked immediately since, if the underlying asset is sold, the interest-related gain or loss goes into the IMR; and if it is retained, the book earnings on it are no longer consistent with current market yields (a condition for which the MVA is intended to provide over the life of the asset).

Material gains or losses resulting from market value adjustments on policies and contracts backed by assets that are valued at book, including the associated marginal tax impact, should be captured by the IMR and amortized in the same manner as capital gains and losses on fixed income investments. The amortization schedules should be determined in a manner consistent with the determination of the associated market value adjustment.

The materiality minimum is the greater of \$1,000,000 or .01% of liabilities.

XXV. EQUITY LINKED PRODUCTS, PARTICIPATING BUSINESS

All capital gains/losses used to fund benefits, dividends or increase benefit reserves are excluded from the IMR to avoid utilizing these gains or losses twice in the financial statements.

XXVI. REINSURANCE OF A BLOCK OF BUSINESS

Whenever a block of business is sold and all the liabilities associated with the block are off the company's books, the IMR attributable to that block of business should be reduced to zero. The interest-related gains and losses on the assets are no longer needed to support the block.

It is inappropriate to eliminate the IMR associated with a block of business unless the associated assets are sold at the same time. If these assets continue to be held they will in effect be used to back other lines of business. The IMR procedure makes the appropriate adjustment to allow the assets to be so used.

XXVII. SALE, TRANSFER OR REINSURANCE OF LIABILITIES

The interest related gain or loss (net of taxes) associated with the sale, transfer, or reinsurance of a block of liabilities representing more than 1% of a company's General Account liabilities should be credited or charged to the IMR and then amortized into income. The company may elect a lower standard but once elected it can not be changed without Insurance Department approval. The transaction should be irrevocable and to a non-affiliate to qualify for the following treatment. The amount of the gain or loss that is interest related and the IMR amortization should be determined using the following three step procedure:

- (1) Identify the IMR balance and future amortizations arising from the past and present dispositions of the assets associated with the block of liabilities.
- (2) Identify the IMR balance and future amortizations that would result if the remaining assets associated with the block of liabilities were to be sold.
- (3) Define the interest-related gain or loss (net of taxes) to be the negative of the sum of the IMR balances determined in steps 1) and 2). The future amortizations of this gain or loss are the negative of the sum of the amortizations determined in steps 1) and 2).

The associated assets are the assets allocable to the reinsured block of business for the purposes of investment income allocation. If the company has not been tracking the investment income of the block, it should retrospectively identify the assets using procedures consistent with its usual investment income allocation procedures. The associated assets are not necessarily the same as the assets transferred as part of the transaction.

In certain circumstances, e.g., non-economic transactions between affiliates, assets are transferred at book value. In this case, step 1 applies for past and present realized gains/losses, but step 2 unrealized gains/losses is zero.

For modified coinsurance and coinsurance with funds withheld, the assets reside with the ceding company, and the following rules apply:

If the ceding company passes through to the reinsurer the gains/losses net of the change in the IMR, no IMR adjustment is made. Otherwise if all gains including IMR are passed through, follow Step 3. The assuming company must set up the IMR in the same amount as that released by the ceding company, subject to certain requirements.

The before tax amount of gain that would be realized were the associated assets to be sold is the excess of the current market value over the book value. Thus the interest related portion of the gain or loss on the liability side should be

equal to the excess of the book value of the associated assets over the sum of the current market value of these assets plus the current amount of the IMR associated with the block of business.

The book value of the associated assets less the allocable portion of the IMR is an approximation to the book value that the assets would have carried had there been no sales between the time of the original issue and the sale date. Thus the amount added to the IMR on account of the liabilities is approximately the mirror image of the amount which would be added had the original assets been held to the sale date and then sold coincident with the reinsurance transaction. For this reason this method is sometimes known as the "asset proxy method."

This procedure requires more extensive calculations. It presupposes that the company can identify:

- the assets that are presently associated with the liability, and
- the IMR arising from past dispositions of assets associated with the liability.

The assets allocable to the block would be the same as those used for investment income allocation purposes. This assures consistency and minimizes the administrative burden.

XXVIII. EXCESSIVE WITHDRAWALS

A. Background

Major book-value withdrawals or increases in policy loans can occur at a time of elevated interest rates. If these withdrawals or increases are far in excess of the withdrawals provided for in the company's reserving and cash flow testing, and if asset sales at this point are, in effect, forced sales to fund liabilities that are no longer on the books, the allocation of a negative amount to the IMR is not correct.

A company may also experience a "run on the bank" due to adverse publicity. This could occur even during a period of low interest rates, and the sale of assets to meet a run would conceivably produce gains. It is appropriate to register the gains immediately.

If the withdrawals were scheduled payments under a GIC, then there is a presumption that any gains or losses that might occur at the time of withdrawal should be added to the IMR since the gains or losses would be spurious if the company has followed a policy of matching its assets to its liabilities.

Note that many of the situations where an upsurge in withdrawal activity generates real losses arise when a company has a severe mismatch between its assets and its liabilities. Such losses can be present even in the absence of any realized gains or losses. The primary protection as to the adequacy of reserves in these circumstances is the requirement for an actuary's opinion.

B. IMR Exclusions

All realized interest-related gains or losses which arise from the sale of investments required to meet "Excess Withdrawal Activity" as defined below will be excluded from the IMR and will be reflected in net income.

XXIX. RECAPTURE OF REINSURANCE CEDED (10/99)

Upon recapture or commutation of a reinsurance arrangement, the reinsurer must follow the rules for reinsurance ceded and the original issuer must follow the rules for reinsurance assumed.

If the recapture is from an alien reinsurer not subject to IMR, an IMR liability adjustment is required, if the assuming company or any of its affiliates ever held the business, equal to the unamortized IMR liability adjustment of the business it originally held in the parent or a subsidiary.

XXX. WITHDRAWABLE RESERVES

Withdrawable reserves is the reserve or liability net of policy loans associated with any policy or contract that might be subject to a withdrawal or surrender without market value adjustment, either by the contractholder or plan participant.

Withdrawable reserves include the reserves associated with such things as

- Ordinary and Industrial Life,
- SPDA's, and
- Benefit sensitive GIC's where the associated plan allows participant withdrawals or transfers

To the extent that separate account assets are included in the IMR, the associated withdrawable reserves should be included with other withdrawable reserves.

XXXI. EFFECTIVE WITHDRAWALS

Effective withdrawals include withdrawals and surrenders that are unscheduled and calculated without market value adjustment plus the net increase in policy loans. Also included are transfers to separate accounts, other than transfers that are merely passing deposits or other considerations to the separate accounts or transfers that have been computed with market value adjustment.

- a. Withdrawal Rate is the ratio of the Effective Withdrawals to the Withdrawable Reserve at the beginning of the year.
- b. Threshold Withdrawal Level is 150% of the product of the lower of the Withdrawal Rate in the preceding and in the next preceding calendar year times the Withdrawable Reserves at the beginning of the year.
- c. Excess Withdrawal Activity is the amount by which Effective Withdrawals for the year exceed the Threshold Withdrawal Level.

The 150% threshold is somewhat arbitrary. IF the threshold were set lower, there would be a significant likelihood that the normal year to year fluctuations might generate excess withdrawals. On the other hand setting the threshold at a higher level might exclude a large fraction of the withdrawals even in the case of a run on the company. The factor should be re-examined periodically to assure that an appropriate balance is maintained between these two competing goals.

Only those investments required to provide cash flow to meet excess withdrawal conditions are to be excluded from the IMR. If the company can identify the specific sales that are associated with the excess withdrawal activity, these sales would be excluded from the IMR. Alternatively a pro rata portion of all sales during the year equal to the amount of excess withdrawal activity should be excluded from the IMR.

d. Example

Example - Suppose a company has the following Withdrawable Reserves and Effective Withdrawals.

<u>Year</u>	<u>Withdrawable Reserve Beginning Of Year</u>	<u>Effective Withdrawals</u>
t-2	1,000	100
t-1	1,200	108
t	1,300	195

Then the Withdrawal Rate is 10% for year t-2 and 9% for year t-1. The Threshold Withdrawal Level for year t is 150% of 1,300 times 9% or 175.5, and the Excess Withdrawal Activity is 19.5. Thus if the company had asset sales in excess of 19.5, a portion of those sales would have to be identified as associated within the withdrawal activity and the associated capital gains and losses should be excluded from the IMR. If the company had asset sales of less than 19.5, all of the associated gains or losses should be excluded.

XXXII. PREFERRD STOCK

Preferred stock should be treated in a manner similar to bonds since they are rated. That is, gains or losses will be considered interest-related if ratings have not changed by more than one category in the period since purchase (or December 31, 1992, if later) and the rating has not been RP 4 to RP6, or P 4 to P6, during that period.

XXXIII. REPLICATIONS (Synthetic Assets)

Realized capital gains/losses, other than those due to counterparty default, on the derivative component of the replication, that is not a swap of prospectively determined interest rates should be reported as interest related or credit related to the AVR sub-component, as if they were gains /losses on the replicated assets.

Capital gains/losses on the cash components of the replication should be categorized and reported as if there was no replication transaction.

Interested related gains/losses associated with the cash component should be amortized in the same way as if there were no replication. Interest related gains/losses associated with the derivative component of the replication that is not a swap as previously described, should be amortized as if that arose from the replicated asset.

Realized capital gains/losses arising from a swap of prospectively determined interest rates constituting a component of a replication transaction should be reported in the IMR maturity bucket corresponding to the side of the transaction with the longest guarantee period.

Capital gains/losses arising from counterparty default should be separately identified and reported in the AVR bond or preferred stock sub-component.

XXXIV CAPITAL AND SURPLUS NOTES (1998)

Interest related gains and losses realized on directly held Capital and Surplus Notes are included in the IMR as their fundamentals are consistent with those of other fixed income investments. The gain/loss is classified as interest related if the note is eligible for amortized value accounting both at issue and at time of sale.

XXXV. APPENDIX: GROUPED AMORTIZATION SCHEDULES

In order to determine an amortization schedule that is appropriate for the calendar year groupings for the simplified method, the following assumptions were made:

- . The Company owns only bonds purchased at par;
- . Within any five year interval, the par amount of the bonds sold is evenly distributed by duration to maturity;
- . The sales are evenly distributed throughout the year; and
- . There is no correlation between the sale date, the duration to maturity, and the coupon rate.

Under these assumptions the ratio of the unamortized gain remaining at the end of a year t years following the year of the gain to the total original gains on bonds with between $5n+1$ and $5n+5$ calendar years to maturity at the time of sale is given by:

Numerator/Denominator

Where

$$\text{Numerator} = \left\{ \begin{array}{ll} 5 \cdot v^{5n-t} \left(\frac{1-v^5}{\delta} \right) & \text{if } t < 5 \cdot n \\ 5 \cdot (n+1) - t - \left(\frac{1-v^{5(n+1)-t}}{\delta} \right) & \text{if } 5 \cdot n \leq t \leq 5 \cdot (n+1) \\ 0 & \text{if } 5 \cdot (n+1) \leq t \end{array} \right\}$$

$$\text{Denominator} = 5 - v^{5n} \cdot \left(\frac{1-v^5}{\delta} \right) \cdot \left(\frac{1-v}{\delta} \right)$$

R = Reference Interest Rate for SPIA's to nearest 1%

$$v = \left(1 + \frac{R}{2} \right)^{-2}$$

δ = The force of interest

$$= 2 \cdot \ln \left(1 + \frac{R}{2} \right)$$

ROLE AND PURPOSE OF THE
ASSET VALUATION RESERVES

XXXVI. PURPOSE

Develop a better measurement and communication of the overall risks of asset credit or default losses faced by a company - through the development of an asset valuation reserve and Risk Based Capital. The Asset Valuation Reserve is designed to provide for fixed income asset credit or default risks with the same probability or level of confidence as that of all other statutory valuations reserves held and developed for book value based asset values for life insurance products. This reserve accumulates the risk portion of each investment yield payment to provide for future credit losses as they occur and builds toward a desired reserve objective. This AVR requirement reduces minimum Risk Based Capital requirements significantly. The AVR is also added to Total Adjusted Capital in the Risk Based Capital requirements comparison.

XXXVII. SUMMARY

When a company purchases an asset, there is a risk that the promised cash flow from the asset will not be achieved, and it is proper accounting to require the company to reserve against such risks. Without such reserving, financial income is overstated from time to time. In fact, in doing cash flow testing, the actuary is required to deduct an appropriate amount from the promised cash flow to provide for the possibility that some interest will not be paid, or that there will be a loss of some of the principal. This can either be done directly in the calculation or indirectly by using the AVR Default Component Reserve Objective as the measure of these possible future losses, as noted earlier. The AVR's objective is to provide for these asset credit or default risks with the same likelihood or probability as that of other statutory reserves held. These risks are an integral portion of the valuation risks that are to be considered by the Company and the Valuation Actuary in doing asset adequacy testing.

The actuary also has to comply with minimum valuation standards, which assume that future obligations will be discounted at a low rate of return. When a more risky asset is purchased, the promised yield is usually higher than the low valuation rate by considerably more than the average expectation of loss. Thus the probability that the asset will be sufficient to mature the obligation is at least 50%.

