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January 22, 2018

Mr. Kevin Fry
 Chair
 NAIC Investment Risk-Based Capital Working Group

RE: Updated Recommendation of Corporate Bond Risk-Based Capital (RBC) Factors

Dear Kevin:

The American Council of Life Insurers¹ (ACLI) appreciates the opportunity to comment on the most recent RBC C-1 proposal provided by the American Academy of Actuaries (“Academy”) dated October 10, 2017. We specifically would like to acknowledge the Working Group’s decision to expose the proposal for a 90-day comment period allowing stakeholders the opportunity to conduct a thorough review, analysis, and prepare written comments. Furthermore, we were encouraged by your statements expressed during the Working Group’s October 23rd conference call that stressed the importance of the Working Group performing its due diligence in its process and taking the time to come to decisions on important outstanding issues. Finally, the decision to set a target implementation date of 2019 will allow time for the Working Group, industry, and other key stakeholders to work through remaining issues and provide adequate time for insurers and the NAIC to process system changes and other implementation requirements.

Executive Summary

The latest proposal does not address the concerns that we have previously raised: the material increase in the C-1 bond capital charges, especially for smaller insurers (see the “Impact of the Current Proposal” section); and the change in the slope of the capital charge which could encourage investment in lower grade bonds (see the “Benchmarking to History” section).

As a result, we cannot support the proposal in its current form, but we remain committed to working toward the development of C-1 factors that reflect the desired increase in granularity, are consistent with the risks of a credit portfolio, reflect the diversity of asset types, and produce a rational scale of capital charges.

While we believe that the best way of accomplishing these desired changes would require a different model, we recognize that the NAIC Investment RBC Working Group does not believe wholesale changes to the underlying model are practical at this point. Therefore, we have developed two adjustments that could be incorporated within the current proposal and the underlying model to address the larger issues that the ACLI has previously identified. We believe the combination of the

¹ ACLI is a Washington, D.C.-based trade association with approximately 290 member companies operating in the United States and abroad. ACLI advocates in state, federal, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers’ products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing 95 percent of industry assets, 93 percent of life insurance premiums, and 98 percent of annuity considerations in the United States. Learn more at www.acli.com.

following two adjustments would produce outputs similar to what a more modern and robust credit portfolio model would produce:

1. Spread Adjustment: Incorporate a small amount of additional risk premium in the model above the current conservative assumption to more accurately reflect the fact that reserves make provision for more than mean expected loss. This is explicit at a CTE 70 level in Principle-Based Reserves (PBR), and by comparison is evident in pre-PBR reserves. This small shift helps right-size both the overall capital level as well as the relative difference between investment grade and below investment grade capital charges, and is still very conservative relative to the default costs explicitly used in PBR.
2. Additional Asset Classes: Expand the recovery experience behind the C-1 bond factors to include municipals and private corporate bonds. This better reflects the different risk characteristics of these asset classes relative to senior unsecured public debt. These results could either be incorporated via distinct charges at the asset class level, or incorporated into an overall weighted set of factors.

In addition to these adjustments, we believe that now would be the opportune time to also reflect the impact of the new corporate tax rates in the development of the final C-1 bond factors. We have done some preliminary modeling to understand the impact tax reform has on the proposed factors, but additional analysis will be necessary to finalize them.

ACLI stands ready to work with regulators to incorporate these changes.

In the remainder of this letter, we will cover the following topics:

- Detail on Proposed Adjustments to Model
- Impact of Current Proposal
- Benchmarking to History

Detail on Proposed Adjustments to Model

The following proposed adjustments (spread adjustment and incorporating additional asset classes) are a practical way to improve the factors and better replicate a more modern credit model. Additionally, the existing model may be used to validate the impact of the recommended changes and thus decide on a final set of factors well before the target implementation date.

Spread Adjustment

Proposal: Adjust the spread assumption.

Increasing spreads to level shown in Figure 1 (i.e. Academy Spread * 97% + Average Spread * 3%) generates quite similar results to those produced by the robust model previously supplied by the ACLI (it transforms the current model into a portfolio model). This is a minor adjustment but has a significant impact on the final results.

The results in Figures 4 and 5 (see “Benchmarking to History” section) utilize the spread assumptions in the most recent proposal, which are average discounted default losses. These results illustrate one of the modeling concerns previously identified by the ACLI: the spread assumption being used in the current proposal is overly conservative as actual credit spreads are multiples higher. More importantly, since the variance increases as the credit rating improves, the

current model's spread assumption drives the bias towards higher Investment Grade and lower Below Investment Grade capital charges.

