

**Statutory Accounting Principles (E) Working Group
Spring National Meeting
Comment Letters Received**

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February 10, 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

RE: Items Exposed for Comment by the Statutory Accounting Principles Working Group with
Comments due February 10th

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposure drafts released for
comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working
Group) on December 13, 2022, with comments due February 10th.

We offer the following comments:

Principles-Based Bond Definition

The Working Group exposed changes that include proposed revisions to reflect the bond
definition in SSAP No. 26R—Bonds and SSAP No. 43R—Asset Backed Securities. Exposure
also includes corresponding revisions to other SSAPs, which includes guidance restricting asset-
backed securities (ABS) from SSAP No. 2R and guidance for debt instruments that do not
qualify as bonds in SSAP No. 21R.

Interested parties have submitted a separate comment letter on these proposed changes.

Ref #2019-21: Proposed Bond Definition

The Working Group also exposed reporting changes for bonds under the principles-based bond
project. In addition to a new schedule and granular reporting lines, the exposure includes
proposed revisions to other schedules and instructions that reference bond reporting. The
exposure also includes a revised issue paper to detail discussions and decisions on the bond

project.

Interested parties have not provided any comments on these exposures during this comment period as we have provided comments previously on similarly exposed items. Also, based on conversations with NAIC staff, interested parties believe that our comments can be optimized once the official Blanks items are exposed from the Blanks Working Group in March.

Issue Paper: SSAP 86, Derivatives and Hedging

The Working Group proposed a new issue paper to detail revisions previously adopted with the review of ASU 2017-12, Derivatives and Hedging and ASU 2022-01 Fair Value Hedging – Portfolio Layer Method.

Interested parties have no comments on this item.

Ref #2022-01: Conceptual Framework – Updates

The Working Group re-exposed revisions to the definition of a liability and issue paper to incorporate the concepts from Financial Accounting Standards Boards (FASB) Concepts Statement No. 8.

Interested parties are currently reviewing the additional materials provided by NAIC staff and will comment at a later date.

Ref #2022-11: Collateral for Loans

The Working Group re-exposed revisions to SSAP No. 21R to clarify that invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets.

The impact of the new exposed language can be interpreted to affect requirements for collateral loans which are backed by investments in joint ventures, partnerships, and LLCs. As commented during the 2022 NAIC National Fall Meeting, we believe that audits of joint ventures, partnerships, and LLCs, while required under SSAP No. 97 and SSAP No. 48 for those assets held directly, are not necessarily suited for the task of assessing sufficiency of collateral, because an audit does not validate fair value of the investment, which is a core standard of collateral guidance, and audits may be unreasonably costly for this narrow purpose.

Interested parties noted that regulators indicated concern over arrangements in which the collateral asset or the collateral loan itself may be related to or affiliated with the reporting entity. We believe that this concern is more directly addressed in recent industry exposures and adoptions over related party reporting; a collateral loan involving a related party is required to be labeled as such in annual statement filings. A collateral loan which is backed by a related joint venture, partnership, or LLC, is expected to be disclosed as such under existing SSAP No. 25 guidance. It is our view that in cases where an audit is not performed, allowing an unrelated third party to perform a fair value assessment would address objectivity concerns for this narrow

purpose, noting that primary guidance over related party transactions is addressed elsewhere outside of SSAP No. 21R.

Interested parties propose that the following footnote be included in SSAP No. 21R which would effectively permit companies with these investments to obtain a third-party valuation assessment in place of an audit, where the third-party assessment would satisfy both the admitted asset requirement as well as the fair value sufficiency requirement applicable to collateral assets.

Footnote:

Because an audit, which is required for certain investments in joint ventures, partnerships, and LLCs to be admitted assets, does not necessarily provide assurance over the fair value of such an investment which is collateral for a loan, companies are permitted to obtain a fair value assessment provided by an unrelated third party in place of an audit, in order for a collateral asset which is a joint venture, partnership, or LLC to qualify as an admitted asset under this standard.

Ref #2022-12: Review of INT 03-02: *Modification to an Existing Intercompany Pooling Arrangement*

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and re-exposed the intent to nullify INT 03-02. This re-exposure requested industry to provide comments on specific instances in which the interpretation was being applied. In addition, the following key points were noted for consideration during the exposure in response to some of the comments received.

Staff provided the following comments regarding some of the key points from industry. Interested parties' response to each comment is provided in italics below following each comment:

1. In the current interest rate environment, the fair value of many bonds is below book value. For example, a bond with an amortized cost of \$100 with a fair value of \$85. The way INT 03-02 is written a bond with a fair value of 85 could be used to settle an intercompany reinsurance pooling obligation of \$100. If the reporting entity paid with cash, they would be required to pay \$100. The actual cash value of obligations when they are extinguished is a relevant measure of the transaction.

If a bond was transferred at market value in order to settle the \$100 pooling obligation as proposed by NAIC staff in the example above, a bond with a fair value of \$100 would have to be used to settle the obligation. In the event that the bond was in an unrealized loss position at the time of the transfer, a realized loss would be recognized on the transferring entity's books and the combined pool's books. To avoid this situation, a legal entity could use cash to settle the obligation, but the use of such cash may not be the most efficient use of the transferring entity's resources.

*If the bond was transferred at FV as proposed by NAIC staff but the bond was in an unrealized gain position, a more significant issue would arise. Realized gains would be recorded in the financial statements of the transferring entity, thus resulting in an initial gain in surplus at the legal entity level of reporting as part of the intercompany pooling modification **and requiring the intercompany pooling reinsurance to be accounted for as retroactive reinsurance.***

There are extreme anomalies with transferring bonds at market value, as illustrated above.

2. Using book value for measurement of payments between affiliates can result in either unrecognized [gains or losses] of in effect dividend or losses. SSAP No. 25 requires such transfers of assets between affiliates to use fair value. If a subsidiary can pay the parent with assets that have a lower fair value than book value (ex, owes \$100 but pays with a bond of 85), this has a similar effect as an unrecognized capital contribution to the subsidiary. SSAP No. 72 requires a capital contribution to be valued using fair value.

The hypothetical capital contribution noted by NAIC staff is mitigated by the fact that, in actual practice, the transferring company would likely have two options if it did not transfer the bond:

- *The company could sell the bond, recognize a realized loss, and reinvest in a higher interest-bearing bond which would offset the realized loss over time.*
- *The company could hold the bond until maturity, at which point it is redeemed at the \$100 par value.*

We also note that modifications to intercompany pooling arrangements are subject to prior regulatory review and approval, and if the example noted by NAIC staff were part of a planned intercompany pooling transaction, the regulator could address it before granting approval to the intercompany pooling modification.

3. Staff agrees that at the ultimate parent level such transfer of assets (in accordance with SSAP No. 25 guidance) may be noneconomic in that the parent continues to hold an interest in the same assets. Therefore, at the parent level, such transfers of assets may result in the deferral of gains. Staff believes that losses would not be deferred at the ultimate parent level.

The issue noted by interested parties is not that the bond transaction may be economic at the subsidiary level but non-economic at the parent level. Rather, the interested parties letter notes that the transfer of reserves in an intercompany pooling modification is a non-economic transfer, and INT-03-02 treats the transfer of bonds consistently (i.e., non-economic) with the transfer of the liabilities.