However, an additional asset valuation reserve (AVR), is appropriate under statutory accounting because there will be variation from expected results. This reserve should be available to absorb default losses in excess of expected. Although this additional reserve could be established immediately upon the acquisition of a risky asset, such a practice is inconsistent with the present system of statutory reserve standards and asset book values. Also, as a practical matter, it would deter insurers from making investments in risky assets. Instead, the Asset Valuation Reserve is built up gradually toward the desired reserve objective. Such buildup is funded annually by a portion of the extra yield on the asset (to the extent not needed to pay for current asset losses). This is consistent with the concept that potential losses will occur sporadically over a period of time.

In this way, the asset valuation reserve works very well in an environment of formula statutory minimum reserves and book value accounting of assets. It also works effectively in a cash flow testing environment, and to this end the reserve should be treated the same as any other actuarial reserves for cash flow testing purposes. When the asset valuation reserve is low, the actuary doing cash flow testing may need to set up additional reserves and vice versa.

The Asset Valuation Reserve concept emphasizes the "reasonably conservative" approach and is analogous to the level of conservatism in policy reserves. As such, the AVR is an important measure of some of the asset risks of the company, just as reserves measure some of the other risks.

The remainder of the asset risk (the provision for catastrophic risks) should be covered by unallocated surplus according to standards set in a consistent manner. RBC was developed to cover the minimum surplus requirements. Hence, there is a continued need to coordinate this work with the work on life risk-based capital.

The Life RBC and AVR and IMR Committees coordinate their efforts to ensure consistent treatment and coordination of their respective requirements.

XXXVIII. DETERMINATION OF NUMERICAL VALUES FOR AVR FACTORS

The Bond and Preferred Stock factors assume a 10 year horizon, a 40% recovery in event of default, a 26.25% tax rate, a discount rate of 5.9%, and appropriate basic default data covering extended economic cycles.

In many respects the work to develop factors is never finished. Although the current AVR factors are reasonable, there will always be the need for further work. The factors should continue to undergo periodic updating and refinement to achieve consistency with the philosophy and rationale that underlies them. Questions of risk, probability and uncertainty are always difficult to translate into numerical terms, and this is as true for the valuation of assets as for any other aspect of life insurance. Relevant experience studies are needed and also careful analytic work. Future work must continue to be given the full support of the insurance industry and its regulators.

XXXIX. CRITERIA/TIMING FOR FUTURE CHANGE OF FACTORS

Factors may be changed as a result of emerging data, significant changes in experience, a request by the regulators or by interested parties. Any change will be coordinated with similar changes in RBC factors. See Appendix G for a complete description of this process.

The AVR factors will generally be changed one to two years later than those of RBC due to codification process.

THE DEFAULT COMPONENT OF THE ASSET VALUATION RESERVE

XL. GENERAL DESCRIPTION

The Asset Valuation Reserve is split into four subcomponents by major type of asset, not for the purpose of limiting the application of each component, but in order (i) to track separately the level of each subcomponent to see that it is performing as intended, and (ii) to permit the possible use of a different structure by type of asset. The two subcomponents having to do with fixed-interest securities are grouped in the Default Component, and the two equity subcomponents are grouped in the Equity Component.

The Default Component within the Asset Valuation Reserve consists of the following subcomponents:

- Bond and Preferred Stock Subcomponent (which includes mortgage backed securities)
- Mortgage Subcomponent

This component is designed to provide for all credit-related risks for fixed income investments.

XLI. THE BOND AND PREFERRED STOCK SUB-COMPONENT

A. Sub-component Balance

The Sub-component Balance at the end of the year is

the Accumulated Balance, plus

an Additional Contribution, plus

any transfers from other sub-components, plus

any voluntary contributions, less

any transfers to other sub-components

The Ending Balance cannot be less than zero nor greater than the maximum.

B. Maximums

Within each sub-component, a maximum factor is established for each constituent category of fixed income investment. The Maximum Balance for that sub-component is the sum of the statement value in each category times the corresponding maximum factor. Maximums are defined in a subsequent section.

The maximum factor for each asset class is set equal to the RBC factor for that class. This is logical since the AVR reserve objective is about 85% vs. a 98% objective for RBC. The AVR should not logically exceed the RBC amount.

The AVR maximum is equal to the RBC factor times the amount of assets in that asset sub-component.

C. Accumulated Balance

The Accumulated Balance in each sub-component of the Default Component is equal to:

the Reserve or Balance in the sub-component at the beginning of the year, plus,

the credit-related recognized capital gains net of taxes, including deferred taxes, on assets for (1) the General Account and (2) the Separate Accounts corresponding to the sub-component, less,

the credit-related recognized capital losses net of taxes, including deferred taxes, on assets for (1) the General Account and (2) the Separate Account(s) corresponding to the sub-component, less

the capital gains credited/(losses charged) to contract benefits, payments or reserves, plus

the capital gains plus taxes are determined based on the documented company's allocation method for taxes in their financial statements and unrealized gains/losses are adjusted for deferred taxes consistent with the NAIC Accounting Practices and Procedures Manual for Income Taxes I

the Basic Contribution.

Note: The credit-related gains referred to above can occur as the result of the reversal of previous credit-related losses.

Since only recognized credit-related capital gains and losses are charged to the Default Component, it is important that the factors used for the Maximum Reserves, Basic Contributions, and the Reserve Objective be consistent with the rules used to recognize losses. At present, neither a foregone interest payment nor the true economic loss at the time of a restructure is recognized as a capital loss. This is particularly important for mortgages, since missed interest payments, and restructures are more common in the mortgage market than in the bond market. If the accounting rules were to recognize the losses at the time they occur, the rules governing the AVR should be modified to be consistent with the accounting rules.

D. Exclusions

Capital gains or losses that are directly credited to policyholders as benefits, reserves, or payments are deducted since to do otherwise would duplicate the utilization of such gains or losses.

XLII. BASIC CONTRIBUTION

The required Basic Contribution factor for each sub-component of the Default Component is calculated to be equal to the expected net long-term annual capital losses after taxes per thousand dollars for each asset class.

The Basic Contribution for each asset class is then determined by multiplying the appropriate factor times the amount of assets in that asset class.

XLIII. ADDITIONAL CONTRIBUTIONS

Gradual funding of the reserve objective will be achieved by making additional annual contributions to the sub-components. This contribution amortizes the difference between the Reserve Objective and the Accumulated Balance. The Additional Contribution is equal to:

$$20\% (\text{Reserve Objective} - \text{Accumulated Balance})$$

Where the Reserve Objective is determined by multiplying the Reserve Objective Factor times the amount of assets in that asset sub-component class. The reserve objective factors were developed to provide the appropriate level of conservation, or confidence levels, comparable to that of other statutory reserves.

Extensive historical studies and simulations were prepared for each class of fixed income investments to calibrate each of the factors.

As a result over time, the AVR balance for each sub-component should average about the reserve objective as this additional contribution will always amortize any differences toward that result. Theoretically the annual contribution (basic plus additional) will tend towards a weighted average of past losses (if the maximum is stable due to a constant level of credit exposure and larger than average if the maximum is increasing due to increasing total company credit exposure).

If a large value for the Amortization Factor were to be chosen, very large reserves would have to be built up in a very short time, and a greatly increased reserve would be required of rapidly growing companies. If the value of the Amortization Factor were to be set very low, the reserve would never build up to any significant amount. It seems logical that the choice of an amortization factor should reflect the amount available to fund the reserve. For fixed income investments, this is the yield spread between the security in question and a risk-free security. As an approximation, this yield spread appears to be roughly 20% of the maximum factors that are described in the next section. An Amortization Factor of 20% is not greatly different from the system in effect prior to the current version of the AVR. Furthermore, since mortgages and real estate are included in the AVR and were not in the prior system the amount of annual contribution that is required was greatly increased in 1992. Hence, an initial phased-in transition was provided in 1992.

XLIV. TRANSFER RULES FOR SUB-COMPONENTS

If the ending balance (Accumulated Balance plus Additional Contribution) in a sub-component is greater than the maximum, then the excess should be transferred to the other sub-component of the Default Component. Only if both sub-components are at or above their maximums should excess amounts be released to surplus. Consideration was given to requiring transfers to the Equity Component when the Default Component is full, but this was rejected because of the significant differences in the nature of the two components.

A company may voluntarily make such a transfer.

XLV. NEGATIVE SUB-COMPONENTS AFTER ADDITIONAL CONTRIBUTION

If a sub-component is negative after the Additional Contribution, and the "sister" sub-component, within the same component, has a positive balance, a transfer should be made but only to the extent it does not reduce the balance in the "sister" to less than 50% of the balance prior to transfer.

The objective is to treat the components of the Asset Valuation Reserve as providing for all types of credit-related loss, regardless of the sources of the reserve. The 50% limit is a practical constraint within this general objective.

XLVI. VOLUNTARY CONTRIBUTIONS

Voluntary contributions may be made by the Company if a sub-component is not at its maximum. Once a voluntary contribution is made it cannot be voluntarily withdrawn.

XLVII. MORTGAGE SUB-COMPONENT

Mortgages have many of the same characteristics as bonds, such as fixed yields that are higher than risk-free rates of return reflecting the higher risk of loss. The basic objective is to establish a structure very similar to that of bonds, yet reflecting some of the special features of mortgages in the sub-component structure. Available loss data is not as reliable as that of bonds.

Most importantly, there are no generally accepted quality ratings for mortgages. Companies often do internal ratings but these do not necessarily accord with any standardized system. Quality ratings sometimes do exist for individual mortgages, and ratings have sometimes been assigned to securitized mortgage pools but these ratings depend as much on financing features as on underlying risk. In short, it is not possible to establish a structure that reflects a mortgage portfolio's quality according to objective external standards.

Mortgage loans are reported in four categories to reflect significant differences in loss experience. These are:

- A. Government Insured or Guaranteed
- B. Other Residential (1 to 4 family units)
- C. Farm/Agricultural
- D. Other commercial.

Any loss on an asset which occurs as an asset is reclassified from mortgage to real estate is assigned to the Mortgage Sub-component.

Clearly there are major differences among companies in the quality of mortgage portfolios for its farm/agricultural loans and for all other commercial loans. In order to give effect to a company's mix of these loans and of their geographic concentration, the basic contribution, the reserve objective and the maximums are adjusted to its own experienced delinquency, foreclosure and restructured rate in relation to the average industry experience. The Experience Adjustment Factor is the moving average (over two years) of the company's quarterly delinquency, foreclosure and restructured rates divided by the comparable two-year moving average for the industry. The industry experience is obtained through annual surveys by the NAIC. The initial survey period was done for 1990 and 1991 for use in December 1992.

Because of timing problems the industry and company experience is based on a two-year period ending in the third quarter of the current statement year.

XLVIII. EXPERIENCE ADJUSTMENT FACTOR (EAF)

The Experience Adjustment Factor is calculated by dividing the Company's Experience Factor (CEF) by the Industry's Experience Factor (IEF). The Company's Experience Factor is the average of the ratios calculated for each of the preceding eight quarters, with the eighth quarter being as of September 30 of the current statement year.

The company will calculate each quarterly ratio (CEFQy) by taking: the sum of (1) .02 x the amount (mean value) of Farm and Commercial Mortgage loans overdue by more than 90 days, (2) .025 x the amount of loans in the process of foreclosure, (3) .12 x the amount of Commercial Mortgage loans foreclosed during the time period and (4) .01 x the amount of restructured and in good standing Commercial mortgages Loans divided by the sum of (1) the mean book value of Farm and Commercial mortgage Loans held, (2) .5 times the amount of loans foreclosed during the quarter, . Where the mean is the average of the values at the beginning and end of the quarter.

A reasonability range has been set for the Experience Adjustment Factor; namely that it should not be less than .5 nor greater than 3.5. This range will prevent values that could arise from unusual or spurious data.

In immature portfolios, where a company has not had five years of applicable mortgage experience, the Experience Adjustment Factor should not be less than 1.

The EAF is calculated as the average of the CEFQy for the same eight quarters experience divided by the average of the IEFQy for the eight quarters.

As a result the AVR for mortgages depends on the company experience relative to industry experience. If a rating system is developed for mortgages, then individual factors should be developed for each class just as there are for bonds.

Companies not required to file a quarterly statement will calculate the Experience Adjustment Factor as if a quarterly statement had been prepared. The maximum reserve factor resulting from Experience Adjustment calculation may not be less than 1.75%, and may not exceed 12.25%, except that for companies with less than five years mortgage experience, the minimum factor is 3.5%. Actual results depend on the column reporting in the AVR instructions.

The factor recognizes restructured mortgages since restructured mortgages often are a signal of deteriorating quality. However, the schedule shows existing mortgages that have been restructured at any time in the past, and therefore represents an inventory of restructures rather than the amount of activity in the most recent quarter. Hence to simply add this amount into the denominator of the ratio would overweight the restructures in comparison to the foreclosures and delinquencies (which reflect recent activity only). To correct for this, restructured mortgages are included in the Experience Ratio for year t using $t-2$ and $t-1$ years experience, giving a 50% weight to restructures in each year. For example, for 2004 use the 2002 and the 2003 restructure experience.

XLIX. APPLICATION OF EAF TO FARM AND OTHER THAN GUARANTEED/INSURED COMMERCIAL MORTGAGES

The Basic Contribution Factor, the reserve objective factor and the maximum factor for (1) farm/agricultural and (2) other commercial mortgage loans are each multiplied by the Experience Adjustment Factor to adjust for the company experience for losses relative to the industry average.