We believe that the historical capital estimates presented in Figure 5 can be used to triangulate capital charges by modifying the spread adjustment in the current model.

Figure 1: Comparison of Average Spreads and Average Default Costs across A, Baa, and Ba Ratings

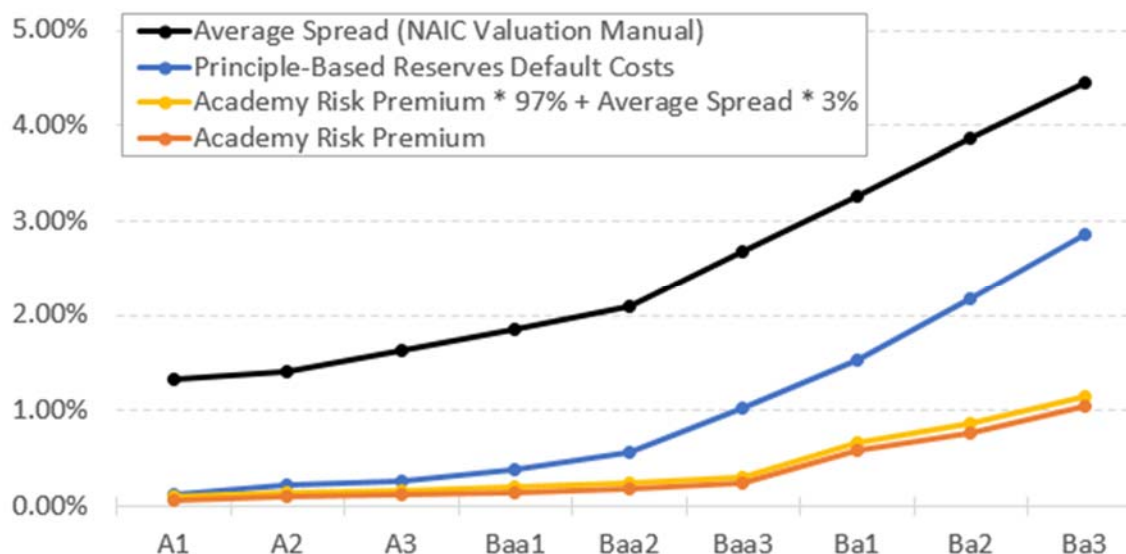


Figure 1 illustrates how much lower the Academy's spreads are relative to both long-run average spreads (as defined in the NAIC Valuation Manual) and Principle-Based Reserves (PBR) default costs. The single A spreads being used by the Academy are approximately 15x lower than long-run spreads, while Baa and Ba are approximately 11x and 5x lower, respectively. Note the line directly above the Academy spread line: we will use the spread between these two lines later as a simple adjustment that produces more consistent capital charges relative to risk premia and experienced spread, even though the recommended adjustment is visually indistinct from what is used in the current model.

It is difficult to say with precision what level of spread is appropriate. Credit spreads include compensation to investors for more than just higher default loss risk than Treasuries such as a premium for lower liquidity than Treasuries. Unfortunately, the size of these other premia is not directly observable. However, there are multiple indications that the average default cost being recommended is overly conservative:

- Reserves cover default losses significantly above the average, either at 1 standard deviation above average or CTE70 (average of the worst 30% of outcomes) for PBR.
- Bonds backing reserves are only earning the spread between investment income promised to the policyholder (implicitly through pricing assumptions or explicitly through cash values) and the total investment income that is earned, whereas bonds backing surplus earn the entire investment income for an insurer. Thus, there is actually less risk in bonds backing surplus than bonds backing reserves, since all of the investment earnings on the surplus can be used to offset the cost of defaults.
- No Chief Investment Officer would invest in corporate bonds that only earn as much as Treasuries on average. A basic principle of finance is that investors are risk-averse: there must be a higher expected return in exchange for higher risk.
- Credit default swap data, available since 2005, imply that the compensation for default risk has never dipped below 50% of the spread for Investment Grade bonds. This 50% observation occurred in late 2008 during the most extreme liquidity crisis in living memory.

By comparison, the average default cost assumption used in the current model is less than 10% for all Investment Grade rating categories.