4. Staff notes that while it may be more expedient to pay intercompany reinsurance pooling transactions with assets, the valuation used should be similar to if the obligation was extinguished with cash. Therefore, an entity can still choose to pay with assets, they just need to be valued consistently with SSAP No. 25 guidance.

This comment seems to imply that staff disagrees with the views of the Statutory Accounting Principles Working Group, which deliberated this issue in 2003 and decided that the appropriate guidance is SSAP No. 62 and not SSAP No. 25.

5. SSAP No. 62R, paragraph 36d provides an exception to retroactive reinsurance accounting guidance which allows for prospective accounting treatment for intercompany reinsurance among 100% owned affiliated provided there is no gain to the ceding entity. If there is a gain to the ceding entity, there is guidance in SSAP No. 62R, paragraph 37 which requires a more punitive method of accounting than either prospective or retroactive reinsurance accounting. Therefore, NAIC staff comment is that the statutory accounting objective is to provide different treatment for retroactive reinsurance contracts if there is a gain to the ceding entity. This is another reason that the guidance in INT 03-02 is problematic. The object is to correctly measure the effects of the contract, which drives the accounting. The objective is not to obscure whether there is a gain to the ceding entity, which can happen in the event that the assets used in payment are not measured correctly.

INT 03-02 avoids the gain in surplus issue by requiring that the transfer of bonds be at book value. This avoids inconsistent accounting of intercompany pooling modifications between prospective reinsurance accounting and retrospective reinsurance accounting. INT 03-02 provides consistent accounting for all such modification transactions.

Interested parties believe that INT 03-02 was not meant to address whether assets used as payments in an intercompany pooling modification are measured correctly, but rather the INT was meant to address which accounting is appropriate given the facts and circumstances of the transaction. We still believe that INT 03-02 provides a reasonable approach with respect to accounting for intercompany pooling modifications and provides consistency in reporting across companies.

6. Interested parties noted that modifications to intercompany pooling arrangements are typically effective retroactive to the beginning of the year. Staff notes that the payment value when the transaction is settled should be equivalent to the cash value of what is owed on the date of extinguishment of the liability.

This view raises the question of whether the “fair value” of the reserves need to be considered. That would be unprecedented and not consistent with any statutory accounting guidance.

7. Many of the interested parties’ comments regarding GAAP use of book value are more relevant to consolidated basis accounting which is not consistent with the legal entity basis of statutory accounting.

Interested parties respectfully disagree. The interested parties comment letter references the example of accounting for mergers, which is not the same as consolidation accounting.

8. Interested parties' comments noted that there is a difference in treatment for intercompany pooling participants who are not 100% owned by a common parent. NAIC staff notes that retroactive pooling agreement changes with participants that are not 100% under common control do not meet the exception to retroactive accounting provided in SSAP No. 62R, paragraph 36d. NAIC staff notes that SSAP No. 62R, paragraph 37 provides guidance for retroactive reinsurance agreements among affiliates where there is a gain to the ceding entity.

This comment appears to conflate the issue of being under the control of a common parent versus under 100% common control of a group. The interested parties comment letter was distinguishing between intercompany pool entities which have a common parent versus intercompany pool entities which do not have a common parent. All of the intercompany pool entities are under 100% common control, but not necessarily under the same common parent.

As an example, there may be downstream insurance subsidiaries of two top-tier insurance entities. The downstream insurance subsidiaries do not have common parents but are under 100% common control of the group.

We believe that nullification of the existing INT will likely result in inconsistent interpretation of the guidance by both companies and regulators and will result in inconsistent accounting treatment.

Ref #2022-14: New Market Tax Credits

The Working Group moved this agenda item to the active listing, categorized as a new SAP concept, and exposed a discussion document to expand current statutory accounting guidance for low-income housing tax credits to capture all tax equity investments that provide general federal business tax credit and state premium tax credits if they meet specified criteria.

Interested parties agree with having uniformity in accounting and reporting for equity investments for which the return is earned primarily through tax credits. Interested parties agree that the proportional amortization method is an appropriate method to use for any type of investment (debt or equity) where the return is primarily earned through tax credits. We are providing responses to the questions exposed in the Discussion Paper in this document. There are two key take aways from our responses summarized as follows:

1. Interested parties ask the Working Group to consider allowing for the reporting of both the amortization of the investments and the use of the tax credits themselves in the same income statement line similar to what is required under U.S. GAAP.
2. Interested parties have concerns regarding tax credit investments that are issued in debt form and requiring those investments to be reported on Schedule BA instead of Schedule D. Interested parties believe that tax credit investments issued in debt form are better suited for Schedule D reporting.

We have provided responses to the questions in the Discussion Paper below for your

consideration.

- 1) Paragraph 1 – The scope intends to include programs that provide general business federal tax credits, which are income tax credits, and programs that meet the criteria that provide for state premium tax credits. This would be an extension from the FASB exposure that only permits income tax credits but is in line with comments received by the FASB that insurers receive credits for state premium tax. Comments are requested on the proposed inclusion for programs that meet the criteria in paragraph 3 that generate state premium tax credits.

Interested Parties Response: Interested parties agree that all investments, no matter what legal form, for which the return is earned primarily through tax credits should follow the proportional amortization method.

The proposal seems to only scope in equity investments in tax credit structures and a very limited set of debt tax credit investments. Interested parties note that there are also other types of debt investments for which the return is primarily earned through tax credits with many structures including cash payments as well. We have listed examples of such debt structures in the Appendix. We have the following comments specifically related to these debt investments for which the return is earned primarily through tax credits if the intent is to scope those investments as well into the proposal:

- a. Currently, debt investments in CAPCOs which provide state tax credits follow the SSAP No. 26 guidance and reporting, including INT 06-02 *Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*. It is unclear from the exposure whether these investments will continue to be reported on Schedule D and/or whether new investments under this program should follow the new revised guidance. See the Appendix for more information on these investments.
- b. For companies that currently invest in bonds for which the return is primarily earned through tax credits, moving these investments to Schedule BA causes concerns since there are limitations on the amount of assets that can be reported on Schedule BA. These investments are sound and of high credit quality because the tax credits are highly probable and any contractual cash payments are typically escrowed in cash. Interested parties would also note that these programs are aimed at promoting the development and growth of distressed communities and moving them to Schedule BA may deter insurers from investing in these structures since the level of risk perceived from Schedule BA assets would not be commensurate with the return on these investments (more like debt returns versus more risky Schedule BA returns). Interested parties ask the Working Group to consider allowing for debt tax credit investments to be reported on Schedule D. Although tax credits in the legal form of debt may not result in a direct payment of cash from the borrower to the investor, there is a reduction in cash payments by the investor for income tax expenses, premium tax expenses, or state income taxes, depending on the nature of the tax credit investment. Interested parties note that cash is fungible so whether in the form of direct payments of cash from the borrower to the insurer for principal and interest or reduced insurer payments of taxes, the investment results in increased cash

- available to the insurer. The debt form of tax credit investments has contractual fixed payments of principal and interest in the form of reduced cash payments as noted. From this perspective, these instruments may meet the proposed principle-based bond definition.
- c. Companies currently report tax credit debt investments on Schedule D with an NAIC designation, which usually comes from the SVO. If the intent is for these investments to move to Schedule BA, it is imperative that these investments are allowed to be reported with an NAIC designation (see high credit quality referenced in prior paragraph). We would like to stress the fact that the risk profile of tax credit investments is not commensurate with equity-type risk as these investments tend to be of high credit quality with a very good history of performance. It is very important to take into consideration any potential RBC impacts when making any accounting or reporting changes.
 - d. Interested parties also note that if the proposal intends to scope in all tax credit investments in debt form, which we would be supportive of, this needs to be clarified in the exposure as the exposure may be interpreted to only include equity investments. For example, the criteria currently included in the exposure to apply the proportional amortization method is very specific to investments made in equity form. If the proposal is scoping in debt investments as well, the criteria need to be updated so that it is tailored to debt investments as well.
- 2) Paragraph 3 – The criteria mirror the concepts included in the proposed FASB guidance. Under U.S. GAAP, the use of the portfolio allocation method is an election, but under SAP, the guidance would be required if the criteria are met. (This would be consistent with the existing guidance in SSAP No. 93 for LIHTC.) Based on the FASB comment letters reviewed, the criteria are expected to be met for most state premium-based tax equity investments. Should other criteria be considered or are there concerns with requiring application if the criteria are met?