L. MORTGAGE LOAN FACTORS

The mortgage loan default component factors for each of the four categories defined earlier based on a 1994-1995 study were developed for the basic contribution, the reserve objective and the maximums for:

1. Mortgage loans in good standing (original terms)
2. Mortgage loans in default - not in process
3. Mortgage loans in process of foreclosure

The AVR committee sponsored this study of the risk of loss on commercial mortgages with the Society of Actuaries data, using modeling technologies not previously available. The modeling technology is based on loan-to-value ratios, similar to those used in pricing models for residential secondary mortgage markets. After a series of model input quality questions were answered, interested parties concluded that the model confirmed that realistic risk of loss experience warranted a lower factor for commercial performing mortgages of 2.0%. Subsequently, the AVR committee and the Life Risk Based Capital Working Group agreed on a 2.25% factor for commercial performing mortgages.

LI. OTHER MORTGAGE CATEGORY'S FACTORS

The factors for the other categories were developed consistent with the commercial mortgage factor. The Committees were also guided by the general conclusion that the mortgage risks were about midway between the risks of Class 2 and Class 3 bonds. The available loss data is not as reliable as that of bonds. Furthermore, troubled mortgages are often restructured in a way that no accounting loss is recognized at the time of restructure, but rather the economic loss is taken as a reduction in future interest earnings or a deferral of repayment.

LII. U.S. GOVERNMENT SECURITIES

Securities backed by the full faith and credit of the U.S. Government, or required by state or federal law to be treated by insurers in a manner similar to full faith and credit instruments of the U.S. Government, are exempt from AVR treatment. The loan-backed securities of such agencies and structured securities, as defined in the NAIC Annual Statement Instructions for Schedule D, Part 1A, Section 2, regardless of issuer, are not exempt.

The SVO Manual instructions define which securities are classified as exempt or included in the AVR.

LIII. FEDERAL AGRICULTURAL MORTGAGE CORPORATIONS (3/99)

The Federal Agricultural Mortgage Corporations are exempt from the AVR. This includes their bonds, notes, etc.

LIV. MUTUAL FUNDS

There is a distinction between money market funds and other mutual funds. Securities backed by the full faith and credit of the U.S. government, or similar securities, including money market funds invested in such securities, are exempt from the AVR. Thus, if the money market fund invests exclusively in full faith and credit U.S. Treasury bills, notes, and bonds, and collateralized repurchase agreements comprised of these obligations, then the fund is exempt from the AVR requirements. These investments are reported on Schedule DA, Part 1.

The reserve factor for other money market funds (other than those qualifying under the criteria in the final paragraph) should correspond to the rating by S & P or Moody's Investor Services. These funds would be reserved according to a matrix which would use the Standard and Poor's/Moody's ratings as a starting point, with appropriate additional factors. Money market funds would accumulate reserves in a manner similar to other fixed income components.

Other mutual funds, which are not Money Market funds, should continue to be reserved as equity securities. However, the reserving treatment for certain proscribed classes of bond mutual funds parallels the treatment they would receive were the investments of the mutual fund held directly. To qualify for NAIC 1 equivalent treatment, these bond funds must submit documentation to the NAIC's SVO. The qualifications include: maintaining the highest credit quality rating given by an SVO-approved rating agency to a fund that invests in class one bonds issues or guaranteed as to principal and interest by agencies and instrumentalities of the U.S. government; including loan-backed bonds, and collateralized mortgage obligations, and collateralized repurchase agreements comprised of those obligations; cannot invest in derivative instruments; and, cannot invest in a number of leveraged or deleveraged notes which pay a multiple or fraction of an index or indices; and various other securities. The complete requirements are outlined in the SVO Purposes and Procedures Manual.

THE EQUITY COMPONENT OF THE ASSET VALUATION RESERVE

Background

The task of achieving consistency between the valuation of equity investments and insurance liabilities is much more difficult than the corresponding task for fixed income investments. The difficulty is further compounded by the disparity between the accounting methods used for real estate and Schedule BA assets and the accounting methods used for common stock.

Current accounting practices also create mismatches and possible distortions in financial statement operating income when capital gains/(losses) realized or unrealized, are part of the product design or pricing and, therefore, the reserves (e.g., equity indexed products or Universal Life policies) or policyowner dividends. Consideration has been given to further refine the AVR Equity Component to minimize these distortions but they have not been agreed to or implemented.

It might be natural to want to treat equity investments in a manner that is entirely parallel to other investments, but that proved not entirely possible. For example, it is appropriate in theory to carry an interest maintenance reserve for equity investments since the value of those investments do respond to changes in the interest rate environment. However, the problems in constructing an IMR for equity investments was seen to be too great; therefore, this aspect of the reserve was dropped. Furthermore, it is necessary to recognize the movement of market values more explicitly in the treatment of equity investments since market appreciation is part of the expected long run return on equities. Common stocks are indeed valued at market, but real estate and some other equities are carried at depreciated value or amortized value. In order to recognize significant increases in the underlying value of real estate assets, a variation from the basic AVR approach was selected.

LV. AVR EQUITY COMPONENT

A. Roles

The AVR equity component serves two roles. First it acts primarily as a buffer to unassigned surplus to protect it from the changing market values of common stock. This enables the company to demonstrate its ability to manage unassigned surplus independent largely of market changes to common stock values that are beyond its control.

The equity component also provides for credit or default losses on equities. As noted earlier, it is very difficult to measure or distinguish these separately as was done for fixed income investments.

B. Level of Aggregation

There is no theoretical reason to separate the common stock AVR from that of other equity investments; but the desire to track separately the results on common stocks and possibly to separate assets valued at market from those valued at book, as well as to be sure that the factors chosen do indeed lead to a sufficiently strong reserve, led to separate sub-components, in a more or less parallel manner to the two sub-components in the Default Component.

C. Components-Rules

The Equity Component of the Asset Valuation Reserve is divided into two separate sub-components, one for common stock and one for real estate and any other invested assets. The structure of an Accumulated Balance, including a basic contribution, plus an additional contribution, reserve objectives and maximums should be the same as those for the Default Component (although the definitions will differ to ensure meeting desired objectives) and the rules for transfers between sub-components established for the Default Component should also apply to the Equity Component.

LVI. BASIC CONTRIBUTION, RESERVE OBJECTIVES, MAXIMUMS

A. Basic Considerations

The factors for the basic contribution were set equal to zero for common stock and real estate. Theoretically, they should be negative to reflect average expected gains that are typically expected of these investments. The basic contributions for other invested assets (Schedule BA) are the same as those of the underlying investments. That is bonds are like bonds, mortgages like mortgages, etc. All others are zero.

B. Reserve Objectives/Maximums

The maximums are set equal to the reserve objectives since this component will tend toward the maximum as it captures all capital gains, none of which are released to surplus until the equity component is at maximum. These definitions were driven by practicality and are consistent with the overall AVR objectives.

LVII. VOLUNTARY CONTRIBUTIONS/NEGATIVES

Voluntary contributions may be made. Negative balances shall be adjusted to zero.

LVIII. REPLICATIONS (6/98)

For replicated (synthetic assets) the basic contribution, the reserve objective and the maximum reserve are determined using the appropriate asset class of the replicated asset times the asset class factor. For the cash component that qualify for a credit, use the factors for the asset class of the cash component but not higher than the result for the replicated asset.

LIX. DERIVATIVE INSTRUMENTS

A. Hedging Transactions

Capital gains/losses are allocated to the IMR or the AVR based on the treatment of the underlying asset. Realized gains/losses on portfolio or general hedges are included with the hedged asset. Gains/losses on specific hedges are only recognized if the specific hedged asset is sold.

B. Income Generation

Report in the same sub-component where the gains/losses of the underlying interest for a put or covering asset for a call, cap or floor is reported. See the NAIC Accounting Practices and Procedures Manual for detailed accounting guidance about Derivatives.

THE COMMON STOCK SUBCOMPONENT

The need to fund a reserve that produces a net carrying value (statement value minus associated AVR) strong enough to survive fairly adverse market circumstances has led to a 13% maximum reserve after tax factor for the typical portfolio of publicly traded common stocks. This factor covers 85% of the biggest drops in the S&P 500 Index values during a two-year period. See the appendix titled "Justification for the AVR Factor for Stocks", for a description of the statistical rationale underlying this factor and showing that this structure produces extremely strong reserve and net carrying value. This factor must be adjusted by Beta to reflect the risks in portfolios that contain publicly traded stocks of greater or lesser riskiness than the typical portfolio.

See the Appendix for a description of Beta and how it is to be calculated. A company shall use an appropriate foreign index (e.g., TSE 300 for Canadian Stocks) to calculate Beta if it has identified common stock supporting liabilities both of which are in the same foreign currency (1998).

Consistent maximums were also established for subsidiaries, controlled or affiliated company common stock, and non-public stock. In the case of life subsidiaries that hold their own AVR or its equivalent, there need be no additional AVR at the parent level. A look through to the asset risks and AVR requirements of the underlying assets is used for Investment Subsidiaries. This ensures that assets do not get transferred from the parent to the subsidiary merely to avoid AVR; although not entirely satisfactory this does provide a practical solution (note that operating profits or losses do flow to the parent company's surplus once divided up or covered by infusion). For all other subsidiaries and privately held stocks, the reserve objective and maximum is 16% after taxes.

LX. CONVERTIBLE BONDS OR PREFERRED STOCK

Any gain or loss realized from the sale of any convertible bond or preferred stock before conversion, purchased while its conversion value exceeds its par value, and whose NAIC/SVO classification did not change by more than one NAIC/SVO rating classification during the holding period, is included in the equity component of the AVR. Conversion value is defined to mean the number of shares available currently or at the next conversion date, multiplied by the stock's current market price (including capital SHLB).

The Federal Home Loan Bank stock will have the same factors as those of preferred stock.

LXI. SUMMARY—RESERVE OBJECTIVES AND MAXIMUM

For publicly traded stocks, the reserve objective and maximum is 13% of statement value, adjusted by a Beta factor, but no less than 10% nor more than 20%. A "safe harbor" 20% factor may be used to avoid the Beta calculation. The 20% factor is also used for publicly traded common stocks issued within the past five years, or where no Beta is available.

For subsidiaries, the factors are 0% and 13% where appropriate.

For all other common stock, 16%

For common stock holdings of the Federal Home Loan Banks, the basic contribution is 0.0018, the reserve objective is 0.0050 and the maximum is 0.0080.

LXII. REAL ESTATE SUBCOMPONENT

A. Contributions, Reserve Objectives, and Maximums

1. Real estate is reported in four categories:

- a) Company occupied;
- b) Investment properties;
- c) Acquired by foreclosure and
- d) Held on Schedule BA

Based on internal company records. These classifications have been used in the statutory state until codifications. The new classifications are not useful for risk measurement purposes for both the AVR and the RBC.

B. Basic contribution, Reserve Objective, Maximum Reserve

The basic contribution and the additional contributions are set equal to zero. As with common stock, the basic contribution should be negative as one expects appreciation of real estate to be an integral part of its total return and it should in almost all cases exceed any defaults or credit losses.

The Reserve Objective is set equal to the Maximum Reserve. The factors for both are 7.5% of the statement value plus any encumbrances, for company occupied and investment real estate and 11% for foreclosed properties reflecting their higher risk.

C. Determination of Factors

If real estate were always carried in the annual statement at market value, the reserve objective and maximum could be expressed directly as a function of the statement value. The maximum factor should be related to the volatility of market values. One unpublished study of a large pool of commercial real estate properties has a standard deviation of 9%. Another study (Ibbotson) reported a standard deviation of 5% using appraised values. Since research has shown that the appraisal process reduces volatility by almost half, this is also equivalent to about a 9% standard deviation of "actual" market valued property. It appears that the volatility of real estate is less than half of the pre-tax factors for common stocks, and thus a reserve objective and maximum of 15% is appropriate, or 10% after taxes. An exception might be for unimproved real estate, for which, once reporting mechanisms are established, a higher maximum might be appropriate.

However, where the market value of real estate exceeds the book value, the difference is an "unrecognized gain" that is not reported on the statement. The reserve maximum should be reduced by the unrecognized gain. But rather than express the maximum as 10% of market value, less any unrecognized gain, a better approach is to express it as 10% of statement value, less 90% of unrecognized gain. The purpose of doing it this way is to provide a formula that can be used by those companies that choose to forego the determination of unrecognized gains.

In estimating risk for real estate, it must be understood that for encumbered real estate the risk is proportional to the gross investment, not the net after the deduction of encumbrance.

The Maximum for real estate conceptually should be 10% of the statement value plus any encumbrances. However, real estate subject to a non-recourse mortgage should not be assigned an AVR Maximum higher than the insurer's carrying value. The Maximum may be reduced, for those companies that choose to use a satisfactory appraisal process, by 90% of the unrecognized gain. In no case, however, may the maximum be less than 2% of the statement value plus encumbrances.

The use of appraisals would be necessary if market values of real estate are to form the basis of calculations, since the determination of value is not determined by an active and homogenous market as is the case for common stocks. The determination of appraised value is always somewhat subjective, and therefore standards and procedures must be set to ensure that discipline is maintained. Furthermore, since appraisals do not normally recognize selling costs, these must be deducted to achieve the proper basis for calculation of the reserve.