The Academy's October 2016 response letter to initial industry comments submitted in September 2015 addressed its reasoning for using the average default losses as the spread. Excerpts include:

- “While not explicitly defined in current valuation standards, general actuarial consensus is that the life policy reserves make provision for risks under moderately adverse conditions”
- “The RP [risk premium] is only an appropriate assumption for the required capital on those bonds backing life insurance policy reserves. Using the mean was based on judgment, but also consistent with the approach used in developing the current C1 factors”
- “The ‘correct’ answer for the [spread] lies between zero and the 67th percentile; we thought the 50th percentile was reasonable given the lack of an explicit quantification of the level of default”

The current model uses the mean because this is what was used previously, but the Academy acknowledges that the correct spread is quite possibly higher.

While this decision might be workable given no other modifications, other assumptions were also updated that affect modeled losses by rating. The most prominent such example is the removal of Loss Given Default (LGD) differentiation by rating, which previously incorrectly assumed better LGDs for higher rated bonds. By not also fixing the spread assumption, the Academy's proposal is disrupting delicate balance that previously – either by chance or by design – resulted in reasonable tradeoffs in capital charges for Investment Grade relative to High Yield.

Figure 2: Comparing Academy and ACLI Proposals to Current NAIC Framework

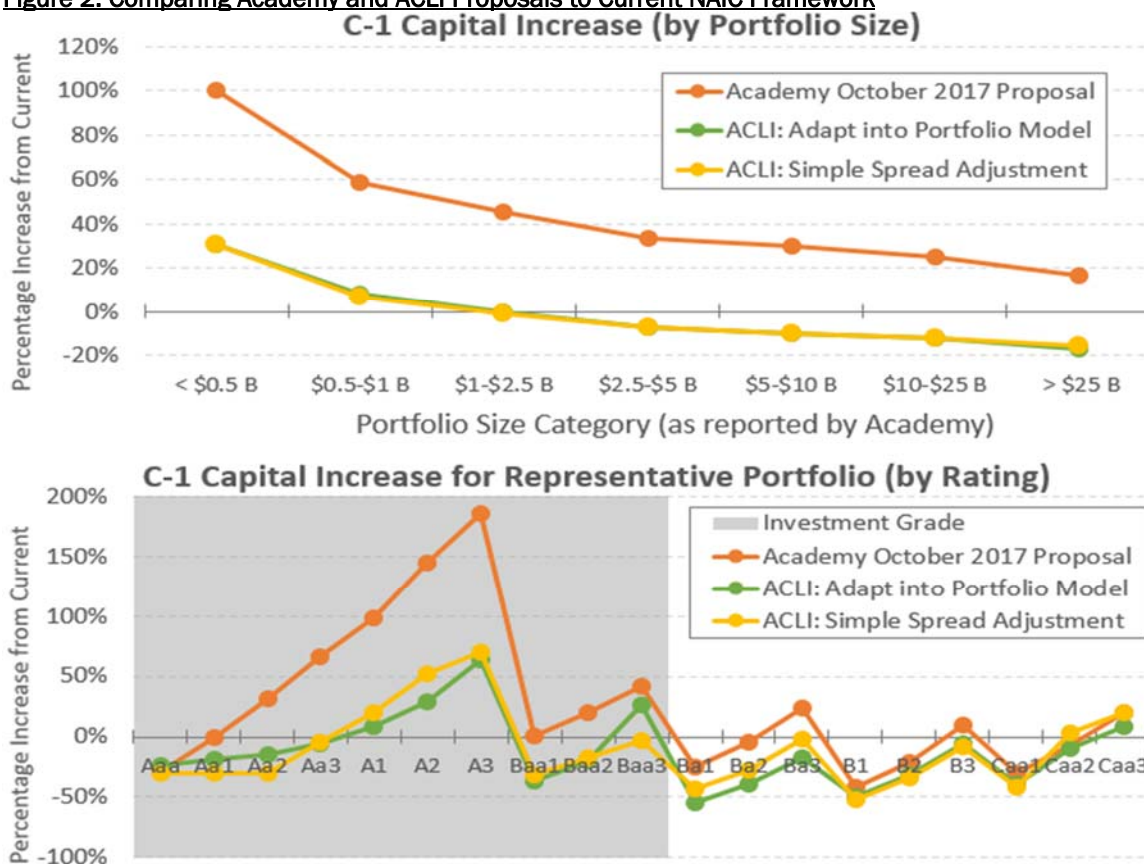


Figure 2 shows the ACLI’s two versions of updates to the latest model. Both ACLI versions are much closer to the current RBC framework than the current proposal²:

- Overall capital by portfolio size changes no more than 30% up or down. Note how the biggest impact by portfolio size relative to the current proposal is for the smallest insurers despite not changing the portfolio adjustment; the lower Investment Grade bond factors impact the smallest insurers the most because their portfolios contain a higher share of Investment Grade bonds.
- Single A capital charges still increase, but only by 70% instead of by 200%.
- The difference between the two sets of ACLI proposals is quite small.

