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October 15, 2018

Kevin Fry, Deputy Director Financial/Regulatory – Illinois Department of Insurance
Chair, Investment Risk-Based Capital (E) Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106

VIA Email Transmission: igarber@naic.org

RE: Bond Risk Factors Report for P&C and Health RBC Exposure

Dear Mr. Fry:

The following comments are submitted on behalf of the member companies of the National Association of Mutual Insurance Companies¹ regarding the report produced by the American Academy of Actuaries Joint Bond Factor Work Group of the P&C RBC Committee and the Health Solvency Committee (PCHWG) exposed for comment on August 4, 2018.

NAMIC members are pleased to offer comments on PCHWG report, as it represents an extensive review of the American Academy of Actuaries C1 Work Group (CIWG) bond factor recommendation report. The PCHWG evaluated the methods and assumptions used by the C1WG, as well as the recommended bond factors. The PCHWG has produced a report with indicated risk factors for both the P/C RBC formula and the Health RBC formula and have identified important regulatory decisions to be made based on the key assumptions and methods used to form the resulting indicated risk factors. The following are NAMIC's comments on the increased granularity presented in the PCHWG report and the methods and assumptions used to produce the indicated risk factors.

Starting with the decision to expand the number of bond rating classes from six to twenty, this working group has led the way in increasing granularity within the formula, which will serve as a major update to the factors since they were first implemented in the 1990's. As it relates to the PCHWG report and increased granularity, the report is in line with recent decisions made by this working group and other working groups under the Capital Adequacy Task Force. The report presents factors for the P/C RBC formula and the Health formula that are different from those proposed for the Life RBC formula.

¹ 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.



Over the last several years, the P/C RBC formula has undergone significant changes, and while the results of those changes may not be fully understood, the formula in general has become more granular, particularly in the way the factors are developed. For instance, the redeveloped and newly adopted reinsurance recoverable charge is more risk-focused and has made its' impact on the P/C RBC formula already. In addition, a catastrophe risk charge was included in the formula for the first time as a stand-alone factor in 2017. The new basic operational risk add-on charge will be effective for the first time this year with the filing of the 2018 RBC formulas. The add-on is equal to 3% of total RBC after covariance, so it's impact will be a direct reduction in RBC for all filers. In the future, bond exchange traded funds and municipal bonds will all be studied and additional granularity by way of new or updated charges may be added to the P/C RBC formula. Still further, growth risk and cyber risk may be other areas to be considered for the formula.

The purpose of the RBC formula is a tool for regulators to identify weakly capitalized companies. The additional granularity that has been added to the formula over the years has sharpened this tool and has contributed to the general maintenance of the formulas. The three main areas of focus for the RBC formulas are asset risk, underwriting risk, and other risk; although, the emphasis on these risks differs from one formula to the next. As it relates to asset risk, overall asset risk in the P/C RBC formula has increased overtime and is taking a greater slice of the total risk prior to covariance; however, historically the impact asset risk has had on the P/C RBC formula has been minimal. Typically, it is underwriting risk, such as reserve risk or premium risk, that has the most impact on RBC.

Beyond presenting separate indicated risk factors for the P/C and Health RBC formulas, the PCHWG has considered additional granularity with the assumption to segment the analysis based on type of bond, i.e. investment grade or speculative grade. This proposal deserves some attention. For investment grade bonds (NAIC 1-2), the PCHWG uses the bond default risk model prepared by the CIWG and modifies it by utilizing a 96% target confidence interval with a five-year time horizon. For speculative grade bonds (NAIC 3-5), the PCHWG introduces a new method that calibrates the risk based on market value risk. NAMIC members support segmenting investment grade bonds versus speculative grade bonds and support the assumptions used to develop these indicated risk factors.

Well over 90% of fixed income assets owned by NAMIC members are investment grade bonds which is typical of the entire P/C insurance industry. Drawing a distinction between bond quality is beneficial and would be similar to statutory accounting guidance in the reporting of P/C fixed income investments, where investment grade bonds are held at amortized cost and speculative grade bonds are held at fair value.