Interested Parties Response: Interested parties agree that the same criteria currently required under U.S. GAAP should apply to SAP for application of the proportional amortization method. Interested parties do not have an issue with the proportional amortization method being a requirement, as opposed to an option, if the criteria are met. We have two observations regarding the criteria:

- a. Criteria “d” requires that “substantially all of the projected benefits are from tax credits and other tax benefits, determined on a discounted basis using a discount rate that is consistent with the cash flow assumptions utilized by the reporting entity for the purpose of making a decision to invest in the project.” Interested parties would like to confirm that this criterion along with the rest of the criteria are assessed at the time of purchase of the investment and not at every reporting period. This is consistent with the Bond project proposals for the principles-based bond definition also. For certain tax credit investments such as renewable energy tax credit investments, this criterion is usually met at origination. However, if the project does

- not produce the actual amount of production tax credits expected at origination, the investee may be contractually required to make cash distributions from operations in excess of what was originally anticipated to compensate investors for the reduction in expected tax credits. In this case, substantially all of the projected benefits may end up not being from tax credits and other tax benefits. This is why it is important for the criteria to be assessed at origination.
- b. As explained under question #1 if the intent is to also scope in debt investments, the criteria need to be modified so that both types of investments are addressed. We have included some examples of tax credit investments issued in debt form in the Appendix.
- 3) Paragraphs 5-8 – The information details IRS provisions to qualify for the tax credit and overall information on the use of tax credits investments. Under the IRS rules, the federal business tax credits are not transferable, as only the entity that has a true equity interest can take the tax credit. Furthermore, the designs are most often established to have provisions to liquidate the equity investment (through a put/call) at the end of the timeframe. Comments are requested on whether other designs are prevalent as well as inclusion of this guidance in the SSAP and/or the Issue Paper.

Interested Parties Response: We agree with the discussion topics in paragraphs 5-8 regarding federal and premium tax credit programs with a few exceptions. As explained in the Appendix, there are other forms of debt investments for which the return is primarily earned through tax credits that do not seem to be addressed in the Discussion paper. Interested parties would also like to clarify that debt tax credit investments are usually transferrable, but for debt tax credit investments that require the purchase of an equity interest, they would have to be transferred along with the equity investment. Therefore, although the debt piece may not be transferable on its own for those types of deals, it is transferable along with the equity.

In addition, the Discussion paper states “a guarantee of return disqualifies the investor as obtaining a tax credit for federal income tax purposes. A limited exception to this structure can exist for NMTC using a financial institution syndicating a NMTC in which the financial institution guarantees the credit or returns.” Interested parties note that guarantees exist in structures other than New Market Tax Credit (NMTC) structures. For example, there are at least 2 financial institution syndicators actively offering LIHTC transactions with an 80% tax credit guarantee for which tax opinions have been obtained to ensure this still qualifies the investor as a “true partner.” There are also various guarantees offered in the Renewable Energy Tax Credit space where guarantees may be issued by financial institutions to provide for a dollar-for-dollar guarantee for the first 25% of tax credits recaptured or disallowed. Any guarantees issued by financial institutions on the tax credits are done in a way that still ensures the eligibility of the credits. Our reason for bringing this up is that the Discussion Paper seems to limit the existence of such guarantees to NMTC deals and we want to clarify that guarantees exist in other tax credit transactions. At the same time, for the debt deals where these guarantees exist, the risk profile is even stronger since the insurer will get a return of all or a portion of its initial investment if the tax credits do not emerge and as a

result, we believe whether a guarantee exists or not, should be irrelevant to the use of the proportional method and the proposed reporting.

- 4) Paragraphs 10-14 – This information mirrors guidance from the proposed ASU with SAP clarifications. Comments are requested on whether SAP modifications should be considered.

Interested Parties Response: Interested parties request that SAPWG consider applying the same geography requirements under U.S. GAAP to SAP. Currently under SAP for Low Income Housing Tax Credit Investments, the amortization of the investment is reported in net investment income (NII) and the tax credits are reported in the tax expense line for federal tax structures and in state premium tax or state income tax for state tax structures. Under U.S. GAAP, both the amortization and the tax credits are reported together in the income tax line. We believe that reporting both the amortization and the tax credits in tax expense for federal programs and in the state premium tax or state income tax lines for state programs more faithfully represents the intent of the credits, which is to reduce the expenses and thus is a much better presentation of these investments. When the amortization is reported in net investment income, these investments are reported as if they had a negative return since the amortization is divorced from the tax credits, which is not a true representation of the return on these investments. If the tax credits allow state income tax or premium tax credits to be taken by an insurer, the expense line of the income statement will result in much more volatility when the amortization of the credits is not matched with the tax credits themselves in the same income statement line item. Not matching could have an indirect impact on insurers “rate setting” process on P&C business.

Interested parties would be happy to work with the Working Group to determine the best way to present tax credit investments on the investment schedules with amortization being reported in the same income statement line item as the tax credits themselves. One item that would have to be addressed for federal tax programs is whether a deferred tax asset (DTA) would still be recorded for any tax credit carryforwards. Under U.S. GAAP, DTAs are not recorded for LIHTC investments accounted for under the proportional amortization method since both the amortization and the tax credits are reported in income tax expense.

- 5) Paragraphs 15-16 - This guidance details the application of the proportional amortization method for statutory accounting. It is more detailed, but generally consistent with SSAP No. 93. The existing SAP guidance was driven from EITF 94-1 and refers to recognition at the time a tax credit can be included in a tax return. However, that guidance is contradictory with the recognition of tax credit carryforwards under both current SAP and U.S. GAAP. The proposed guidance in paragraph 11 reflects the new GAAP guidance for recognition in the year in which the credit arises, and the guidance in paragraph 16 identifies how carryforwards would be considered a DTA.

Interested Parties Response: Interested parties agree that DTAs would be set up for any tax credits that can be carried over. As stated above, we understand that under U.S. GAAP, there are no DTAs set up for tax credit carryovers since the amortization and the tax credits are reported in the same line.