Asset Class Differentiation Adjustment

Proposal: Incorporate other asset categories – e.g., private corporate bonds and US municipals.

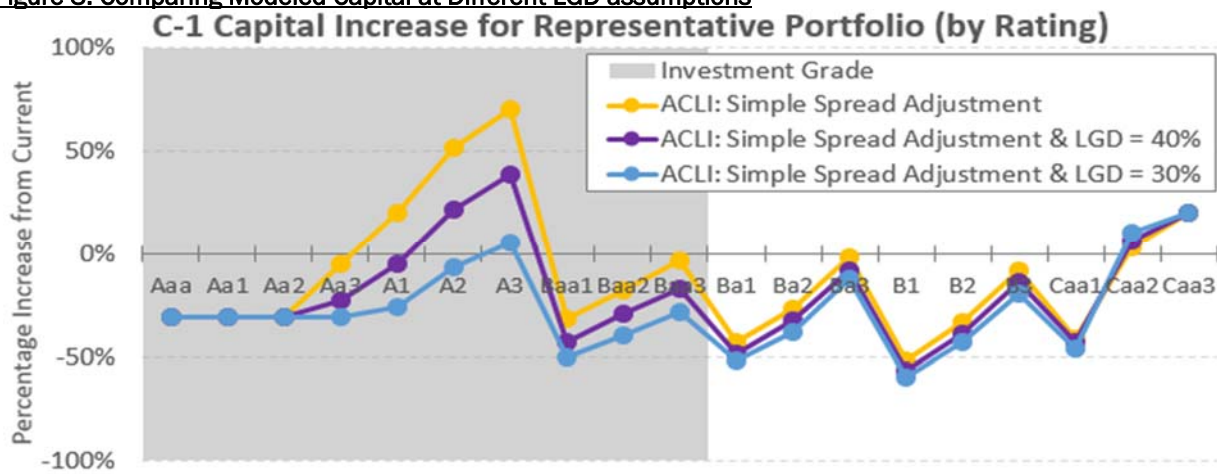
Another modeling concern that we believe needs to be addressed is the lack of asset class differentiation. Currently, the model treats all bonds as public corporate bonds, which ignores the two primary benefits of other bond asset classes such as private corporate bonds and US municipals:

- Long history of better recovery after default than public corporate bonds
- Diversification benefit within the portfolio

The rationale cited for using the same capital charges for all bond asset classes is that Nationally Recognized Statistical Rating Organizations (NRSROs) use a global ratings process such that an “Aa rated corporate bond and an Aa rated municipal bond by Moody’s both have the same outlook for future loss experience”. This future loss experience, however, refers to expected loss, which is an average loss that makes no claim about how the distribution of default losses looks.

All credit models, including the current model, decompose default loss into a Probability of Default (PD) and a Loss Given Default (LGD) such that the expected loss (EL) equals average PD times average LGD. Capital is determined by looking at default losses in severe scenarios far from the average; for any given level of EL, capital will vary depending on how that EL is decomposed into PD and LGD. Thus, the higher the LGD for any level of EL (and therefore the lower the PD), the higher the capital requirement will be because the outcomes become more severe in ‘tail’ events.

Figure 3: Comparing Modeled Capital at Different LGD assumptions



² Please refer to Appendix A for the C-1 Bond Factor Comparison (current to October 2017 proposed) for the representative portfolio.

This effect occurs in the current model too. Figure 3 shows how capital by rating decreases as average LGD decreases from the current assumption of 52% to both 40% (roughly the historically experienced US municipal LGD) and 30% (roughly the historically experienced private corporate LGD). In each of these cases, default rates were increased in the model by the same proportion as the decrease in LGDs so that average default losses (expected losses) are identical.