D. Appraisals

Two basic premises or guidelines for appraisals are: First, the appraisal must be credible. Second, the appraisals and the ongoing appraisal process should be cost efficient. Possibilities that meet these criteria are:

1. Annual appraisals are proposed for property of a book value of .5% or more of general account assets and for property whose book value exceeds 5% of an insurer's surplus.
2. Properties having book values less than those stipulated in paragraph 1, above, would have appraisals performed every other year.
3. The appraisers utilized by the insurers should have demonstrated professional competence and independent accountability. Appraisers may be either employees of the insurer or consultants retained by the insurer.
 - a. Internal Appraisers. Appraisers who are employees of the insurer should be appointed by the insurer's board of directors to perform the appraisal procedures. In making its appointment, the board of directors should determine that the individual(s) appointed have sufficient training and experience to perform appraisals of the type of real estate owned by the insurer. The appraisal records should be kept by the insurer and should be made available to the [superintendent] upon request.
 - b. Consultant Appraisers. An insurer may retain consultant appraisers to perform the real estate appraisals; provided, that any such consultant appraiser shall either: (a) be licensed as an appraiser by the regulatory authority of the state in which the property exists; or (b) have a professional designation which, in the judgement of the insurer, is indicative of the required professional competence.

Given the difficulties of implementing all the rules for determining excess of market values over book for real estate, the objectives and maximum for real estate were based on statement value plus any encumbrances, unadjusted for the excess of market value over book. The 10% factor was reduced to 7.5% to reflect the lack of specific provision for reducing the requirements when market value is above book. However, real estate subject to a non-recourse mortgage should not be assigned a Maximum higher than the insurer's carrying values.

LXIII. SCHEDULE BA ASSETS

It is difficult to make a numerical judgement of the risk involved for BA assets without knowing the nature of the assets on a particular company's Schedule BA. The best approach is to split the assets between categories according to their true nature and include them in the appropriate sub-components with their factors for each asset. For example:

Transportation equipment should be treated as fixed income assets with AVR treatment depending on the bond rating of the senior debt of the lessee.

Collateralized loans, mortgage participation certificates, and similar holdings should be classified as fixed income assets with an AVR treatment based on an SVO bond rating.

Timber and mineral rights have potential variability of return and should be categorized as equity securities in the AVR.

Partnership investments should be classified as fixed or equity securities or as equity real estate, depending on the purpose of the partnership. The AVR treatment and factors should be appropriate for that asset classification and consistent adjustments for encumbrances should be made.

·A "look through" approach should be taken for any Schedule BA assets not specifically listed, so as to reflect in the AVR calculation the essential nature of the investment.

Where it is not possible to classify an asset in accordance with one of the AVR sub-components, a 13% maximum factor and reserve objective should be used.

Collateral loans from Schedule BA are eliminated from the AVR since prior to 1998 they were reported in Schedule C and no AVR factor was applied. Transferring them to Schedule BA should not subject them to a 20% factor.

SEPARATE ACCOUNTSLXIV. IMR FOR BOOK VALUE SEPARATE ACCOUNTS

Where assets and liabilities of a Separate Account are valued on a market value basis, no IMR is needed as assets and liabilities are already consistently valued. Assets and liabilities of a Separate Account may, however, be on a book value basis as, for example, for modified guaranteed annuities or modified guaranteed life where the book value Separate Account option has been elected under New York Regulations 127 or 136 respectively. In such a case, an IMR is required as it is for any other General Account product; it is not required for market value Separate Accounts.

A. Requirements for Asset Defaults Borne by the Company

Where asset defaults are passed directly on to policyholders, for example variable annuities and variable life insurance, clearly no AVR is needed. There are, however, Separate Accounts where asset defaults are essentially borne by the company. Examples would be modified guaranteed annuities and modified guaranteed life where the company passes on some of the interest rate risk but generally retains the asset default risk (note that this is equally true whether the market value or book value Separate Account option has been chosen). In such cases, an AVR is required as it is for any other General Account product.

B. AVR Treatment if AVR Equivalent is Required

On the other hand, there are certain Separate Accounts where asset defaults are borne by the company but where the equivalent of an AVR is required by the reserving. An example would be Separate Account group annuities valued under New York Regulation 128. Under Reg. 128, additional amounts must be held based on various asset categories and qualities, which are intended to provide for the asset default risk. Reg. 128 explicitly stipulates that no AVR is to be calculated for such products (otherwise there would be double counting). In such a case, no AVR need be held.

C. Financial Statement Requirements

An AVR is required for Separate Accounts where some or all of the asset default risk is borne by the company, except where regulations require the equivalent of an AVR be included in other reserves.

An IMR supporting a Separate Account's assets is established in that Separate Account. A Separate Account AVR is combined with the General Account's AVR.

An IMR is established in the Separate Accounts, when it is appropriate under the direction provided above. The AVR for Separate Accounts, if required, must be combined with the AVR for the General Account in order to calculate the maximum reserve correctly. It should be noted that Reg. 128 permits that any additional assets held in lieu of the AVR may be apportioned between the General and Separate Accounts.

D. AVR Separate Account Bases

For Separate Accounts, the AVR's Contributions and Maximum Values should be based on statement value.

Where assets are valued at book, it is understood that the identical rules would apply for the Separate Account AVR as for the General Account AVR. Where assets are valued at market, however, the AVR should appropriately be based on market values as book values are not always maintained for these Separate Accounts.

A further consideration arises for the Default Component of the AVR where assets are valued at market and losses related to asset quality are automatically reflected in the market values. It would be appropriate then to permit some early recognition in the AVR of the quality related losses prior to actual default or sale of an asset. As this would involve additional record keeping which some companies may prefer to avoid, it should be an option rather than a requirement.

LXV. DETERMINATION OF CAPITAL GAINS (LOSSES)

Where the AVR Default Component supports assets valued at market, gains or losses net of incurred tax charged to the AVR should be determined using one of the following two methods (applied consistently by Separate Account):

- A. A gain or loss is charged as for the General Account rules. For example, upon sale of a bond which has changed more than one rating category or upon asset default. Once an asset is in default, all subsequent market value changes are reflected in the AVR.
- B. A similar procedure to Method 1 above is followed but, additionally, a gain or loss is charged whenever a bond held changes by more than one rating category. As there might be more than one change in asset quality for a particular asset, e.g., a two rating downgrade followed by subsequent sale of the asset, the amount charged the AVR is net of any such prior amounts charged for that asset.

FEDERAL INCOME TAXATION ASSUMPTIONSLXVI. GENERAL

Federal Income taxes are reflected in the IMR and AVR calculations and in the development of the AVR factors either when actually incurred or when recognized as deferred according to current statutory accounting rules. Taxes are levied on realized capital gains. Tax savings arising from realized capital losses are only available if they offset realized capital gains within the specified time period. Most asset writedowns are recognized for deferred tax purposes. Tax regulations allow banks to write down mortgage loans for tax purposes when they are required by regulatory authorities to write them down for book purposes. If these regulations were extended to life insurance companies, additional book writedowns may become deductible (those currently not admitted).

LXVII. IMR-FIXED INCOME RELATED CAPITAL GAINSA. Federal Income Tax Allocations:

1. Taxes (credits) on realized fixed income gains should be allocated to these gains according to current company annual statement practices.
2. These taxes once determined are to be amortized in proportion to the amortization of the pretax gains.

Companies currently allocate taxes to these gains or losses in various ways. Some allocate the tax to each investment directly and then add just the total to those actually paid. Others use marginal, pro rata, or some other method. Companies are given reasonable latitude in determining their tax allocation. Once determined, they should be amortized in proportion to the gains consistent with the underlying theory without introducing any significant additional calculation difficulty.

B. Alternate Re-investment Rates for Tax Allocations

When a realized gain occurs and the proceeds are reinvested at a different interest rate, the resulting income stream will have different taxes than if the gain hadn't occurred. Generally these differences in taxes will have approximately the same pattern as the amortization of the capital gains taxes (and of the opposite sign) so no further adjustments are required.

Note: The IMR is a true actuarial reserve and as such, should be recognized for tax purposes for reasons discussed earlier.

LXVIII. ASSET VALUATION RESERVEA. Annual Contributions

The annual contributions that build the AVR reserve are charges against surplus and thus have already been subject to tax, if the company is a taxpayer

B. Asset Writedowns

- 1) For bonds, any writedowns due to credit related losses are partially recognized for tax purposes. If the written down asset is subsequently sold, the tax loss will reduce taxes to the extent it exceeds the deferred taxes assumed if timely gains are available.
- 2) For mortgages, writedowns may be tax deductible or may be recognized in the deferred tax calculations. Where they are, and offsetting gains are available, the tax credits should be reflected in the AVR calculation.
- 3) For stocks, tax credits are generally available since deferred taxes are recognized on the "writedown."

C. Investment Earnings on AVR

The investment earnings on amounts in the AVR are subject to tax.

LXIX. AVR TAX RECOGNITION ASSUMPTIONS

The AVR fixed income factors assumed that 75% of the writedowns or credit losses are tax deductible. If deferred taxes were fully reflected as they are in a GAAP statement, 100% of the losses would be tax deductible. Before recognition of deferred taxes, it was assumed that half were deductible with a one-year delay in recognition to reflect the assumption that some were immediately realized and others were deferred. Seventy-five percent reflects the change due to a restricted recognition of deferred taxes.

The AVR equity factors assume 100% of the "writedowns" are tax deductible. This assumption is consistent with the expectations for common stock or real estate where assumed future capital gains or increases in investment value are an integral part of the pricing. Capital gains are an essential part of the total expected return. Results will vary from year to year. Nevertheless, unrealized losses are more than likely to be fully recognized as an offset to current unrealized capital gains that will occur over the years the investment is held.

One Additional Note: If the statutory reserves include some provision for credit related losses, the loss provision is tax deductible to the extent reserves are deductible. This is independent of the AVR .

STANDARDS FOR ACTUARIAL RESERVES
WITH AN IMR AND AN AVR

LXX. IMR RESERVE STANDARD

The Interest Maintenance Reserve is a true actuarial reserve, and actuaries should use the assets supporting the Interest Maintenance Reserve when opining that the assets supporting the company's reserves make adequate provision for the company's obligations. In the case of a negative IMR, the actuarial opinion should include an explicit statement that the impact of the negative IMR on reserve adequacy has been considered and that the reserves after deduction of the negative IMR still make adequate provision for the liabilities.

LXXI. GENERAL EXPLANATION

The IMR is designed to work with minimum statutory reserves based on formulas contained in laws or regulations. Where, for example, the valuation rate is based on the interest rate conditions prevailing in the year of deposit, the assets supporting the liabilities will be consistent with the liability assumptions. Disposal of the assets during a period of declining interest rates will produce interest-related gains, but these gains will be needed to support the liabilities that are still valued at the interest rate levels prevailing at time of deposit. Thus, it is appropriate in the case of positive IMR to treat the IMR as an additional reserve requirement above and beyond formula minimums.

In cash-flow-testing actuaries take future cash flows into account from existing assets. In an example such as described above, existing assets may well have been purchased at rates below those prevailing at the time reserves were established. The positive IMR that has been built up has captured the gains and not allowed them to be available for distribution. The IMR is recognized as part of the reserves available to meet future obligation cash flows.

Thus from either point of view a positive IMR is treated as a true actuarial reserve. The same arguments should apply equally well in the case of a negative IMR, but some concern has been expressed that in this case the net reserves are in effect lower than statutory formulas minimums, and therefore special considerations are required.

LXXII. AVR RESERVE STANDARDS

The Asset Valuation Reserve should be considered as a reserve for the purposes of cash flow testing, and the assets supporting it should be a part of the assets available to meet the company's obligations, to the extent that the AVR is not larger than the present value of the losses assumed by the actuaries in their projection of asset cash flows.

The AVR should be recognized in doing cash flow testing work. In doing cash flow testing, it is necessary to estimate on a somewhat conservative basis the default losses on fixed income securities and deduct these from the yield, either directly or indirectly via the AVR. The AVR default component reserve objective is available to meet these credit losses and therefore should be treated by actuaries as an addition to the reserves being tested. In view of concerns that have been expressed about the AVR possibly being larger than the losses that have been assumed by the actuaries, it is reasonable to limit the application of the AVR to these losses.

The Actuary may use the AVR default component reserve objective in cash flow testing directly as the assumed default losses for reserve adequacy testing, some states by regulation allow percentages of the AVR maximum reserves as assumed average charges or may make their own assumptions as to default/credit losses. Presumably the results are comparable under either of the two options. Using the AVR default components reserve objective amounts may be easier to implement with less additional work required

ACCOUNTING TREATMENTLXXIII. INTEREST MAINTENANCE RESERVEA. Annual Statement

This reserve should be shown among the policy and contract liabilities in the upper part of page 3, the Liabilities page of the Annual Statement; it is actually shown in the lower portion. In the Summary of Operations the amortization of this reserve is shown in the gross income area, on a line close to investment income. These accounting treatments reflect that this reserve has a close relationship to actuarial liabilities and to the level of investment income of the company.

B. Schedules

A schedule page shows the details and calculation of this reserve. It exhibits the amortization for each future year of this year's gains as well as prior year's gains.

C. Reporting of Realized Capital Gains/Losses

Realized gains are shown as part of "net income" on page 4, the Summary of Operations. Realized gains that are to be transferred to the IMR are reported separately from other realized gains.

LXXIV. AVR TREATMENT OF CAPITAL GAINS

The change in the AVR is reported in the surplus account on page 4. Although there is some opinion that the nature of the reserve makes it appropriate to include the reserve change in "net income", the consensus is that, for the present, this should not be done, in light of the long-standing accounting concept that unrealized gains should not impact net income. The AVR does reflect both unrealized gains and a portion of realized gains.