- 6) Paragraphs 17-20 – These paragraphs provide explicit SAP provisions for admittance. If the program does not generate tax credits or if the reporting entity cannot use the tax credits, the guidance requires nonadmittance. Consideration was given as to whether admittance should be permitted based on the ability to liquidate the investment, but that is not proposed. As detailed in the scope criteria, substantially all of the projected benefits from the investment should be from tax credits or other tax benefits. From information gathered for the federal tax credit programs, liquidation may be restricted for set periods of time or be contingent on finding a buyer for the equity interest. Although a put/call provision may be in place to revert the equity interest at the end of the life for the investment, such amounts are nominal to the original investment amount. With the guidance, if the tax credits will not be received or cannot be utilized, then the investment shall be nonadmitted. If an entity cannot obtain or utilize tax credits from the investment, and can liquidate the investment, then a reporting entity should consider liquidating the investment to have cash for reinvestment / admittance purposes. Until then, the investment is proposed to be nonadmitted.

Interested Parties Response: Interested parties believe that it is too punitive to require non-admission of the whole investment if an entity does not have taxable income in a given year. As stated above, insurers may be able to utilize the tax credits through carryback to the prior year. If not, insurers would usually set up a DTA for any tax credit carryforwards if there is an expectation that the credits will be utilized in future years. Therefore, interested parties believe that if there is no valuation allowance on the tax credit DTA and the DTA is admitted under the three-year turnaround criteria, then the investment should be fully admitted. This would not preclude impairment analysis on the investment itself.

The Discussion Paper also includes discussion about requiring a tax opinion for admissibility purposes. Interested parties would like to confirm that the tax opinion is required upon acquisition of the investment by the insurer and not at every reporting date.

It is also important to clearly distinguish between non-admission and impairment. Question #6 makes reference to the program not generating tax credits or the reporting entity not obtaining the tax credits. Under these circumstances, it seems that the guidance would point to impairment and not non-admission.

- 7) Paragraphs 21-24 – This guidance is generally consistent with SSAP No. 93, except the recognition of a liability for a future contribution follows the loss contingency guidance in SSAP No. 5R. This is consistent with the ‘probable’ threshold reflected under U.S. GAAP.

Interested Parties Response: Interested parties agree that the guidance in SSAP No. 5R regarding contingencies needs to be evaluated to determine if a commitment related to future contributions gives rise to a liability.

- 8) Paragraphs 25- Paragraph 25 is consistent with SSAP No. 93, except it incorporates fair value as the compared value. Current SSAP No. 93 uses the present value calculation, so it is retained as a proxy of fair value. U.S. GAAP uses fair value, and the existing disclosure in SSAP No. 93 also references fair value.

Interested Parties Response: Interested parties do not have an objection with incorporating fair value in the assessment of impairment. Since these investments do not trade frequently, most companies are probably already doing a present value calculation to determine fair value so this should not change what reporting entities are currently doing.

- 9) Paragraph 26 - This guidance incorporates concepts on whether the structure will continue to produce qualifying tax credits. The guidance specific to LIHTC from SSAP No. 93 is not retained. The guidance has divided the guidance for nonadmittance to reflect situations that impact a reporting entity's use of tax credits and OTTI to reflect issues with the actual investment in generating qualified tax credits. Comments are requested on this approach and the principle concepts for OTTI.

Interested Parties Response: As stated under question #6, non-admitting the entire investment appears too punitive for companies that expect to utilize the credits in a later year. Interested parties agree that impairment would occur when the credits will not emerge at all. Question #6 needs to be clarified to explain these concepts since the way it is currently written, it seems to scope in the impairment criteria into the non-admission review.

- 10) Paragraph 27 – Disclosures in 27a-b are from U.S. GAAP.

Interested Parties Response: Interested parties do not have an objection with disclosing information about the nature of investments for which tax credits are earned. 27(b) seems repetitive with the other information that is being required under paragraph 28 regarding the amount of tax credits and other tax benefits during the years presented. If different information is being requested under 27b, it would be helpful for industry to get more clarity on what specifically is being requested under that item.

- 11) Paragraph 28 - Disclosures in paragraph 28 a-c come from U.S. GAAP. The disclosures in paragraphs 28d-e are based on concepts previously included SSAP No. 93. Comments are requested on whether those disclosures (or other disclosures from SSAP No. 93) should be included. (For 28d, the prior SSAP No. 93 disclosure was for a number of remaining years of unexpired tax credits and the required holding period, but since that is an individual investment disclosure, it has been modified to reflect an aggregate investment disclosure.)

Interested Parties Response The proposed disclosures in paragraph 28 a-c are similar to what is already required under SSAP No. 93 so they should not be a concern. 28e will require additional work to be done since the requirement is to disclose the aggregate amount of tax credits to be earned each year on all tax credit investments for the next fifteen years, which is not currently disclosed. Such detail is not required for other investments. As a result, we would encourage SAPWG to evaluate whether it is needed.

- 12) Paragraph 30 – This disclosure is in SSAP No. 93 and comments are requested on whether it should be retained.

Interested Parties Response: This disclosure requires detailed balance sheet and income statement information for tax credit investments if, in the aggregate, tax credit investments exceed 10% of the total admitted assets of the reporting entity. It is probably rare for insurers

to hold tax credit investments that represent such a significant amount of total admitted assets. In addition, detailed balance sheet and income statement information for the underlying investees does not seem to provide very relevant information about these investments since the return on these investments is primarily through tax credits and not related to the earnings of the underlying investees. Interested parties believe that this disclosure requirement should be removed.

Other Interested Party Comments

Although the Discussion paper is focused on SSAP No. 93 and equity investments for which the return is primarily through tax credits, we provide the following observations regarding SSAP No. 94 as we understand that the Working Group may add another project to its agenda regarding this standard:

1. We believe that one of the key differences between SSAP No. 93 and SSAP No. 94 is that SSAP No. 93 relates to tax credit structures where the insurer is an actual investor (i.e. equity owner) whereas SSAP No. 94 addresses certificated state tax credits that are purchased outright without the insurer owning an equity or debt security. More clarity on the difference between both standards is welcomed especially since we understand that under the Inflation Reduction Act, there will be certificated federal tax credits available for purchase as well.
2. We note that the accounting under SSAP No. 94 requires for the certificates purchased to be reported as “other-than-invested” assets. Therefore, these certificates are not currently reported on Schedule BA. They are reported in the “Aggregate Write-Ins for Other Than Invested Assets” balance sheet line. We would like to make sure that the Working Group is aware of this difference in reporting.
3. The accounting for the certificates laid out in SSAP No. 94 requires that the carrying value of the tax credits be reduced as the credits are redeemed through a reduction of an insurer’s tax payable. Therefore, the way of amortizing the asset is similar to the proportional amortization method, except that under SSAP No. 94, the amortization and the tax credits are only reflected in the balance sheet. Any gains on these deals, which are usually related to the fact that they are purchased at a discount, are required to be reported in other income per SSAP No. 94, not NII. Interested parties look forward to further discussing the income statement presentation of these gains if changes are made to SSAP No. 93 regarding income statement presentation to ensure consistency in reporting.

Some of the feedback received from interested parties is that in practice, the offset to the tax liability account usually occurs in the year when the credit is available for use regardless of when the tax return is filed. Clarification may be needed on this point in the standard.

Ref #2022-15: SSAP No. 25 – Affiliate Reporting Clarification

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 25 to clarify that any invested asset held by a reporting entity which is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment.

Interested parties have no comments on this item.