Note how the distinction in LGD matters more in Investment Grade rating categories, particularly for A-rated bonds. This adds further credence to the assertion that the current NAIC 1 bond factor is not too low on average, as about half of NAIC 1 C-1 eligible bonds as of year-end 2016 are not public corporates. Other bond asset classes' lower capital charges could be reflected in one of two ways:

1. Separate capital charges by bond asset class, at least in Investment Grade
2. Lower average capital charge by rating where there are substantial holdings of other bond asset classes

Furthermore, making this adjustment to the current model does not reflect the potential diversification benefits of investing in other asset classes. While there may not be much diversification benefit to be had between public corporate bonds and private corporate bonds, there is certainly more when comparing public corporate bonds to government-related bonds such as municipals or sovereigns.

To adequately capture the effect of diversification, the representative portfolio's various asset classes and ratings would need to be modeled in a portfolio model with various correlation assumptions. Modern credit practitioners focus much of their time and energy on appropriately calibrating correlation inputs, which portfolio managers consider when making investment allocation decisions. Holdings within each of the proposed 19 NAIC rating designations are modeled on a standalone basis; unfortunately, there is not a simple and accurate way to account for the effects of diversification within this current construct. In our opinion, a model can only produce results that approximate actual investment experience if its representative holdings are modeled holistically. Again, we understand that wholesale changes will not be occurring; however, we hope this adjustment is taken into consideration when finalizing the C-1 bond factors.

Impact of the Current Proposal

Intuitively, reviewing the changes that are currently proposed indicate that capital will increase dramatically for those carriers with a portfolio of investment grade securities.³ The magnitude of the increase is severe for smaller companies when the new portfolio adjustment factor is applied. The ACLI has performed a member impact survey. ACLI survey results⁴ further substantiate the observation that the impact of the proposed changes will be significant, especially for smaller insurers. The impact noted in our survey indicates an approximate \$10 billion increase in C-1 capital versus the estimated \$6 billion mentioned in the Academy's work.

Results by Size

Size of Insurer (Total Invested Assets)	Increase/(Decrease) In C-1o Capital
< .5 billion	37%
.5 - 1 billion	30%
1 - 2.5 billion	15%
2.5 - 5 billion	17%

³ Please refer to Appendix A for a comparison in the percentage change in the factors.

⁴ The compiled survey results represent 57% of 12/31/2016 Reported Invested Assets (and approximately 56% of bonds).

5 – 10 billion	10%
10 – 25 billion	15%
25 billion	6%

Results by # of Issuers

# of Issuers	Increase/(Decrease) in C-1o Capital
< 100 issuers	36%
100 < issuers < 500	24%
Over 500 Issuers	7%

The ACLI has been consistent in its message that, if adopted in its current form, the current proposal would have wide-ranging impacts:

- **Policyholders:** Pricing will need to reflect the material increase in capital cost and/or increased riskiness of assets
- **Life Industry:** Disadvantages for smaller insurers that will have larger capital requirements; in total as well as relative to larger insurers
- **Shareholders:** Added risk as incentives push investment in higher risk assets
- **Capital Markets:** Increase in cost of operation for investment grade corporate issuers as well as an incentive to operate under more leverage (Life insurer holdings represent approximately 1/3 of all US Investment Grade corporate bonds per Barclays)

Benchmarking to History

Given the magnitude of the proposed changes, it is especially important to be as confident as possible that changes are warranted. There are three possible reasons for such large changes in the modeled results:

1. Changes in historical experience (i.e. model input data) between the early 1990s and today
2. Changes in the model (i.e. added granularity, different percentile, etc.)
3. Flaws in the model causing an inability to handle updated inputs