LXXV. ASSET VALUATION RESERVE

A page for the Schedules section of the Annual Statement includes a form for the calculation of the AVR. Once calculated, the AVR is to be shown as a liability. In addition, the change in the AVR is reported as part of the surplus account.

LXXVI. ALTERNATE TREATMENTS CONSIDEREDA. Contra Asset

Some accountants believe that the AVR should reduce the value of the reported assets since it "corrects" the book value for assumed credit or default losses that are likely to occur

B. Actuarial Reserve

Some actuaries believe the AVR should be included in the actuarial reserves since it reflects one of the key risks that isn't properly reflected in the formulaic reserves and is part of the asset adequacy testing for reserves.

C. Conclusions

Although both views have merit, the current conclusion was to continue to treat the AVR as a separate stand alone liability for financial statement purposes.

APPENDIX A

TRANSITION FROM MSVR TO AVR IN 1992

It was necessary to define how the then current MSVR would be apportioned among the various sub-components of the AVR. Of the many possible ways of doing this, two were selected. In addition it is desirable to provide for the optional folding in of the various voluntary asset reserves that may exist.

The initial amount of the AVR was based on the amount of the MSVR as of that point, using one of the following two methods:

- (A) Specific: The bond component of the MSVR is transferred to the bond sub-component of the AVR, and the common stock component of the MSVR is transferred to the common stock sub-component of the AVR.
- (B) Pro rate: The MSVR is to be allocated to the four sub-components of the AVR in proportion to the 1992 year-end maxima for those sub-components.

Any voluntary asset reserve may be transferred to the MSVR in accordance with either one of the above rules, or continue to be independently maintained or eliminated.

In no event is the initial value of the AVR at the beginning of 1992 to be less than the 1991 year end MSVR bond and preferred stock component and common stock component.

APPENDIX BFUTURE DIRECTIONS

In late 2002, the Interested Persons (as its name had become) considered refinements of the AVR/IMR for the next several years, from that vantage point, some of the major areas of effort appear to be as follows:

1. There should be recognition of negative values of the IMR. The group had long recognized that the philosophical basis for the IMR supports negative values of the reserve as well as positive. There is a need to have investment return match the liabilities associated with the investment; and a need to remove the incentive for a company to make investment decisions based on the short-term balance sheet effect; and these needs exist also on the negative side of the IMR.

No doubt there are concerns that a negative reserve of this type could somehow lead to an unsound condition, so there has been appended to this report a discussion entitled "Why Are Negative Values For the IMR Necessary?" It also seems as though there should be additional safeguards in the case of a negative IMR. Rather than put arbitrary limits on the amount of the negative reserve, however, consideration is being given to an actuary's statement that an asset adequacy analysis has been carried out that demonstrates the soundness of the reserves.

2. Updated factors and changes in the AVR contribution formula will be considered from time to time so as to reflect more accurately the risk of loss in the various categories of assets. As future experience develops, there will likely have to be changes in the basic contribution, the reserve objective and the maximums. The updated factors should be closely related to the statistical analysis of the risk, the needed reserve and coordinated with the risk-based-capital factors. In logic, the AVR maximums should be and are currently equal to (or lower) than the RBC factors. Criteria for future changes are shown in the Appendix.
3. A number of other issues have been considered, such as an alternative formula for the AVR for real estate, based on periodic real estate appraisals. This alternative may be better able to reflect the risks involved.

Also on the future agenda are the questions of the appropriate AVR treatment of uncollectible interest and foregone interest on restructured loans as well as other issues.

4. All codification approved SSAP'S are reviewed for possible impact on the AVR and the IMR.
5. With the passage of time, new studies, and increased understanding, the AVR and/or the IMR may have to be refined and clarified to reflect current thinking.
6. Should separate accounts supporting annuity products with guaranteed death benefits and or guaranteed living benefits require an AVR?
7. At an appropriate time, the Interested Persons draft proposal submitted in September 2000 that would replace the Real Estate RBC factors for the various categories with one factor for the entire portfolio based on cash flow structure might be resubmitted for consideration.
8. Reconsider treatment of restructures (see NAIC Accounting Practices and Procedures Manual) after experience with this Standard develops.

9. Consider refining Bond Class 1; possibly splitting it into Class AAA, Class AA, Class A.
10. Consider AVR implications of portfolio hedges of risks.

APPENDIX C

PRIOR CHANGES APPROVED/IMPLEMENTED

Changes approved for 12/31/95

1. Convertible Bonds:

For a convertible bond or preferred stock purchased while its conversion value exceeds its par value, any gain or loss realized from its sale before conversion must be excluded from the IMR and included in the AVR. Conversion value is defined to mean the number of shares available currently or at next conversion date, multiplied by the stock's current market price.

For any convertible bond or preferred stock purchased while its conversion value exceeds its par value, and whose NAIC/SVO classification did not change by more than one NAIC/SVO rating classification during the holding period, any gain or loss realized from its sale before conversion must be included in the equity component of the AVR. Conversion value is defined to mean the number of shares available currently or at next conversion date, multiplied by the stock's current market price.

2. Groupings for amortizing interest-related gains included in the Interest Maintenance Reserve:

the grouping of "1 to 5 calendar years to expected maturity" will be replaced by groupings of "1-2 calendar years to expected maturity" and "2-5 years to expected maturity".

the column headed "1-5" will be replaced by columns headed "1-2" and "2-5".

3. Structured securities not exempt from AVR:

Effective 12/31/95, structured securities as defined in the Life Annual Statement instructions for Schedule D, Part 1A, Section 2, regardless of issuer, are not to be considered exempt.

4. Experience Adjustment Factor - AVR requirement for Mortgages:

Effective 12/31/95, the Industry's and Company's Experience Factors will be based upon the average of eight quarterly ratios for the 8 preceding quarters (7 quarters for 1995).

Changes approved for 12/31/96

1. Question and Answer Material:

(various pages) Modify instructions to incorporate language that previously has been published separately as question and answer material.

2. Threshold for Reinsurance Transactions:

(Page 9.9) Modify IMR top provide flexibility for insurers to make a one-time election regarding the materiality threshold for reinsurance transactions appropriate for their business.

3. Class One Bond Mutual Funds:

(Page 10.6) Reports certain high-quality bond mutual funds with restricted investment practices on Schedule D, part 1 at market value, and adjusts AVR charge to make them subject to bond NAIC 1 factors in default component.

APPENDIX DJUSTIFICATION FOR THE AVR COMMON STOCK FACTOR1. Background

Following the November 1, 1991 meeting with Terry Lennon's MSVR Study Group, we were asked to justify the AVR factor, which had been recommended for publicly, traded stocks. It was also observed that a higher factor seemed to be appropriate for a portfolio, which was either small and undiversified, or simply more risky than the norm. For these cases, we were asked to consider the merit of applying a portfolio's factor to the recommended AVR factor.

2. Our Sub-Group's Conclusions and Recommendations

Following considerable analysis, we have concluded that a 20% AVR is a strong AVR for a typical portfolio of publicly traded stocks, and we recommend that this be established as the maximum AVR for 1992 (instead of the current 33 1/3%). A 20% AVR corresponds to a confidence level of approximately 85%.

We have also concluded that there is merit in the -modifying approach for portfolios of publicly traded stocks, which are more risky than would typically be the case.

We recommend that for a portfolio of publicly traded stocks, the maximum AVR be set equal to the portfolio factor (calculated as described below) multiplied by 0.2, subject to an upper limit of 0.3 (the risk based capital requirement) and a lower limit of 0.15.

However, for companies which do not want the extra administrative complexity of calculating the factor, we recommend a "safe harbor" AVR pretax maximum of 30%.

The method which we have in mind for calculating the portfolio factor is described below.

3. Calculation of the Portfolio Factor

We believe that companies with portfolios of publicly traded stocks of any significant size would likely recalculate the portfolio monthly (or possibly more frequently), but at least quarterly. There is an obvious need to have a prescribed method for this calculation if the results are to be used for AVR purposes. We believe that a method along the following lines is suitable.

Let us assume that the portfolio is recalculated quarterly.

Because of trading strategy, it is quite possible for the value of β to change by a few percent from quarter to quarter, so an average value of β is assumed to usually be a better guide to a portfolio's risk characteristics than a single point estimate.

Let β denote the current year. Let β_0 denote the portfolio β coefficient at the end of December, year ($\beta-1$). Let β_1 , denote the portfolio β coefficient at the end of the first quarter, year β , β_2 the portfolio coefficient at the end of the second quarter, year β , and so on.

Define the Average β , measured as at the end of year β , to be:

$$\text{Average } \beta = \left(\sum_0^3 \beta_i MV_i \right) / \left(\sum_0^3 MV_i \right)$$

where MV_i denotes the market value of the portfolio.

We recommend that an insurer be able to use one of two alternative methods for calculating the values of β which are needed.

The first method would determine β through simple linear regression using 52 weeks of time weighted rates of return for the portfolio and for the S&P 500 index, or other appropriate index for non U.S. stock portfolios.* Referring back to the formula for calculating the average β for the portfolio, it will be seen that employing this first method utilizes 2 years of experience data.

The second method would be a mechanically simplified method of calculation, using the β coefficients of individual stocks provided by service organizations. Weighting these coefficients by the proportion of the portfolio invested in each stock (by market value) would give the portfolio β . For uniformity, the service organizations would need to calculate the β coefficients the same way, which we propose to be through simple linear regression using 5 years of monthly time weighted rates of return.

4. More on the Portfolio β Factor

A large company might well have, say, a portfolio of U.S. stocks, a portfolio of Canadian stocks, a portfolio of U.K. stocks, etc. In this case, there would be a β factor for the U.S. portfolio, another one for the Canadian portfolio, etc. Clearly the overall β factor would be the various β factors weighted by the corresponding average market values.

Where one or more of these portfolios is not material, we recommend that the 30% safe harbor be available.

6. Justification of the 20% AVR Common Stock Factor. This is given in the Appendix. (E))

*TSE 300 index for Canadian stock portfolios, FT All Shares index for U.K. stock portfolios, the TOPIX index for Japanese stock portfolios.

APPENDIX E

JUSTIFICATION OF THE 29% COMMON STOCK FACTOR

A Use of Historical data

1. Intuitively it seemed to us reasonable to consider the amount by which the market value of a common stock portfolio might drop over a 12-month period. We could expect approximately an 85% probability that such a drop would be less than one standard deviation of the 12-month rates of change in the market value.

Over the last 30 or 40 years one standard deviation has been about 14% to 16% of market values. Thus an AVR set at about 15% of market value would be indicated.

One reason for thinking in terms of 12-month drops in market value is that in practice there might be some elasticity in the market -- some upward bounce following a significant drop (and vice versa).

2. A more conservative approach is to consider a two-year period instead of a 12-month period, and the drop from the beginning of the period to the lowest point during the two-year period (which we refer to as the biggest drop throughout).

Using monthly S&P 500 Index values for 1960 through 1991, the biggest drops during a running two-year period were determined.*

These biggest drops were then ranked according to size, and the most relevant results are shown in Table 1. From these results we can conclude that an AVR sufficient to have covered 75% of the biggest drops in market value would have been about 14% of market value. An AVR sufficient to cover 80% or 85% of the biggest drops would have been about 16% and 20% of market values, respectively.

Note that had the full post World War II period been used an AVR sufficient to cover 85% of the biggest drops would only have been close to 16%.

Note also that based on a running 12-month period for 1960 through 1991, instead of a running two-year period, the 85% confidence AVR would have been close to 15%. (This result, based on historical data, is also very interesting in relation to the expectations described in section 1, above.)

3. We therefore conclude that for a portfolio which behaves similarly to the S&P 500 Index (and most companies' portfolios would), a 20% AVR is a good, 85% confidence level AVR.

*Actually, the present values of these biggest drops were determined. For example, six months discount if the lowest point occurred six months from the beginning of the two-year period

4. Table 1 also shows results based on the biggest drops during a running five-year period, during the years 1960 through 1991.

We believe that moving to a five-year period is stretching things, but the results do not alter our conclusion concerning the strength of a 20% AVR

B. Use of Simulations to Test Types of AVR

The proposed method for determining the stock component of the AVR is to amortize the AVR towards its maximum using a 20% amortization factor.

Having concluded that a 20% AVR is a good, solid 85% confident AVR, it was appropriate to test the proposed method to see what the average AVR might be compared with 15%*, whether the resulting AVR would likely be at the 20% level in most years, how volatile the AVR might be, and how frequently it might drop to zero. The tests were done on three scenarios as to future market performance, using the well-known lognormal mathematical model for simulating the performance:**

	<u>I</u>	<u>II</u>	<u>III</u>
Expected annual compound rate of market appreciation:	0%	4.6%	6.7%
Standard deviation of annual rate of market appreciation:	15%	15.0%	16.2%

If expectations were in accordance with scenario I, nobody would invest in stocks; i.e., scenario I is a bleak outlook, with high relative volatility, for illustrative purposes. Scenario III corresponds to reasonable expectations based on the last 30 years' history, and scenario II is meant to be a conservative version of scenario III; i.e., the expected rate of capital appreciation is lower and relative volatility (ratio of standard deviation to expected appreciation) higher.

* A level of AVR which seems appropriate for covering drops in market values over a 12 month period.