Ref #2022-16: *ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 100R to adopt *ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions* with modification to be consistent with statutory language in the respective statutory accounting statements, as illustrated above. Note that this agenda item does not recommend incorporating the new proposed GAAP disclosures on sales restrictions, but identifies those items restricted as to sale would be captured as restricted assets per SSAP No. 1 and subject to admittance considerations under SSAP No. 4.

Interested parties have no comments on this item.

Ref #2022-17: Interest Income Disclosure Update

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 34, to add additional disclosures, and to data-capture the disclosures.

Interested parties propose that the exposed changes which are an outgrowth of the Bond project should share the same effective date. This will also allow companies to make the system changes needed to provide this information.

Interested parties also suggest the following editorial revisions to the disclosures contained in SSAP No. 34 for clarification and to be consistent with the proposed Blanks changes:

7. The following disclosures shall be made for investment income due and accrued in the financial statements. (SSAP No. 37 captures disclosures for mortgage loans on nonaccrual status pursuant to paragraph 6.)
 - a. The bases by category of investment income for excluding (nonadmitting) any investment income due and accrued;
 - b. Disclose total amount excluded;

- c. Disclose the gross, nonadmitted and admitted amounts for interest income due and accrued.
- d. Disclose aggregate deferred interest ~~and cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance.~~
- e. Disclose cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance.

Ref #2022-18: ASU 2022-04, Disclosure of Supplier Finance Program Obligations

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 105R to reject ASU 2022-04 for statutory accounting as the disclosures are not relevant for insurance entity preparers.

Interested parties have no comment on this item.

Ref #2022-19: Negative IMR

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.

ACLI will submit a separate comment letter on February 17, 2023.

* * *

Thank you for considering interested parties' comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell

Rose Albrizio

cc: NAIC staff
Interested parties

Appendix A – Examples of Debt Tax Credit Structures

These are some of the debt tax credit structures of which industry is aware:

- i. Bonds Issued by CAPCOs - Although the peak of these investments was in 2003, there has been a resurgence in functionally equivalent forms of this structure starting in 2010. Connecticut, Mississippi, Pennsylvania, Utah and Ohio have recently issued these bonds and legislative vehicles for these bonds are growing increasingly popular to address rural economic development. The bond is usually issued at a premium ranging from 50-90%. A material portion of the return in these structures is earned through cash payments (generally ranging from 40-60%). CAPCO and CAPCO-like deals are different from other state tax credit deals for a few reasons: (1) these entities have more time to invest the capital they receive than other state or federal deals; (2) they may have a smaller acquisition premium; (3) there is no equity investment required. Tax credit bonds issued by CAPCOs are usually only transferrable to affiliates of the reporting entity.
- ii. Other State Tax Credits issued in Bond Form – Any state can issue debt investments where the investor earns tax credits outside of the CAPCO structures. Some of these are referred to as New Market Tax Credits (NMTC), which are different from the federal NMTC program. These programs multiplied as states saw the positive impact of the federal program on low-income communities. Unlike federal credits, these credits may be specially allocated by a partnership. In these deals, an issuer creates a special purpose vehicle (SPV), which purchases equity investments in entities that make investments in distressed communities. The SPV then issues securities to investors composed of tax credit debt and a small equity component (typically 1%) to be admitted as a partner and receive an allocation of credits. The tax credit debt has a higher acquisition premium than CAPCO and CAPCO-like structures (typically 90%). Although most of the return is earned through state tax credits, these investments earn about 10% of their return in cash. The tax credits earned by the SPV are passed on to the investors based on the SPV's partnership agreement. This structure may be used in other contexts where credits can be specially allocated (e.g. state historic tax credits, low-income housing tax credits and other economic development tax credit programs). In order to transfer the bond investment, a sale of the equity interest must take place simultaneously to the same investor.
- iii. State or Municipal Tax Credit Bond Strips – These include bonds issued by state or municipalities for certain projects such as school construction (i.e. Build America bonds). The bonds are stripped into a principal amount and the tax credit amount. Investors in the tax credit strips only earn a return through the tax credits provided by the municipality or state. These strips are transferable. There are no cash payments on the tax credit strips as the return is solely earned through tax credits.
- iv. Federal NMTC programs – These are already addressed in the exposure. To summarize, an investor must purchase a pro rata share of the equity and the debt in these structures. Federal tax credits are earned as long as the investor is an equity investor as well. In order to transfer the bond investment, a sale of the equity interest must take place simultaneously to the same investor. The return on these investments is earned solely through tax credits. The investor

receives cash for the principal on the bond, which is usually less than 10% of the original investment since these investments are issued at a significant premium.

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February 10, 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

RE: Interested Parties Comments on the SSAP No. 26R, SSAP No. 43R, and Other SSAP exposures related to the Principle-Based Bond Definition Project

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the above-mentioned documents that were exposed for comment by the Statutory Accounting Principles Working Group (Working Group) on November 16, 2022.

Interested parties also appreciate the collaborative effort on this project, the receptivity to our comments in our previous letter(s), and the disciplined thought that has gone into this project. We continue to believe this effort is headed in the right direction and look forward to continued collaboration on what undoubtedly is a complex and wide-ranging project.

In that spirit, interested parties would like to provide the following comments.

Paragraph 6d of SSAP No. 26

Paragraph 6d is arguably one of the more complex concepts within the principle-based bond definition. This paragraph attempts to define non-debt variables that are or could be embedded within a financial instrument, that call into question the overall instrument's debt or bond like characteristics, while not also capturing embedded derivatives commonly found within debt instruments that do not call into question their overall debt or bond like characteristics. Interested parties believe this paragraph generally captures regulator concerns, while appropriately recognizing instances where such embedded derivatives are or should not be of concern. The following focuses on two instances where interested parties believe regulators did not intend to capture (and should not want to capture) embedded derivatives within financial instruments that

could be considered non-debt variables, and thus where the overall financial debt instruments would not be considered bonds for reporting on schedule D.

Credit Rating-Related Interest Rate Adjustments

Paragraph 6d, includes an exclusion that prevents certain embedded derivatives from “tainting” the host financial instrument and thereby preventing it from being reported as a bond where the embedded derivative does not call into question its bond-like characteristics. This exclusion includes “credit-rating related interest rate adjustments” where a bond coupon rate could be adjusted upward if the entity issuing the debt is down-graded by a rating agency. Such adjustments align the interests of debtholders and issuing entities by incentivizing the issuing entity to keep its financial house in order and compensating the debtholder if it does not.

Interested parties agree with this exclusion but suggest it be modified from “credit-rating related” to “credit-quality related” to encompass the broader range of such adjustments that align interests of debtholders and issuing entities (e.g., debt to EBITDA ratio, interest coverage ratio, debt service coverage ratio, etc.). Such bonds are very prevalent in insurer portfolios.

Sustainability-Linked Bonds (SLBs) With De Minimis Interest Rate Adjustments

Interested parties believe paragraph 6d also would inappropriately capture certain bonds with an interest coupon rate linked to sustainability goals. For example, the debt may have coupon interest equal to either a fixed or floating rate (e.g., SOFR) that is adjusted based on one or more sustainability goals or variables (e.g., the company’s CO2 emissions or workplace injury record). That is, the company’s performance against the metrics, in this example, could cause the interest rate to either decrease or increase 5 basis points for a total range off the potential base interest rate of 10 basis points. Both the CO2 emissions and workplace injury record are metrics of the borrower’s operation of physical assets owned by the company.