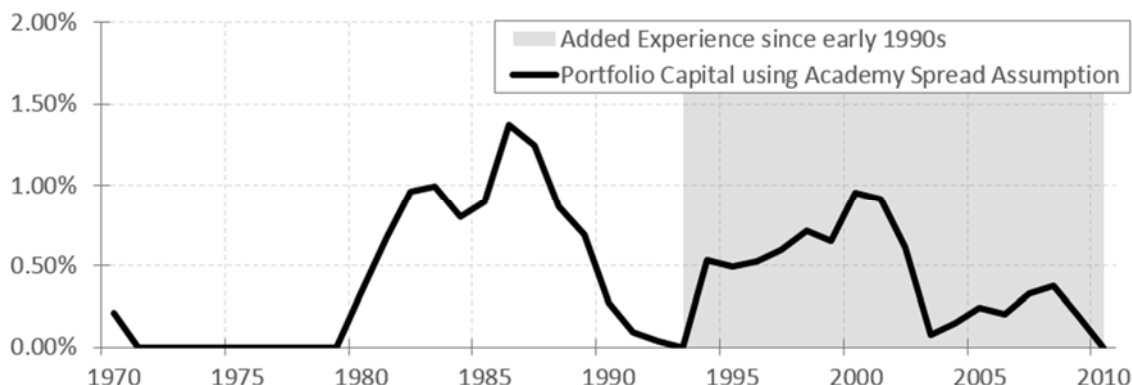
If capital charges are increasing solely due to worsening historical experience (reason #1), the significant changes being proposed would be justified. If capital charges are materially increasing primarily due to model changes (reason #2), proposed increases may be justified but the model changes need to be closely scrutinized. This extra scrutiny is necessary to ensure that the increases are not occurring due to flaws in the model (reason #3), in which case the model should either be replaced or further modified to achieve more reasonable results.

We undertook a simple exercise of historical benchmarking to help isolate whether worsening historical experience is to blame for the dramatic increases in capital charges. We use the Academy's definition of capital to calculate the capital that would have been needed starting each year 1970–2010 to survive the worst shortfall over the next 10 years. The following data are used for the analysis:

- **Yearly default rates by rating and yearly recovery rates.** These are from the same Moody's report used by Academy. Note that the recovery rates we use are "trading price" recoveries as opposed to the "ultimate" recoveries used by the Academy because only the trading price recoveries are published by year. Trading price recoveries are more conservative: they average about 37% as compared to the Academy's assumption of about 48%.
- **Yearly Treasury yields (10 year).**

- Academy's assumption for average spread over Treasuries**, defined to be average discounted default losses by the Academy (referred to as the "risk premium"). This assumption is overly conservative, as highlighted in detail earlier in this document; however, comparisons between different time periods are still valid when applying this assumption uniformly to all points in time.

Figure 4: Estimated Capital Required for Representative Portfolio using Academy Spread Assumption



In Figure 4, we calculate capital required in each starting year for the representative portfolio defined by the Academy and using the Academy's spread assumption. Intuitively, this shows capital needs peaking at the start of the major credit events that have occurred in the past half century (late 80s/early 90s, early 2000s, and 2008/09).

The key takeaway from the initial result is that capital needs for the representative portfolio were significantly higher in the late 1980s than at any point afterwards. This default loss experience was available to the original creators of the RBC C-1 framework. Since the new experience has *improved*, it is counterintuitive that insurers would need substantially *more* capital. Moreover, it has been publicly suggested that declines in GDP and economic growth constitute the adverse experience that warrants an increase in required capital. We respectfully submit that this suggestion is conflating macroeconomic indicators with credit default and recovery rates, when in reality, the two measurements exhibit a more nuanced and independent relationship.

Figure 5: Estimated Capital Required for Select Ratings using Academy Spread Assumption

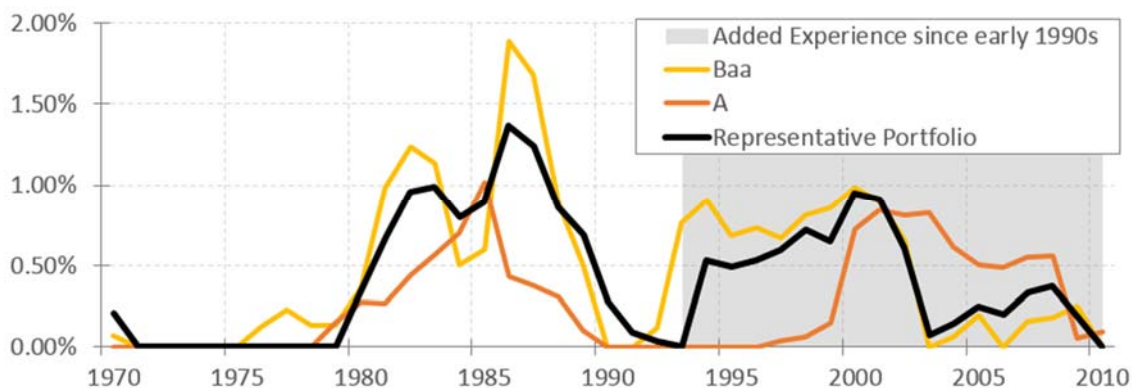


Figure 5 repeats the previous analysis separately for A and Baa issuers. Just as for the entire representative portfolio, capital required for each of these ratings individually also peaks in the

1980s. Thus, there is no evidence that worse experience or added granularity is driving higher capital charges: it again indicates that capital is increasing due to inappropriate changes to the model or flaws in the model.