** The lognormal parameters for the three scenarios were (0, .14), (.045, .14) and (.065, .15).

In these simulations, it was assumed that there was no trading, which means that (a) all gains and losses that were credited to the AVR were unrealized gains and losses, and (b) there were no income tax impacts. To the extent that capital gains tax might be paid, the amount credited to the AVR would be reduced, and the AVR would not spend quite as time at its maximum as the results would indicate. Similarly, to the extent that negative capital gains tax on losses can be recovered, the AVR would not spend quite as much time at the lower levels.

Typical results were as follows:

	<u>I</u>	<u>II</u>	<u>III</u>
Average AVR:	12%	16%	17%
Proportion of years AVR at the maximum:	32%	50%	58%
Proportion of years AVR at zero:	10%	4%	4%
Volatility (standard deviation) of AVR:	6.9%	5.5%	5.0%

In these simulations, the starting value of the AVR was picked at random from the range zero to 20%.

C. Further Use of Historical Data

The tests based on simulations crystallized our viewpoint. However, having satisfied ourselves that the proposed method with a 20% maximum AVR and 20% amortization rate should be quite good, it was applied to historical S&P 500 capital appreciation data for the years 1960 through 1991, and passed with flying colors. Starting with a conservative zero value of the AVR at the beginning of 1961, it was found that the calendar year end AVR would have had an average value of 16.6%, have been at its maximum 19 out of 31 years, and at zero only once.

(Again, this was on the basis where all gains and losses were unrealized).

D. Common Stocks backing Actuarial Reserves

We have explored another way of looking at this problem, viz. by how much would you have to reduce the current value of the stocks so that with 85% confidence the resulting rate of return is likely to exceed the average, investment grade, long term bond rate of return. Of course the reduction in current value represents the target AVR.

Years 1960 through 1991.

In this instance the rate of return on stocks includes dividends as well as capital appreciation, so that the parameters of the mathematical model used to study the problem are different from those underlying scenario III, in section B. Based on the experience of 1960 through 1990, the expected compound rate of return of a typical stock portfolio would be about 9.9%, with a standard deviation of about 16.0%*, versus an average long term bond yield of about 7.3%.

Using this model and setting the AVR at the 20% level, the confidence with which we would expect the return on stocks to exceed the return on bonds was calculated to be as follows:

<u>Holding Period (years)</u>	<u>Confidence Level</u>
1	95%
3	87
5	85
10	84
15	84

Thus these results also support the thesis that a 20% AVR is adequate.

* The lognormal parameters being (.094, .148).

TABLE I

The results are based on the maximum drop in the market value during a running 2-year period and also a running 5-year period. The S&P 500 data base for each month October 15, 1960 through December 15, 1991 was used. Capital appreciation only.

<u>Confidence Level</u>	<u>Present Value of Maximum Drop During</u>	
	<u>2-Year Period</u>	<u>5-Year Period</u>
75%	14.1%	19.4%
80	16.4	21.0
85	19.9	24.4
90	22.6	27.9

APPENDIX FHISTORICAL PERSPECTIVES

I The Asset Valuation Reserve - captures all credit-related recognized capital gains and losses in the appropriate sub-component. In addition, basic contribution and an annual contribution are made to each sub-component.

Realized gains or losses, net of capital gains taxes, and any other recognized capital gains and losses net of deferred taxes and unrealized gains and losses on hedging instruments not related to interest rate changes should be included with the hedged asset. Gains or losses, net of capital gains tax, on specific hedges should be included only if the hedged asset is sold or disposed.

Voluntary contributions and limited transfers between sub-components are permitted.

II AVR CONTRIBUTION

Prior to 1997 the AVR contribution was calculated using a four-step process.

1. The maximum for each of the four sub-components was determined by applying a factor for each asset type constituting the sub-component to the corresponding statement value.
2. The accumulated balance for each sub-component was determined as follows:

$$\begin{aligned} \text{Accumulated Balance} &= \text{Beginning Balance} \\ &+ \text{Capital Gains} \\ &- \text{Capital Losses} \end{aligned}$$
3. The AVR contribution to each sub-component was determined as follows:

$$\text{Contribution} = 20\% \text{ of } (\text{Maximum} - \text{Accumulated Balance})$$
4. The AVR was then (2) + (3) but not less than 0 or more than the maximum

$$\text{Accumulated Balance} + \text{Contribution} = \text{Ending AVR Balance}$$
 Ending balance not less than zero nor more than the maximum
 Maximums defined below.

III ASSET VALUATION RESERVE MAXIMUMSA Prior to 19971 Default Component

2 Bond and Preferred Stock: Same as in 1991 under the MSVR.

3 Mortgages: 3.5% of statement value, multiplied by an experience adjustment factor which reflects each company's recent experience in delinquencies and foreclosures relative to the industry average. In 1993 the adjustment was refined include loan restructuring as well as delinquency and foreclosure activity). In any case, however, the maximum factor will not be less than 1.75% (3.5% for companies with less than 5 years mortgage experience) nor greater than 10.5%. Separate balances will be reported for farm, residential - insured or guaranteed, residential - all other, commercial - insured or guaranteed, and commercial - all other mortgage loan categories.

IV EQUITY COMPONENT

A Common Stocks: For publicly traded stocks, 20% (with an adjustment that reflects the volatility of the portfolio).

B Real Estate: 7.5% of statement value

C Schedule BA Assets: Included in the real estate *AVR* sub-component, but a maximum reflecting the true nature of the assets.

V ANNUAL CONTRIBUTIONS

A Prior to 1997

During the phase-in in 1992-94 the annual contribution for 1992 was 10% of the excess of (1) the maximum for the sub-component over (b) the accumulated balance in that sub-component. The amount was 15% for 1993 and 20% for 1994-96.

VI SHORTCOMINGS OF THE MSVR

The history of the development of the MSVR process (initially created in 1951) is well documented in the report of the Joint Study Group of the NAIC and ACLI on the MSVR. The Committee reviewed that report and other information available to it and noted the following inadequacies of the MSVR.

A . Focus too narrow

It has already been pointed out that the MSVR should cover all assets. The MSVR addressed only about 60% of invested assets of the life insurance industry. For example, no account is taken in the MSVR for the following:

- Mortgage loans
- Real Estate Investments
- Other Invested Assets in Schedule BA.

B Purpose Unclear and Potentially Misleading

Those who are not familiar with life insurance accounting may be excused for thinking that MSVR was similar to other reserves carried on the annual statement, particularly when they see it placed among the liabilities of the company. But it was unlike other reserves; it was not calculated the way most reserves are, and it was not treated as a reserve by most experienced observers.

Sometimes it was thought of as allocated surplus, earmarked as a contingency reserve against particular types of unexpected catastrophic loss. But the MSVR also had some attributes of a reserve against expected capital losses, and some of the attributes of a smoothing mechanism.

C. Failure to make necessary distinctions among types of gains

Gains on fixed-income securities which arise from movements in prevailing interest rates should be treated differently from other types of gains, such as defaults, credit deterioration, or stock market gains. If, for example, a fixed income security is sold before maturity and replaced with a security of equal quality but bearing a current interest rate, the gain is merely the present value of future interest differentials, and the impact on the balance sheet should be consistent with this fact. Other types of gains, or changes in value, may represent a much more immediate and real impact on the long-term solvency of the company.

D Undesirable segmentation

There are some in the industry (but not all) who believe that the existence of a separate stock component created an uneven impact of the MSVR on surplus and may result in the release of gains to surplus from one component at a time when the other component is very weak, or could create unnecessary strains on surplus at a time when the other component is quite strong.

E Incompatibility with the valuation actuary concept

There are many reasons why the rapidly developing changes in actuarial methods and responsibilities made MSVR reform urgent. Briefly, some of them were:

- (a) The MSVR was not held to a "good and sufficient" standard. It is not at all clear how much of the MSVR is needed to bring asset valuation to the same standard of conservatism as that prescribed for liability valuation.
- (b) It was difficult to integrate the MSVR into cash flow testing. It would be desirable to have a reserve that could be treated on the same basis as other reserves in cash flow testing work.
- (c) Interest gains and losses (sometimes called "trading gains") were not reserved in the MSVR in a manner that is consistent with cash flow testing. As mentioned elsewhere, an approach that gradually releases trading gains over the valuation period is desirable.

VII INTERIM IMR GAIN/LOSS EXCLUSIONS

When the IMR was being developed, the need for an exception in this case was recognized. But it was thought that there would be technical difficulties in carrying out the concept. As a first step in addressing the problem, a provision was adopted for 1992 that allowed the exclusion of gains and losses on the sale of assets associated with the reinsurance transaction from the IMR.

An interim recommendation for 1992, specified that all realized interest-related gains or losses which arise from the irrevocable sale, transfer, or reinsurance of a block of business to a non-affiliate will be excluded from the IMR and will be reflected in net income.

This Interim Proposal had a number of shortcomings:

- it is difficult to clearly delineate the assets sales that are associated with the reinsurance transaction,
- if the assets associated with the liability are not sold they may be valued inappropriately to back new business, and

- it is possible that the IMR attributable to a block of business will be non zero even after all of the assets and liabilities associated with the block of business are off of the company's books.

After reviewing these shortcomings, it was decided to adopt a revised method that avoids the difficulty of identifying the asset sales associated with the reinsurance transaction and also largely corrects the valuation of the remaining assets. However, the method requires more extensive calculations. The method presupposes that the company can identify:

- the assets that are presently associated with the liability, and
- the IMR arising from past dispositions of assets associated with the liability.

The assets allocable to the block would be the same as those used for investment income allocation purposes. This assures consistency and minimizes the administrative burden.

A. Each capital gain or loss on a fixed income investment would be split into two pieces, a piece arising from the change in the general level of interest rates and a piece arising from the changed circumstances of the issuer. At the time of sale or write down, the asset would be revalued as though it were still of the same quality as it was at the time of purchase. The excess of this new value over the original book value would be classified as a gain or loss from changed interest rates. If the residual gain or loss exceeded 10% of the book value it would be classified as a credit-related gain or loss. Otherwise the residual would be included with the gains or losses due to changes in the level of interest rates.

B. In the case of investments such as mortgages and unrated bonds it would be necessary to infer a credit rating for the investment. This can be accomplished by comparing the yield at acquisition to the yields for rated bonds. For instance, if the investment bears a yield comparable to BBB bond, then it would be revalued as a BBB bond at disposition in order to determine the split between the gain or loss due to interest rates and the gain or loss due to credit changes.

Although Method II is more theoretically correct, it is much more difficult to administer.

Conclusion: Capital gains and losses on fixed income investments should be separated into a component due to changes in the level of interest rates and a component due to changes in credit using Method I above. Slight variations in the treatment of preferred stock are set forth in a later section and 12/31/95 changes have been approved for convertible assets.

TO: Thomas Botsko, Chair, Capital Adequacy (E) Task Force
Philip Barlow, Chair, Risk-Based Capital Investment Risk and Evaluation (E) Working Group
Dale Bruggeman, Chair, Statutory Accounting Principles (E) Working Group

FROM: Carrie Mears, Chair, Valuation of Securities (E) Task Force

CC: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau
Julie Gann, Assistant Director, NAIC Solvency Policy
Dave Fleming, Sr. Life RBC Analyst, NAIC Financial Regulatory Affairs
Eva Yeung, Sr. P/C RBC Analyst/Technical Lead, NAIC Financial Regulatory Affairs

RE: Referral regarding a Proposed Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)

DATE: June 1, 2023

Summary – The Valuation of Securities (E) Task Force (VOSTF) requested that the Securities Valuation Office (SVO) staff make a comprehensive review of the definition of an NAIC Designation in the P&P Manual. The SVO identified that there are portions of the definition in both Parts One and Two some of which are redundant. In addition to the redundancy, this splitting of the definition has led to some users to the interpretation that there are two meanings of an NAIC Designation: one meaning, found in Part One, applicable to all securities, whether assigned NAIC Designations pursuant to the Filing Exemption process or by the SVO and a second meaning, found in Part Two, applicable only to securities assigned NAIC Designations by the SVO. It is the SVO staff’s belief that there is only one definition of an NAIC Designation and that it is applicable however the NAIC Designation is assigned. The revisions proposed in the amendment, which is included with this referral, reflect a consolidation of the instructions that define an NAIC Designation to make a single uniform definition. It also includes updates to the definition to address questions and concerns raised about the purpose of NAIC Designations versus credit rating provider ratings. Additionally, the SVO is recommending consolidating the current “NAIC Designation Subscript S” section in Part Two into the revised NAIC Designation section in Part One because the application of a Subscript S to an NAIC Designation for other non-payment risks signifies a change in the meaning of the NAIC Designation and is a policy of the Task Force.

The majority of this proposed amendment involves moving text from Part Two, the “*Operational and Administrative Instructions Applicable to the SVO*”, into Part One, the “*Policies of the NAIC Valuation of Securities (E) Task Force*”. A clean version of the amendment was included to simplify the review, with the new text also clearly highlighted.

Referral Request – Given the importance of NAIC Designations in quantifying investment risk for various NAIC regulatory purposes and guidance, the Task Force is sending this referral with a request that your groups consider the revised definition and assess whether or not it meets your needs. If the definition meets your needs, please informally let the SVO staff know that no response will be submitted. If the definition does not meet your needs, please notify the SVO staff by June 29th that you will be proposing modification to the definition and we request that you submit those modification or a request for

additional time by July 31st so that the revisions or matter can be considered and discussed at the NAIC's Summer National Meeting. Thank you for your consideration of this request.