Interested parties understand that the NAIC wants to focus on solvency when developing standards, and not necessarily make special accommodation for social causes at solvency’s expense. Though insurers are increasingly focused on environmental, social, and governance attributes of investments they make, risk/reward remains an overriding consideration. In the case of SLBs, the contingent coupon adjustments generally do not factor into the insurer’s risk/reward calculations as they are uniformly de minimis. Interested parties do not believe SLBs, which are somewhat prevalent, warrant non-schedule D reporting and potentially punitive risk-based capital treatment.

Interested parties therefore suggest either a special exclusion for these type of debt instruments such as “SLB-linked bonds with de minimis interest rate adjustments” or “SLB-linked bonds with interest rate adjustments with the potential to adjust the total return from interest by no more than 10%”. Quite possibly, it may be more appropriate for such a “de minimis” exclusion to be applied to other non-debt variables more broadly so there is not an abrupt cliff effect for non-schedule D reporting due to the potentially punitive risk-based capital treatment, for de minimis non-debt variables in general.

Interested parties look forward to working with regulators and NAIC staff on this issue to appropriately thread the needle between preventing concerns of regulators while also not capturing de minimis types of adjustments that are potentially both prevalent and not the primary concern of regulators.

Paragraph 22 of SSAP No. 21 and Other Debt Securities That do not Qualify as Bonds

SSAP No. 21 has proposed changes for Debt Securities That Do Not Qualify as Bonds and is meant to capture any security which does not qualify as either an issuer credit obligation (ICO) or asset back security (ABS) and addresses the accounting and reporting for such securities. Such securities in scope would be limited to:

- a. Debt securities for which the investment does not reflect a creditor relationship in substance,
- b. Debt securities that do not qualify for bond reporting due to a lack of substantive credit enhancement, or
- c. Debt securities that do not qualify for bond reporting due solely to a lack of meaningful cash flows.

These categories reflect instances where a debt instrument does not meet the principle-based bond definition as laid out in SSAP No. 26R. However, there may be further instances where a security does not meet the definition of a bond such as with paragraphs 5 and 7 of SSAP No. 26R (e.g., not meeting the definition of a security or not meeting the primary source of repayment requirements, respectively, etc.). Further, condition a. above is a potentially broad category inclusive of non-qualifying equity backed securities all the way toward financial instruments with embedded derivatives that are potentially de minimis. Interested parties would like to think this through with Staff if further refinement is necessary especially if the intent of these categories is to feed risk-based capital factors where additional refinement may be necessary.

Securities solely not meeting condition c. shall use the same accounting and measurement basis described in SSAP 43R – Asset-Backed Securities, including using a carrying value method determined by NAIC designation. Reporting entities that are reporting an amortized cost measurement shall obtain an NAIC designation in accordance with the parameters of the Purposes and Procedures Manual of the NAIC Investment Analysis Office and report the designation on Schedule BA. It is unclear if the NAIC designation required for accounting purposes would also be used for risk-based capital. Interested parties would like to think this through with Staff to understand the intent. For example, if the NAIC designation is not used for risk-based capital purposes, is it appropriate to require an NAIC designation for purely accounting purposes?

All other debt securities that do not meet conditions a. and b. shall be reported at acquisition cost, including brokerage and other related fees on Schedule BA. These securities are permitted as admitted assets, with subsequent measurement at the lower of amortized cost or fair value. Changes in measurement to reflect the lower value or to reflect changes in fair value shall be recorded as unrealized gains or losses.

Paragraph 22 includes the following:

Debt securities in scope for which the source of repayment is derived through rights to underlying collateral, qualify as admitted assets only to the extent they are secured by admitted invested assets. Any amounts in excess of the fair value of the underlying admitted invested assets shall be nonadmitted.

Interested parties believe we understand the rationale for why this was drafted. That is, if an ABS security does not meet either the substantive credit enhancement or meaningful cash flows criteria, the security in question is potentially very similar to a collateral loan. Nonetheless, this is a meaningful penalty (i.e., from bond treatment to non-admission) and interested parties would like a little more time to think through and discuss with Staff. This paragraph ultimately only came into our focus late in our review and we would like the opportunity to further think through the appropriateness of the abrupt cliff effect. For example, it is even conceivable, that a securitization would have the residual tranche be reported as an admitted asset while a more senior tranche would be a non-admitted asset.

Paragraph 10 (b) of SSAP No. 26R

Interested Parties noted that there is an inconsistency with the treatment of residual tranches between SSAP No. 43R and SSAP No. 26. SSAP No. 26 refers the reader to SSAP No. 21 to determine the accounting for residual tranches whereas SSAP No. 43R states that residuals are to be reported on Schedule BA as other invested assets at the lower of cost or market (SSAP No. 43R, paragraph 11.c). Since the revised SSAP No. 21 guidance only addresses debt securities (and does not address residual tranches) and we understand that the Working Group does not view residual tranches as debt instruments, we have the following proposed wording changes to SSAP No. 26 to address this inconsistency:

The first loss position may be issued as part of a securitization in the form of a debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss position (or a more senior position(s), if the first loss position(s) lacks contractual payments along with a substantive credit enhancement) is issued as part of the securitization, and does not have contractual principal and interest payments along with substantive credit enhancement and is held by a reporting entity, the investment(s) does not qualify for reporting as a bond and should be reported on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value consistent with the accounting treatment for residuals. ~~as a non-bond security pursuant to SSAP No. 21R—Other Admitted Assets.~~

Paragraphs 43 – 46 of SSAP No. 26R

Paragraphs 43 - 46 of SSAP No 26R are related to effective date and transition. Interested parties believe the transition guidance is appropriate under the circumstances but propose some minor editorial adjustments which we believe provide more granular meaning to what we believe was

the intent. These proposed adjustments related to the second and third sentences of paragraph 44 as follows:

The bond definition requires assessments at the time of Acquisition (as of the origination date), and it is recognized that reporting entities may not have the means to complete historical assessments for securities held at the time of transition. For these instances, if information is not readily available for reporting entities to assess a security as of the date at ~~acquisition~~ origination, reporting entities may utilize current or acquisition information in concluding that a security qualifies for reporting as a bond as either an issuer obligation or asset-backed security.

Interested parties believe the transition guidance should also indicate that the disclosures should reflect that the revised bond categories from the annual statement prospectively beginning with the first year of adoption and not result in a restatement of the prior year's reporting.

Further Clarification on RSATs

Replication Synthetic Assets (RSATs) are nuanced types of transactions, which must be approved by the Securities Valuation Office (SVO). Interested parties propose the following edits to ensure that RSATs, which have been historically allowed, continue to meet the replication accounting requirements regardless of changes to the definition of a Schedule D Bond. Besides the edits proposed below, as a result of the accounting convention for certain bonds being other than amortized cost, interested parties would like to work with Staff on the specific paragraphs of SSAP No. 86 that currently address the accounting for replication transactions as changes may be needed to coincide with the effective date of the principles-based bond definition.

Provide a Footnote after the first sentence of the structured note definition in paragraph 6di of SSAP No. 26R to clarify that one needs to also look to SSAP No. 86:

A replication (synthetic asset) transaction addressed in SSAP No. 86-Derivatives may reproduce the investment characteristics of an otherwise permissible investment that would not meet the principles-based bond definition (e.g., is distinct from a “structured note” as defined here); the admissibility, classification and measurement of a replication (synthetic asset) transaction are not preemptively determined by the principles-based bond definition, and should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within SSAP No. 86- Derivatives.