Turning to the time-horizon assumption, the PCHWG proposes using a liability runoff time horizon and indicates that using a time horizon linked to credit cycles is not appropriate for P/C risks. NAMIC members agree with this assumption, as it is more risk-sensitive and more closely matches assets with liabilities, a fundamental concept for financial institutions. With underwriting risk being the largest component within the P/C RBC formula, the PCHWG focused on two things: 1) the risk of potential adverse development over the period until all claims are settled, and 2) the potential adverse results of a single accident year. They concluded that the time horizons for both risks combined are considerably less than the 10-year time horizon as proposed for the life formula.



As it applies to the confidence interval assumption, it is noted that the NAIC does not prescribe a target safety level for the overall formula. In fact, differences exist in target safety levels and time horizons based on the risk being considered. As indicated in the PCHWG report, the 96% confidence level was a decision made by the regulators for the life formula and NAMIC members support this decision.

Finally, the indicated risk factors for speculative grade bonds were calibrated using a market value risk approach. This is a new concept that the working group has not considered in the past; therefore, it may be beneficial to explore this option. NAMIC members are supportive of looking at this approach and the various assumptions used in building this method. One aspect of this approach that is appealing is that it is calibrated to the current common stock factor of 15%. Intuitively, this makes sense as both are recorded at fair value in the financial statements and both exhibit similar market risk elements.

Thank you for your consideration of these comments on this matter of importance to NAMIC, its member companies and their policyholders. If there are any questions, please feel free to contact me at 317-876-4206.

Sincerely,

Jonathan Rodgers
Financial Regulatory Manager
National Association of Mutual Insurance Companies

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October 4, 2018

Kevin Fry, Chair
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Patrick McNaughton, Chair
Health Risk-Based Capital (E) Working Group
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Via electronic mail to Jane Barr and Julie Garber.

Dear Mr. Fry and Mr. McNaughton:

We are writing in regard to the report from the American Academy of Actuaries titled, “An Update to the Property & Casualty and Health Risk-Based Capital Bond Factors: Report to the NAIC Investment Risk-Based Capital (E) Working Group, Health Risk-Based Capital (E) Working Group, and Property and Casualty Risk-Based Capital (E) Working Group,” as exposed for comment by your Working Groups. UnitedHealth Group is one of the nation’s largest managed care and healthcare services companies, which administers and provides healthcare benefits serving individuals in all fifty states and the District of Columbia. We thank you for the opportunity to comment on the Academy’s report.

We begin with a comment regarding the treatment of investment income in the analysis. Beyond that, our comments are directed at three distinct areas addressed by the Academy’s report: investment-grade bonds; speculative-grade bonds; and other asset classes. All of our comments relate solely to the factors for Health Risk-Based Capital (RBC), although some of our comments may also be relevant to the comparable aspects of the analysis for Property and Casualty RBC.

Treatment of investment income.

Our first comment is relevant to both investment-grade bonds and speculative-grade bonds. We would like to raise a point that we cannot recall being addressed in previous discussions (and which we have not ourselves raised previously).

Investment income (i.e., bond coupon payments) was not reflected in the development of the bond risk factors for the Life RBC formula, except to a very limited extent. In their report of August 3, 2015, titled, “Model Construction and Development of RBC Factors for Fixed Income Securities for the NAIC’s Life Risk-Based Capital Formula,” the Academy explained the exclusion of most investment income as follows (on page 13): “The implicit assumption is that any profit from investments is fully distributed to policyholder dividends or used to absorb product or operational losses.” (The “profit from investments” referred to was previously described as “investment income (e.g., coupon income)”).

These considerations do not seem relevant to Health RBC. For companies subject to the Health RBC formula, generally very little of their business provides policyholder dividends (or retrospective rate credits) that involve investment income. (The Medical Loss Ratio rebate requirements for some business could be considered to be similar to policyholder dividends, but those rebates do not reflect investment income.) As to absorbing “product or operational losses,” we do not believe that the corresponding risk factors in the Health RBC formula were developed on the assumption that losses would be offset by investment income. If that latter understanding is correct, then neither reason that the Academy stated for exclusion of investment income in the Life analysis would be applicable to Health.