Please contact Charles Therriault or Marc Perlman with any questions.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/Referrals/To CATF and SAPWG/VOSTF Referral to SAPWG CATF RBCIRE - NAIC Designation Def 2023-06-01.docx>

5/15/23



SVO



TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to Update the Definition of an NAIC Designation in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)

DATE: April 26, 2023

Summary – NAIC Designations are currently explained and defined in both Parts One and Two of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the “P&P Manual”). The SVO proposes both consolidating these explanations and definitions in Part One only and clarifying the meaning of an NAIC Designation including their use, purpose and risk addressed.

When the new format for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) was adopted on November 16, 2018 and published in the new format on April 7, 2019, several changes were made in an attempt to simplify the P&P Manual. It has since become apparent that some of those changes have led to the interpretation that there are two meanings of an NAIC Designation: one meaning, found in Part One, applicable to all securities, whether assigned NAIC Designations pursuant to the Filing Exemption process or by the Securities Valuation Office (“SVO”) and a second meaning, found in Part Two, applicable only to securities assigned NAIC Designations by the SVO. It is the SVO staff’s belief that there is only one definition of an NAIC Designation and that it is applicable however the NAIC Designation is assigned. To that end, the revisions proposed in this amendment have consolidated the instructions that define an NAIC Designation to make a single uniform definition and includes updates to the definition to address questions and concerns raised about the purpose of NAIC Designations versus credit rating provider ratings.

Additionally, the SVO recommends consolidating the current “NAIC Designation Subscript S” section in Part Two into the revised NAIC Designation section in Part One because the application of a Subscript S to an NAIC Designation for other non-payment risks signifies a change in the meaning of the NAIC Designation and is a policy of the Task Force.

Recommendation – The majority of the amendment involves moving text from Part Two, the Operational and Administrative Instructions Applicable to the SVO, into Part One, the Policies of the NAIC Valuation of Securities (E) Task Force. Additionally, the amendment would add clarifying language to the newly

combined explanation and definition of NAIC Designations. A clean version of the amendment has also been included to simplify the review, with the new text also clearly highlighted.

Proposed Amendment - The proposed text changes to the P&P Manual are shown below with additions in red font color and deletions in red strikethrough, as it would appear in the 2022 P&P Manual format. Editing notes have been added with [] to explain section moves. New text is highlighted in yellow.

(VERSION WITH CHANGES DISPLAYED AND ADDITIONS HIGHLIGHTED)

**PART ONE
POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE**

POLICIES PERTAINING TO SVO AND SSG OPERATIONS

...

~~NAIC Designations~~*[Editing note: moved from Part One, paras. 37-39 to the new "NAIC Designations" section within Part One]*

~~37. The SVO's analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation that is notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations as defined in this Manual describe a credit quality risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk except when accompanied by the NAIC Designation subscript, described below.~~

- ~~▪ Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.~~
- ~~▪ Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.~~
- ~~▪ The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured.~~
- ~~▪ NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk.~~
- ~~▪ An NAIC Designation must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.~~

~~38. The result of the SVO's credit analysis, expressed as an opinion of credit quality by assignment of an NAIC Designation shall be further expanded into NAIC Designation Categories as, and for the purposes, discussed in this Manual.~~

~~**NOTE:** See "Production of NAIC Designations" in Part Two.~~

Other Non-Payment Risk in Securities

~~39. The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below.~~

~~NOTE: See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

...

NAIC DESIGNATIONS**NAIC DESIGNATIONS****Definitions Use and Purposes of NAIC Designations**

88. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category, ~~or band of credit risk,~~ or gradations of credit quality ~~and credit risk~~ identified by the **NAIC 1** through **NAIC 6** symbols, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks, further discussed and defined in this Manual.

[Editing note: Moved from Part Two, para. 18]

89. **NAIC Designations** reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.

90. **NAIC Designations** are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law *[Editing note: Moved from Part Two, para. 18]* and must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company. *[Editing note: Moved from Part One, para. 37]* ~~NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual. *[Editing note: Deleted from Part Two, para. 18]*~~

91. **NAIC Designations** must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

92. ~~NAIC Designation~~ — Means any one of the gradations of credit quality and credit risk identified by the ~~NAIC 1 through NAIC 6~~ symbols further discussed and defined in this Manual and may reflect notching pursuant to one or both of the notching procedures discussed in this Manual. ~~NAIC Designations are proprietary symbols of the NAIC to be used by the SVO and SSG or under certain circumstances by an insurer to denote a category or band of credit risk.~~

[Editing note: Originally in Part One, para. 88]

NAIC DESIGNATIONS — RISKS ADDRESSED BY NAIC DESIGNATIONS
--

[Editing note: moved from Part One, para. 37]

93. The ~~NAIC's SVO's~~ analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation ~~and Designation Category~~ that ~~is~~ ~~may be~~ notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations ~~and Designation Categories~~, as defined in this Manual, describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk, ~~described below~~, except when accompanied by the NAIC Designation S~~ubscript~~ S, ~~denoting Other Non-Payment Risks~~ ~~described below~~.

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured. ~~NAIC Designations may be adjusted to reflect Other Non-Payment Risks, as described in this manual.~~
- ~~An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g. the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution).~~

- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, though these other risks may be reflected in Other Non-Payment Risks, as described in this manual.

NAIC DESIGNATION SUBSCRIPT S (OTHER NON-PAYMENT RISK)
--

NAIC Designation Subscript S

94. An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.

[Editing note: Moved from Part One, para. 90]

~~**NOTE:** See “NAIC Designation Subscript S” in Part Two.~~

Description of Other Non-Payment Risk

95. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.

[Editing note: Moved from Part Two, para. 33]

96. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.

[Editing note: Moved from Part Two, para. 34]

97. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a schedules basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).

[Editing note: Moved from Part Two, para. 35]

98. Using the broad concepts identified above, non-payment risk may be present when:

- A reporting insurance company takes on a participatory risk in the transaction;

Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.

- The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;

Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.

Illustration – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

[Editing note: Moved from Part Two, para. 36]

- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making periodic scheduled payments of interest and repaying principal in full to the insurer on a date certain;

Illustration – A Principal Protected Security, as defined in Part Three of this Manual.

Illustration – A security with no contractual events of payment default.

Illustration - A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original investment.

Illustration – A security with an interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twenty-four months or past legal maturity.

- ~~Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~

[Editing note: Originally in Part Two, para. 37]

Directive to the SVO to Assign the Subscript S Symbol

99. The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks.

Meaning of the Subscript S Symbol

100. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.

[Editing note: Moved from Part Two, para. 38]

101. The SVO shall assess securities for other non-payment risk:
- Routinely, for any security or financial product filed with the SVO.
 - As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.
 - When requested to do so by any state insurance regulator acting pursuant to this Manual, and:
 - When requested by the VOS/TF; or
 - In support of any other NAIC group engaged in the analysis of investment risks in new securities.

~~**NOTE:** See “NAIC Designation Subscript S” in Part One.~~

[Editing note: Moved from Part Two, para. 39]

Other Non-Payment Risk in Securities

~~96. The result of the SVO's analysis of securities for other non-payment risk is expressed by the assignment of an NAIC Designation Subscript S and the application of the notching procedures described below in this Manual.~~

[Editing note: Originally in Part One, para. 39]

~~**NOTE:** See "NAIC Designation Subscript S" and "SVO Notching Guidelines" in Part Two.~~

APPLICATION OF NAIC DESIGNATIONS

102. **NAIC 1** is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An **NAIC 1** obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 19]

103. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 20]

104. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 21]

105. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer’s credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer’s capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 22]

106. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer’s credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 23]

107. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.

[Editing note: Moved from Part Two, para. 24]

NOTE: See ~~“NAIC Designations,”~~ “Prohibition on Use of NAIC Designation in a Covenant” and “Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force” in Part One; ~~“NAIC Designation Categories”~~ below; and “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” in Part Three.

APPLICATION OF NAIC DESIGNATION CATEGORIES

108. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories, ~~as described and defined in this Manual.~~

[Editing note: Moved from Part Two, para. 25]

109. **NAIC Designation Category** – Means and refers to 20 more granular delineations of credit risk in the **NAIC 1** through **NAIC 6** credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the **NAIC 1** Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades **NAIC 2**, **NAIC 3**, **NAIC 4** and **NAIC 5** indicated by the letters A, B and C and 1 delineation for NAIC Designation grade **NAIC 6**. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.

~~**NOTE:** See “Production of NAIC Designations” in Part Two.~~
[Editing Note: Moved from Part One, para. 89.]

110. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF’s credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
5		C		5.C
6				6

[Editing note: Moved from Part Two, para. 26]

111. NAIC Designations and Designation Categories may be adjusted in accordance with the notching procedures described in this Manual below so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations and Designation Categories may also be adjusted by notching to reflect the existence of Other Non-Payment Risks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.

[Editing note: Moved from Part Two, para. 18]

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

112. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.

[Editing note: Moved from Part Two, para. 27]

113. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.

[Editing note: Moved from Part Two, para. 28]

114. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.

[Editing note: Moved from Part Two, para. 29]

115. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.

[Editing note: Moved from Part Two, para. 30]

116. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.
[Editing note: Moved from Part Two, para. 31]

117. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.
[Editing note: Moved from Part Two, para. 32]

~~**NOTE REGARDING RESIDUAL TRANCHES OR INTERESTS:** For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.~~

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.
[Editing note: Moved from Part Two, para. 32]

NAIC General Interrogatory

118. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:
- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or PL security is not available.
 - The issuer or obligor is current on all contracted interest and principal payments.
 - The insurer has an actual expectation of ultimate payment of all contracted interest and principal.
- [Editing note: Moved from Part One, para. 91]*

NAIC PLGI

119. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security).

[Editing note: Moved from Part One, para. 92]

Monitoring of SVO-Designated Securities

120. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt.

[Editing note: Moved from Part One, para. 93]

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS
APPLICABLE TO THE SVO

PRODUCTION OF NAIC DESIGNATIONS [EDITING NOTE: MOVED TO PART ONE “NAIC DESIGNATIONS”.]**NAIC DESIGNATIONS**

18. ~~NAIC Designations are proprietary symbols of the NAIC. The SVO and sometimes the SSG produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/IF in this Manual. NAIC Designations identify a category or band of credit risk. NAIC Designations are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law. NAIC Designations are adjusted in accordance with the notching procedures described below so that an NAIC Designation for a given security reflects the position of that specific security in the issuer’s capital structure. NAIC Designations may also be adjusted by notching to reflect the existence of other non-payment risk in the specific security in accordance with the procedures described in this Manual.~~
19. ~~NAIC 1 is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer’s credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An NAIC 1 obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.~~
20. ~~NAIC 2 is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer’s credit profile is reasonably stable. This means that for the present, the obligation’s protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An NAIC 2 obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~
21. ~~NAIC 3 is assigned to obligations of medium quality. Credit risk is intermediate and the issuer’s credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer’s capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

- ~~22. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~
- ~~23. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~
- ~~24. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.~~

~~**NOTE:** See "NAIC Designations," "Prohibition on Use of NAIC Designation in a Covenant" and "Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force" in Part One; "NAIC Designation Categories" below; and "Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities" in Part Three.~~

NAIC DESIGNATION CATEGORIES

- ~~25. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories, as described and defined in this Manual.~~
- ~~26. NAIC Designation Categories are a subset of NAIC Designations and are used by the VOS/TF to link the NAIC risk-based capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.~~

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B
5		C		5.C
6				6

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

- ~~27. An insurance company that self assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.~~
- ~~28. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.~~
- ~~29. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.~~
- ~~30. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.~~
- ~~31. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.~~
- ~~32. Securities that are residual tranches or interests, as defined in SS/AP 43R—*Loan Backed and Structured Securities*, shall be reported on Schedule BA—Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.———~~

~~**NOTE REGARDING RESIDUAL TRanches OR INTERESTS:** For 2021 year-end reporting only, residual tranches or interests previously reported on Schedule D-1: Long-Term Bonds shall be permitted to be reported on Schedule D-1 with an NAIC 6* Designation, however an NAIC 5GI is not permitted.~~

~~**NOTE:** The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.~~

NAIC DESIGNATION SUBSCRIPT S

Description of Other Non-Payment Risk

- ~~33. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.~~
- ~~34. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.~~
- ~~35. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a scheduled basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).~~
- ~~36. Using the broad concepts identified above, non-payment risk may be present when:~~
- ~~▪ A reporting insurance company takes on a participatory risk in the transaction;~~

Illustration — The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.
 - ~~▪ The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;~~

Illustration — A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.

Illustration — An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

~~37. Agrees to an exposure that has the potential to result in a significant delay in payment of contractually promised interest and/or a return of principal in an amount less than the original investment.~~

Meaning of the Subscript S Symbol

~~38. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.~~

~~39. The SVO shall assess securities for other non-payment risk:~~

- ~~▪ Routinely, for any security or financial product filed with the SVO.~~
- ~~▪ As part of the analysis of a security or financial product submitted to the SVO under the RTAS—Emerging Investment Vehicle process discussed in of this Manual.~~
- ~~▪ When requested to do so by any state insurance regulator acting pursuant to this Manual, and:~~

~~*When requested by the VOS/TF; or*~~

~~*In support of any other NAIC group engaged in the analysis of investment risks in new securities.*~~

NOTE: See “NAIC Designation Subscript S” in Part One.