Propose further clarification in SSAP No. 86 by adding the following to the end of Footnote 5 within the exposure:

A replication (synthetic asset) transaction addressed within this standard may reproduce the investment characteristics of an otherwise permissible investment that would not meet the principles-based bond definition (e.g., is distinct from a “structured note” as defined here); the admissibility, classification and measurement of a replication (synthetic asset) transaction are not preemptively determined by the principles-based bond definition, and

should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within this standard.

SSAP No. 43R – Example 2

Interested parties appreciate the proposed changes to Example 2 within SSAP No. 26R as they provide an example where recourse to assets can be outside of a securitization. This is a good clarification and makes the examples in aggregate more broadly instructive. Interested parties have two suggested changes, which we believe are editorial in nature that provide a nuanced technical clarification and a more formal conclusion within the example rationale.

Example 2: *A reporting entity invested in a debt instrument issued by a SPV. Payments under the instrument are secured by a note, a legal assignment from the borrower of a lease for real property and an assignment of the lease payments from an operating entity tenant. Additional security is provided by a mortgage on the leased property (the “underlying collateral”). The leased property is owned by the borrower under the note -- the SPV does not have any ownership interest in the underlying collateral, though it has legal recourse to it through the mortgage. The tenant makes contractually-fixed payments over the life of the lease to the borrower, who has assigned both the lease and the lease payments to the SPV as security for the debt. While the debt is outstanding, the lease, the lease payments, and the mortgage all serve as security for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the real property as well as submit an unsecured lease claim in the lessee’s bankruptcy ~~for any~~ all or a portion of the defaulted lease payments. The loan-to-value (as a percentage of property value) at origination is 100%.*

Example 2 Rationale: *The reporting entity determined that the debtholder was in a fundamentally different position than if the real estate was owned directly. The lease is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds which covers all interest payments and 50% of the principal payments. The level of reliance on the collateral value for sale or refinancing is just over the cutoff for using the practical expedient (<50%), so a full analysis is required. In reaching its determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the underlying collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the real property may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (50% loan-to-value) that would be able to be recovered by sale or refinancing at the maturity of the loan.*

Interested parties continue to support the development of high-quality bond standards and believe they are headed in the right direction. Staff has tackled this project with appropriate rigor and their

collaboration with us has been greatly appreciated. We stand ready to continue to assist as this project gets nearer the finish line.

Sincerely,

D. Keith Bell

Rose Albrizio

cc: Interested parties
NAIC staff

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February 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: SSAP No. 7 - IMR

The American Council of Life Insurers (ACLI) appreciates the opportunity to provide comments on the above referenced exposure as well as the thoughtful and timely attention this important topic is receiving from SAPWG and LATF.

The ACLI stands ready to continue working with the NAIC to create sufficient, yet practical, safeguards to ensure that the most appropriate treatment of Interest Maintenance Reserve (IMR) can be applied, and a company's surplus and financial strength are properly reflected, while not disincentivizing prudent investment and risk management in the best interest of all.

A rising interest rate environment from historically low rates is generally favorable to the financial health of the life insurance industry. However, ACLI is concerned that without a change to the current treatment of negative IMR, the environment will give the inappropriate perception of decreased financial strength through lower surplus and risk-based capital ratios. This problem will only be exacerbated if interest rates remain at or near their current levels or increase further; therefore, it is imperative that we work together toward developing an industry-wide solution for implementation by year-end 2023.

Upon the sale of and subsequent reinvestment in a fixed income instrument, the reflection in surplus of either a gain or loss is not reflective of the true economics, as there is no change to solvency, liquidity, or claims paying ability because the difference between the reported amortized cost value and fair value is equal to the IMR. This letter addresses our assessment of the suitability of the five potential guardrails proposed at the SAPWG fall national meeting and raises two additional proposals for consideration.

While this letter will focus on potential additional safeguards, as suggested at the SAPWG fall national meeting, this is a complex topic and we want to summarize, review, and expand on relevant background information largely included in our previous letter dated October 31, 2022.

The NAIC's statutory accounting framework is largely an "amortized cost framework" in that fixed income investments are generally reported at amortized cost and long-term insurance liabilities are generally reported with locked and conservative assumptions.

We strongly support the NAIC framework, 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.

However, an amortized cost framework could also potentially distort the financial solvency of insurance companies through the misrepresentation of surplus. The IMR was developed as a safeguard to ensure surplus is properly reflected within the NAIC's framework.

Specifically, in a declining interest rate environment, an insurance company could sell its fixed income investment portfolio, recognize gains, increase surplus and show increased financial strength. This increase in surplus would largely be illusory as the increased surplus would be offset by a lower yielding investment portfolio.

IMR requires deferrals of those gains from surplus, and the gains are amortized through income over the remaining life of the bonds sold to:

- Ensure accurate representation of a company's reported surplus by eliminating the potential for overstatement of surplus, and
- Keep the relationship of anticipated investment yield consistent with that needed to support the liabilities.

But without IMR, a rising interest rate environment could result in similarly misleading surplus (in this case an illusory lack of surplus) because a company would be investing in higher yielding bonds.

When IMR was developed, it was anticipated that the IMR would work consistently for both net realized gains and losses; however, the allowance of a net negative IMR was not initially adopted upon implementation in 1992. It was expected that the issue would be addressed in subsequent years and remained on the SAPWG agenda at least until 2005 but was never addressed in any substantive way. This was largely because of a lack of urgency due to the decades-long declining interest rate environment where IMR was largely positive for life insurance companies.

This issue had been referred to SAPWG from the AVR/IMR working group which believed the basic rationale for the IMR would conclude that neither a maximum nor minimum is appropriate. It was fully expected that the IMR, whether negative or positive, would be included in asset adequacy testing and addressed by the actuarial opinion.

We are very appreciative that SAPWG and LATF are looking to substantively revisit the negative IMR issue as anticipated during its original development. The current interest rate environment has changed circumstances in a meaningful way. While rising interest rates from historically low levels are beneficial to insurance companies, the recent rapid rise of interest rates has increased the urgency to address the negative IMR issue to avoid the misrepresentation of capital positions of insurance companies.

The current interest rate environment or a further rise in interest rates would only exacerbate the urgency as losses from bond sales could result in a significantly inappropriate portrayal of surplus that would be inconsistent with the rationale for which IMR was initially developed. In this case, insurers would show a significant illusory lack of surplus because they would be investing in higher yielding bonds.

IMR is an important construct that effectively adjusts liabilities so that the balance sheet liabilities net of IMR remain on the same basis as the reported balance sheet assets, limiting artificial volatility within surplus. As discussed above, negative IMR, from an asset-liability perspective, represents either high future income from reinvestments or future reserve releases that will be available to pay claims from an asset liability perspective.

Although the status quo use of permitted practices may grant relief for specific companies, it may lead to an unlevel playing field. Consequently, the ACLI wants to emphasize the importance of developing a uniform national standard for consistently ensuring the appropriate theoretical and practical treatment of IMR (e.g., symmetrical treatment of both gains and losses).

The ACLI would like to work with the NAIC to fulfill the original intent of IMR that ensures surplus and financial strength are properly reflected and do not disincentivize prudent investment and risk management. At the same time, we want to work with regulators to ensure IMR cannot somehow be circumvented in a rising interest rate environment, whether intentionally or inadvertently, to misrepresent financial strength.