In light of that, it does seem appropriate to include investment income in the development of the bond risk factors for the Health RBC formula. Just as the formula would not reflect losses from insurance claims and operating expenses without also reflecting the insurance premium that is charged to fund those losses, likewise the formula should not reflect the losses from investments without reflecting the income from those investments. However, as the report being commented on does not describe a deviation from the Life default model in this respect, we must suppose that the proposed Health bond risk factors do not reflect investment income, except to the very limited extent permitted in the Life default model.

Accordingly, we request that your Working Groups consider whether investment income should be included, on some conservative basis, in the development of the bond factors for the Health RBC formula.

Investment-grade bonds.

For the most part, we agree with the Academy’s approach for investment-grade bonds. The assumptions made for purposes of the analysis seem reasonable (with the caveat about investment income discussed above), and the results of the analysis likewise do not present significant concerns, except in one area.

For the Aaa and Aa1 rating classes, the Academy’s analysis indicated risk factors of zero percent (at least, rounded to the nearest tenth of a percent). For reasons of conservatism, the Academy imposed a minimum risk factor of 0.1%, which is also the factor for the Aa2 rating class.

We understand and agree with the need for conservatism. However, we feel it is also necessary to reflect that the Aaa and Aa1 classes are indeed less risky than Aa2 (as borne out by the Academy’s analysis for longer bond durations). Therefore, while we agree that the factors

should be greater than zero, we also believe they should be lower than the factor for Aa2 bonds. That would not appear to be a problem from a mechanical standpoint, since the Health RBC formula already includes factors that are stated to the hundredth of a percent (e.g., the current factors for Working Capital Finance Investments).

We propose, therefore, that the factors for Aaa and Aa1 be graded down from the factor for Aa2; and as a matter of convenience, we suggest using the same proportions as represented by the Academy's proposed factors for Property and Casualty RBC. Thus, the factor for Aaa would be $(0.2\%/0.6\%) \times 0.1\% = 0.03\%$, and the factor for Aa1 would be $(0.4\%/0.6\%) \times 0.1\% = 0.07\%$.

If, for the sake of consistency, your Working Groups wanted to round all of the bond factors to the nearest hundredth of a percent, that would be reasonable. However, we do not feel it is absolutely necessary.

Speculative-grade bonds.

The Academy has noted, in their report, many potential shortcomings of their analysis underlying the proposed bond risk factors for speculative-grade bonds. We do feel concern about several aspects of the analysis. However, given the limited amount of information available, we do not feel that there is a superior alternative. In particular, we do not feel that an analysis such as that presented in Appendix 3, using the standard deviations of S&P bond indices, provides an appropriate comparison. Standard deviation reflects favorable fluctuations as well as unfavorable ones, and the issue at hand is how the potential losses on speculative-grade bonds compare with the potential losses on common stock. Also, the Annual Statement data that the Academy used reflect that bonds are held at the lower of amortized cost and market value; this has a dampening effect on fluctuations in value, which is not reflected in the index data. Furthermore, as the Academy has noted, the composition of the bond indices is not necessarily representative of the bonds actually held by insurers. Therefore, we believe that an analysis based on the fluctuations in value of bonds held by insurers is preferable.

In keeping with that belief, the only adjustment that we would suggest to the analysis of speculative-grade bonds is the inclusion of investment income, as discussed above.

Other asset classes.

As the Academy notes (page 13 of the report), there are other factors in the Health RBC formula that are based directly on the bond factors. They cite the factors for cash and preferred stock; the factor for receivables for securities is another example. We feel strongly that all such factors should be updated to be consistent with any new bond factors that are adopted.

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We look forward to discussing these matters with your Working Groups.

Sincerely,

A handwritten signature in black ink that reads "James R. Braue". The signature is written in a cursive style with a large, stylized 'J' and 'B'.

James R. Braue
Director, Actuarial Services
UnitedHealth Group

cc: Jane Barr, NAIC
Julie Garber, NAIC
Randi Reichel, UnitedHealth Group