**(CLEAN VERSION WITHOUT CHANGES DISPLAYED WITH ADDITIONS
HIGHLIGHTED)**

**PART ONE
POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE**

NAIC DESIGNATIONS**NAIC DESIGNATIONS****Use and Purposes of NAIC Designations**

88. **NAIC Designations** are proprietary symbols of the NAIC. The SVO, the SSG and, under certain circumstances, insurers, produce NAIC Designations for insurer-owned securities using the policies, procedures or methodologies adopted by the VOS/TF in this Manual. NAIC Designations identify a category, or gradations of credit quality identified by the NAIC 1 through NAIC 6 symbols, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks, further discussed and defined in this Manual.
89. **NAIC Designations** reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default.
90. **NAIC Designations** are produced for statutory accounting, reporting, state investment laws and other purposes identified in the NAIC Financial Regulation Standards and Accreditation Program and/or other NAIC developed regulatory guidance embodied in state law and must be interpreted by the NAIC member in context of the NAIC Financial Regulation Standards and Accreditation Program, other characteristics of the investment, and the specific financial and regulatory status of the insurance company.
91. **NAIC Designations** must also be considered in the context of its appropriateness and consistency of use in the NAIC Policy Statement and Financial Regulation Standards (SFRS) and other NAIC guidance. For example, in many cases the NAIC Designation serves as the basis for determining the appropriate risk-based capital charge for a given security.

RISKS ADDRESSED BY NAIC DESIGNATIONS

92. The NAIC's SVO's analysis of credit risk (hereafter defined), is expressed as an opinion of credit quality by assignment of an NAIC Designation and Designation Category that is may be notched to reflect the position of the specific liability in the issuer's capital structure. Collectively, NAIC Designations and Designation Categories, as defined in this Manual, describe a credit quality-risk gradation range from highest quality (least risk) to lowest quality (greatest risk). NAIC Designations express opinions about credit risk, described below, except when accompanied by the NAIC Designation Subscript S, denoting Other Non-Payment Risks.

- Credit risk is defined as the relative financial capability of an obligor to make the payments contractually promised to a lender. Credit analysis is performed solely for the purpose of designating the quality of an investment made by an insurance company so that the NAIC member's department of insurance can better identify regulatory treatment.
- Credit risk is assessed by analyzing the information and documentation provided to the SVO by the reporting insurance company and its advisors. The SVO does not audit the information submitted and assumes the information to be timely, accurate and reliable.
- The ability of an insurance company to realize payment on a financial obligation can be affected by factors not related to credit risk or by the manner in which the repayment promise has been structured. **NAIC Designations may be adjusted to reflect Other Non-Payment Risks, as described in this manual.**
- **An NAIC Designation shall reflect the likelihood of timely and full payment of principal and scheduled periodic interest, as appropriate, and the probability of principal and interest payment default. It will also reflect consideration to potential "tail risks" (e.g. the probability that a security's payment default will be more than three standard deviations from the mean is greater than what is shown by a normal distribution).**
- NAIC Designations do not measure other risks or factors that may affect repayment, such as volatility/interest rate, prepayment, extension or liquidity risk, **though these other risks may be reflected in Other Non-Payment Risks, as described in this manual.**

NAIC DESIGNATION SUBSCRIPT S (OTHER NON-PAYMENT RISK)
--

NAIC Designation Subscript S

93. An objective of the VOS/TF is to assess the financial ability of an insurer to pay claims. For example, the regulatory assumption is that a fixed income instrument called debt by its originator or issuer requires that the issuer make scheduled payments of interest and fully repay the principal amount to the insurer on a date certain. A contractual modification that is inconsistent with this assumption creates a rebuttable inference that the security or instrument contains an additional or other non-payment risk created by the contract that may result in the insurer not being paid in accordance with the underlying regulatory assumption. The SVO is required to identify securities that contain such contractual modifications and quantify the possibility that such contracts will result in a diminution in payment to the insurer, so this can be reflected in the NAIC Designation assigned to the security through the application of the notching process.

Description of Other Non-Payment Risk

94. It may not be practical, desirable or possible to specifically define other non-payment risk given the assumption that it originates as a result of a contractual agreement or the presence of a structural element of a transaction that is agreed upon between the issuer and the insurer. Accordingly, what follows is intended as general guidance to insurers and others.
95. Most typically, other non-payment risk has been associated with contractual agreements between the insurer and the issuer in which the issuer is given some measure of financial flexibility not to make payments that otherwise would be assumed to be scheduled, given how the instrument has been denominated, or the insurer agrees to be exposed to a participatory risk.
96. Other non-payment risk differs from the type of issues encountered in credit risk. This is because typically, credit assessment is concerned with securities in which the parties create subordination by modifying the lender's priority of payment (e.g., senior unsecured versus junior subordinated) but in a context where the contract otherwise specifies that the failure to make payments on a scheduled basis (defined in the contract) is an event of default (in the case of a bond) or triggers some other specific and identifiable lender remedy (in the case of other fixed income securities).
97. Using the broad concepts identified above, non-payment risk may be present when:
- A reporting insurance company takes on a participatory risk in the transaction;
Illustration – The contract promised payment of a dollar denominated obligation in non-U.S. currency but does not require an exchange rate that would yield foreign currency sufficient to buy a defined principal amount of U.S. dollars. The other non-payment risk in this illustration consists of the reporting insurance company's acceptance of currency risk which may diminish the principal amount of the investment. Currency risk here is not related to the issuer's ability or willingness to pay and therefore is not appropriately reflected in the NAIC Designation of the issuer or captured by notching for credit risk.
 - The contract governing the loan provides for a degree of permanence in the borrower's capital structure that is incompatible with notions of a loan that is expected to be repaid;
Illustration – A loan stated to be perpetual and giving the issuer the right to miss interest or dividend payments otherwise said to be scheduled where the missed payments are not required to be paid on a subsequent date.
Illustration – An instrument denominated as a bond but lacking a maturity date, a mechanism to determine a maturity dates (e.g., a mandatory redemption) or that states a maturity equal to or exceeding 40 years.

- The governing agreements permit irregular or conditional payments that are incompatible with the notion of an issuer making periodic scheduled payments of interest and repaying principal in full to the insurer on a date certain;

Illustration – A Principal Protected Security, as defined in Part Three of this Manual.

Illustration – A security with no contractual events of payment default.

Illustration - A security with contractual terms that have the potential to result in payment of contractually promised interest and/or return of principal in an amount less than the original investment.

Illustration – A security with an interest payment deferral feature that does not capitalize interest into principal or permits interest deferral for greater than twenty-four months or past legal maturity.

Directive to the SVO to Assign the Subscript S Symbol

98. The VOS/TF expressly assigns to the SVO the responsibility for assessing Other Non-Payment Risk and the authority to notch NAIC Designations and assign the Subscript S Symbol, accordingly. It does so in recognition that credit rating providers (CRPs) have no obligation to consider the regulatory assumptions and concerns that are implicit in the NAIC's use of NAIC Designations in its regulatory processes. The VOS/TF may periodically request the SVO report to it on information the SVO gathers from its review of Subscript S securities, including, for example, volume of such securities and the types of other non-payment risks.

Meaning of the Subscript S Symbol

99. An SVO determination that a specific security contains other non-payment risk is communicated by assigning the NAIC Designation subscript S to the specific CUSIP and applying the notching procedure described below. The subscript follows the NAIC Designation as follows: **NAIC 2S**.
100. The SVO shall assess securities for other non-payment risk:
 - Routinely, for any security or financial product filed with the SVO.
 - As part of the analysis of a security or financial product submitted to the SVO under the RTAS – Emerging Investment Vehicle process discussed in of this Manual.
 - When requested to do so by any state insurance regulator acting pursuant to this Manual, and:
 - When requested by the VOS/TF; or

- In support of any other NAIC group engaged in the analysis of investment risks in new securities.

APPLICATION OF NAIC DESIGNATIONS

101. **NAIC 1** is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An **NAIC 1** obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.
102. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
103. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
104. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

105. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.
106. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Regulation Standards and Accreditation Program.

NOTE: See “Prohibition on Use of NAIC Designation in a Covenant” and “Coordination Between the Statutory Accounting Principles Working Group and the Valuation of Securities Task Force” in Part One; and “Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities” in Part Three.

APPLICATION OF NAIC DESIGNATION CATEGORIES

107. Upon the determination of an NAIC Designation, the SVO produces NAIC Designation Categories.
108. **NAIC Designation Category** – Means and refers to 20 more granular delineations of credit risk in the **NAIC 1** through **NAIC 6** credit risk scale used by the VOS/TF to relate credit risk in insurer-owned securities to a risk-based capital factor assigned by the NAIC Capital Adequacy (E) Task Force. Each delineation of credit risk is represented by a letter (a Modifier) which modifies the NAIC Designation grade to indicate a more granular measure of credit risk within the NAIC Designation grade. The more granular delineations of credit risk are distributed as follows: 7 for the **NAIC 1** Designation grade indicated by the letters A through G; 3 delineations each for each of the NAIC Designation grades **NAIC 2**, **NAIC 3**, **NAIC 4** and **NAIC 5** indicated by the letters A, B and C and 1 delineation for NAIC Designation grade **NAIC 6**. The NAIC Designation Category framework is shown in this Manual. All Modifiers roll up into the respective NAIC Designation grade as they are a subset of them.
109. **NAIC Designation Categories** are a subset of **NAIC Designations** and are used by the VOS/TF to link the NAIC risk-based-capital (RBC) framework adopted by the NAIC Capital Adequacy (E) Task Force to the VOS/TF's credit assessment process. The NAIC Capital Adequacy (E) Task Force assigns RBC factors to each NAIC Designation Category as shown below.

NAIC Designation	+	NAIC Designation Modifier	=	NAIC Designation Category
1		A		1.A
1		B		1.B
1		C		1.C
1		D		1.D
1		E		1.E
1		F		1.F
1		G		1.G
2		A		2.A
2		B		2.B
2		C		2.C
3		A		3.A
3		B		3.B
3		C		3.C
4		A		4.A
4		B		4.B
4		C		4.C
5		A		5.A
5		B		5.B
5		C		5.C
6				6

110. NAIC Designations and Designation Categories may be adjusted in accordance with the notching procedures described in this Manual below so that an NAIC Designation and Designation Category for a given security reflects the position of that specific security in the issuer's capital structure. NAIC Designations and Designation Categories may also be adjusted by notching to reflect the existence of Other Non-Payment Risks in the specific security in accordance with the procedures described in this Manual associated with NAIC Designations Subscript S.

NAIC DESIGNATIONS RELATED TO SPECIAL REPORTING INSTRUCTION

111. An insurance company that self-assigns a 5GI must attest that securities receiving this designation meet all required qualifications by completing the appropriate general interrogatory in the statutory financial statements. If documentation necessary for the SVO to perform a full credit analysis for a security does not exist or if an NAIC CRP credit rating for an FE or PL security is not available, but the issuer is not current on contractual interest and principal payments, and/or if the insurer does not have an actual expectation of ultimate payment of all contracted interest and principal, the insurance company is required to self-assign this security an NAIC 6*.

112. NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation in instances in which appropriate documentation does not exist, but the requirements for an insurance company to assign a 5GI are not met.
113. Securities with NAIC 5GI Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. A security assigned an NAIC 5GI Designation incurs the regulatory treatment associated with an NAIC 5 Designation.
114. Securities an insurance company previously assigned as NAIC 5GI are permitted to subsequently receive this designation if the requirements for an NAIC 5GI designation continue to be met.
115. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore, a security assigned an NAIC 6* Designation incurs the regulatory treatment associated with an NAIC 6 Designation.
116. Securities that are residual tranches or interests, as defined in *SSAP 43R – Loan Backed and Structured Securities*, shall be reported on Schedule BA - Other Long-Term Invested Assets, without an NAIC Designation and are ineligible to be assigned an NAIC 5GI or NAIC 6* Designation.

NOTE: The GI after the quality indicator 5 refers to General Interrogatory and distinguishes NAIC 5GI from an NAIC 5 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation.

NAIC General Interrogatory

117. **NAIC 5GI** and NAIC Designation Category **NAIC 5.B GI** is assigned by an insurance company to certain obligations that meet all of the following criteria:
- Documentation necessary to permit a full credit analysis of a security by the SVO does not exist or an NAIC CRP credit rating for an FE or PL security is not available.
 - The issuer or obligor is current on all contracted interest and principal payments.
 - The insurer has an actual expectation of ultimate payment of all contracted interest and principal.

NAIC PLGI

118. Effective July 1, 2018, insurance companies shall be responsible for providing the SVO copies of private rating letters for PL securities, where applicable, until such time as industry representatives and the SVO shall have established reliable procedures for obtaining the necessary information on credit ratings directly from the NAIC CRPs. For PL Securities issued prior to January 1, 2018, if an insurance company cannot provide a copy of the rating letter to the SVO due to confidentiality concerns and the rating is not included in a CRP credit rating feed (or other form of direct delivery from the NAIC CRP), the insurer shall report such securities on such securities' General Interrogatory to be developed for this purpose (i.e., a PLGI security).

Monitoring of SVO-Designated Securities

119. The SVO shall monitor, on an ongoing basis through the information provided by insurers as required by the Material Credit Events Filing described in this Manual, improvements and deterioration of credit quality of securities that are not filing exempt.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2023/2023-05-15 Interim meeting/01-Definition of NAIC Designation Part Two/2023-012.05 P&P Updated Def of NAIC Desig v7.docx>