Figure 5 also highlights the first of the main modeling issues identified by the ACLI: to properly estimate capital for a life insurer's portfolio, a model must simulate the entire portfolio in unison instead of each rating grade independently (as the Academy model does). Note how A and Baa capital needs are not perfectly correlated, and how the portfolio offers substantial diversification benefit. This is intuitive as the composition of rating grades differ in industry and capitalization. Modern credit models recognize this. True capital requirements for any rating category included in a portfolio should be defined as that rating category's contribution to the portfolio-level capital requirements. This concept drives capital "allocation" by rating in the updates proposed by the ACLI in October 2016 that transforms the Academy model into a portfolio model.

Conclusion

The ACLI proposes to make two simple adjustments to the Academy model:

1. Increase spread
2. Incorporate other asset classes

These adjustments have strong theoretical justifications, are easy to implement quickly, and largely correct the misaligned incentives in place in the current proposal. These adjustments will help to address the following:

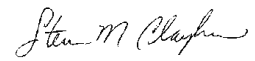
- The results will be more in line with other modern portfolio models which produce lower capital requirements and a different slope between investment grade and below investment grade bonds;
- The adjustments eliminate the double-counting of risks already covered by reserves;
- Not all the debt will be treated as if it were senior unsecured public corporate debt; and
- The resulting capital charges will better match historical benchmarking.

The ACLI also has concerns about the new portfolio adjustment factor will have on smaller insurers. However, we do not have enough information available to be able to evaluate the formula appropriately and to offer an alternative suggestion. Absent new information, the ACLI recommends that portfolio adjustment factors as proposed in the Academy's October 2017 report be used in combination with the new bond factors that result after the spread and asset class adjustments are made.

Finally, in addition to the adjustments identified, we believe this it is also appropriate to factor in the impact of the recent change in the corporate tax rate in developing the final set of C-1 bond factors

As always, the ACLI appreciates the opportunity to contribute to the discussions on this very important framework. We believe that our proposed solutions are a practical way to improve the factors and better replicate a more modern credit model. These changes could be implemented in a simple manner and well before the target implementation date. We look forward to discussing these proposed changes with the Working Group.

Sincerely,



Steven Clayburn

cc: Julie Garber, CPA, Sr. Manager, Solvency Regulation, NAIC
Dan Daveline, Director, Financial Regulatory Services, NAIC

Appendix A – Comparison of Current C-1 Factors to October 2017 C-1 Factors

The following chart is a comparison of the current RBC C-1 factors to the October 2017 proposed factors (as would be calculated for the representative portfolio), with the percent change of each factor:

C-1 Bond Factor Comparison for Representative Portfolio					
Current category	Proposed category	Moody's rating	Current factor	Proposed factor	% Change in factor
NAIC1	1	Aaa	0.41%	0.30%	-28%
NAIC1	2	Aa1	0.41%	0.41%	-1%
NAIC1	3	Aa2	0.41%	0.54%	32%
NAIC1	4	Aa3	0.41%	0.69%	66%
NAIC1	5	A1	0.41%	0.82%	99%
NAIC1	6	A2	0.41%	1.01%	145%
NAIC1	7	A3	0.41%	1.18%	186%
NAIC2	8	Baa1	1.34%	1.35%	1%
NAIC2	9	Baa2	1.34%	1.61%	20%
NAIC2	10	Baa3	1.34%	1.91%	42%
NAIC3	11	Ba1	4.75%	3.57%	-25%
NAIC3	12	Ba2	4.75%	4.54%	-4%
NAIC3	13	Ba3	4.75%	5.87%	24%
NAIC4	14	B1	10.32%	6.05%	-41%
NAIC4	15	B2	10.32%	8.14%	-21%
NAIC4	16	B3	10.32%	11.26%	9%
NAIC5	17	Caa1	23.74%	16.50%	-31%
NAIC5	18	Caa2	23.74%	22.13%	-7%
NAIC5	19	Caa3	23.74%	28.59%	20%



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January 22, 2018

Kevin Fry
Chair, NAIC Investment Risk-Based Capital Working Group
National Association of Insurance Commissioners
VIA Email Transmission: jgarber@naic.org

RE: NAMIC Comments – Updated Recommendation of Corporate Bond Risk-Based Capital (RBC) Factors

Dear Mr. Fry:

The following comments are submitted on behalf of the member companies of the National Association of Mutual Insurance Companies regarding the RBC structure and factors for fixed income asset capital charges.

NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies representing 39 percent of the total market. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC member companies serve more than 170 million policyholders and write more than \$230 billion in annual premiums. Our members account for 54 percent of homeowners, 43 percent of automobile, and 32 percent of the business insurance markets. Through our advocacy programs we promote public policy solutions that benefit NAMIC member companies and the policyholders they serve and foster greater understanding and recognition of the unique alignment of interests between management and policyholders of mutual companies.

On October 23, 2017, the Investment RBC Working Group exposed an American Academy of Actuaries (Academy) letter, dated October 10, 2017, and titled, "Updated Recommendation of Corporate Bond Risk-Based Capital (RBC) Factors" for a 90-day comment period ending January 22, 2018. The exposure represents the latest iteration of recommended RBC factors for fixed-income securities for the NAIC's Life RBC formula. The proposal also includes recommended factors for the Property and Casualty and Health RBC formulas; however, these factors are only considered a starting point for regulators to consider.

The Academy's letter highlights their response to concerns raised by regulators regarding how the statistical safety level was calculated in a prior Academy C1 Work Group recommendation. Prior to the October 10 letter, the Academy recommendation was based on a statistical safety level of the 96th percentile over a 10-year time horizon. This was met by combining the base recommended factors with the portfolio adjustment, and setting the



base recommended factors at the 92nd percentile. Due to the counterintuitive results of the portfolio adjustment, it was decided to revise the portfolio adjustment (set at 1.0) and set the statistical safety level for the base factors at the 96th percentile over a 10-year holding period.

In addition to exposing the updated proposal, two important points related to the project were discussed on the October 23 working group conference call. First, it was announced that 2019 would be the new implementation date for the new structure and updated bond factors. Second, the working group learned that a joint committee between the Academy's health and P/C actuarial groups was formed and will review and evaluate the life bond model, including the proposed factors. The joint committee is up and running and has held at least one conference call that has included health and P/C interested parties.

The development of a new structure and updated factors for fixed-income securities has been ongoing for several years, and with a new implementation date of 2019 announced, companies now have a new target date to plan for. NAMIC is appreciative of the working group pushing back the implementation date one-year as it alleviates one of the biggest concerns for our members; the back-testing needed for a change of this scale. As you are aware, there is a multi-step process for companies to implement a new structure and factors. It begins with the investment accounting system vendors releasing the software that includes the new adopted factors, which is typically done twice per year. Then companies must upgrade their internal systems to populate the new structure and factors and test the new system. Finally, companies will need enough time to integrate the new system into their capital forecasting process. Given all that needs to be in place, the new factors will need to be adopted before year-end 2018 or first quarter 2019 in order to give companies enough time to meet the 2019 target date.

Most of the questions and concerns raised by industry, as far as the inputs and the overall model are concerned, have been addressed in the current proposal, except for the question on whether to apply the life factors to the P/C and Health RBC formulas. In the past, NAMIC has raised concerns about applying the life factors to the P/C RBC formula for many reasons. While we understand doing a study and developing a process like the life process is not feasible given the amount of time it has taken us to get here, we are pleased that a joint committee of P/C and Health experts from the Academy has agreed to review and evaluate the current proposal. NAMIC is supportive of this committee and the process they have created to review the proposal.

The joint committee has held at least one call since the proposal was released and are focusing their efforts on the differences that should be considered for the P/C and Health RBC formulas. In addition to looking at things like the different accounting treatment and tax-effect considerations, the committee is also looking at the differences in holding periods for life, health, and P/C company portfolios. NAMIC members identify this area as



one of the major differences between life and P/C insurance company portfolios. P/C insurers typically have shorter investment cycles; therefore, the reinvestment risk is not as great. NAMIC members are pleased to know that a process is in place to review the life factors and are hopeful that the working group will consider the analysis put together by the joint committee.

Thank you for your consideration of these comments on this matter of importance to NAMIC member companies and their policyholders.

Sincerely,

Jon Rodgers
Financial Regulation Manager
National Association of Mutual Insurance Companies