Common Interest to not Disincentivize Prudent Behavior

We want to reiterate the importance of not disincentivizing prudent portfolio and asset liability management.

In addition to prudent portfolio management and managing credit/investment risk exposure, insurance companies manage duration. These prudent risk management processes all require ongoing transactions that impact the IMR, such as whether it is sales and reinvestment in fixed income investments, which we discussed in our previous letter dated October 31, 2022, or use of derivatives to achieve the same appropriate end. We would note that bond sales may trigger derivative terminations that offset in IMR; however, derivatives settlements can impact IMR without an offset impact from a bond sale.

Hedging strategies are used to address product risks like contract guarantees, disintermediation, and reinvestment risks as part of prudent risk management practices utilized by life insurance companies. These hedging strategies may involve interest rate swaps, caps, floors, swaptions, interest rate futures, among others, that also may generate IMR gains and losses.

For example, negative IMR can be generated by hedging strategies utilized for pension risk transfers. Once the contract is executed, insurers will enter hedging contracts to ensure interest rate certainty while awaiting cash and assets in-kind and/or the right investment opportunities to meet the long-term goals for the accounts. As the hedges are unwound to meet pricing and investment targets, immediate losses and negative IMR may be generated as interest rates rise, but the losses are ultimately offset over time with higher fixed instrument yields.

Further, many life insurance and annuity products have significant long term reinvestment risk, where premiums are received for many decades before benefit payments may be made. Companies may use interest rate futures, swaps, or bond forwards, to reduce reinvestment risk by locking in interest rates at which the future premiums will be invested. When interest rates rise, these hedging transactions may settle, roll-over, or be terminated, leading to expected IMR losses but are ultimately offset by future higher reinvestment yields. Without these hedging transactions, returns might not be equivalent to policyowner obligations, exposing the company to significant interest rate risk.

Similarly, life insurance companies may utilize stochastic asset liability modeling to establish asset duration targets that may include setting different asset duration targets by product if appropriate, through an asset segmentation plan. This considers scenarios where interest rates increase rapidly (where there is potential for disintermediation risk) and very low interest rates (considering product guarantees). Such analysis is refreshed on a regular basis to update the duration target based both on the liability in force characteristics and the economic environment. Portfolio asset duration is managed to the target on an ongoing basis and requires asset sales /purchases or use of derivatives that affect IMR. These are but several distinct examples of the types of prudent risk management practices utilized by life insurance companies.

A rising interest rate environment is generally favorable to the financial health of the life insurance industry. Without a change to the treatment of negative IMR, a rising interest rate environment will give the inappropriate perception of decreased financial strength through lower surplus and risk-based capital ratios, which is both counterintuitive and not reflective of the economics. It may create undesirable incentives for companies to deviate from prudent investment/risk management to avoid creating negative IMR.

It essentially creates two equally objectionable alternatives for insurers and their policyowners.

- Applying the current statutory guidance will improperly reflect financial strength through understating surplus,
- Insurers could take steps to manage their current capital position by limiting trading of fixed income investments and/or usage of derivatives, which would diminish significant economic value or worse, create a mismatch between assets and liabilities and prevent the ability to fulfil long-term contract obligations. Insurers may avoid hedging or trading to ensure future reinvestment risks are mitigated, by being incentivized to overly focus on managing misrepresented short-term financial position by effectively keeping asset duration shorter than their liabilities and taking on interest rate risk.

We do not believe this is in the best interest of insurance companies or their policyowners and believe it is a common interest we share with regulators. Consequently, developing a national standard for allowing negative IMR with appropriate safeguards should be a common goal for all.

As noted above, IMR itself is a safeguard for the NAIC's amortized cost framework that accomplishes two main objectives:

- Addresses the risk of misrepresentation of surplus, and
- Keeps the relationship of anticipated investment yield consistent with that needed to support the liabilities.

Excess Withdrawal Safeguard

An Excess Withdrawal safeguard is already embedded in the IMR framework for the situations in which asset sales are "forced", either due to reputational or disintermediation events, and the liability that the assets supported no longer exists. At such a point, deferring gains and losses to IMR ceases.

While we believe this safeguard was primarily developed to address troubled companies or potential disintermediation in a rising interest rate environment, we understand regulators may want to re-assess the safeguard's robustness. The ACLI supports such a re-assessment and looks forward to working with the NAIC.

Asset Adequacy Testing (AAT)

AAT is an additional safeguard that helps protect against further unintended consequences when IMR goes negative. Reflecting all admitted negative IMR in AAT would replace assets that generate investment income in AAT, where the starting point is statutory assets are equal to statutory liabilities. Unless the remaining assets can earn a sufficient yield due to reinvestment, there will be negative impacts to the results, which could lead to additional asset adequacy reserves and hence a reduction in statutory surplus. AAT provides a framework to ensure that there are sufficient margins to support claims alongside a negative IMR asset that eventually amortizes to zero, hence ensuring adequate reserves and proper representation of surplus. A simplified example of how AAT works with negative IMR in different reinvestment scenarios is included in Appendix I of this letter.

While we believe that AAT provides a robust safeguard that prevents a misuse of allowable negative IMR, we understand the NAIC wants to contemplate additional safeguards, as AAT may not be applied uniformly across states and practitioners and is only shared with regulators annually.

Additional Potential Safeguards

At the SAPWG fall national meeting the following five potential safeguards were discussed:

- 1) Ensure there is reinvestment in fixed income securities (see below),
- 2) Enhancement to asset adequacy testing (see below),
- 3) Shorten the amortization period for negative IMR (see Appendix II),
- 4) Limit negative IMR as a percentage of surplus, assets, etc. (see Appendix II), or
- 5) Restrict surplus via the special surplus funds (see Appendix II).

- 1) Limit based on the risk-based capital framework (see below), or
- 2) Create an “Opt-in Framework” with structured governance (see below).

The remainder of this letter outlines a broad framework of the aforementioned additional safeguards that we believe are responsive to regulators’ specific concerns. Redundant or more arbitrary potential safeguards are further discussed in Appendix II attached to this letter.

Ensure there is reinvestment in fixed income securities

IMR theory assumes sales of fixed income investments are reinvested in new fixed income investments. When doing so, the reinvestment is done in the current interest rate environment, and the difference in earnings arising from the reinvestment is roughly equal in magnitude, but opposite in direction, to the gain or loss realized on the old investment.

In a rising interest rate environment, a sale essentially transforms the loss to negative IMR. There is essentially no difference in balance sheet economics pre- and post-trade, related to liquidity or claims paying ability, as the difference between the reported amortized cost value, and fair value, upon sale, is equal to the negative IMR.

While AAT would arguably address any deficit in reinvestment as illustrated in our example in Appendix I, ACLI is open to supporting additional demonstrations of reinvestment in fixed income investment. 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.

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” – that is “proving” reinvestment of each sale, which would be difficult and potentially inappropriate, if on a macro basis there was a major shift to equities for example, and
- 3) It demonstrates on a macro basis significant reinvestment is occurring.

We note that even if there were a significant shift to equities, in theory, this should be captured by AAT with equity investments being appropriately stressed, but it would also significantly reduce risk-based capital ratios which would provide significant dis-incentivization for this to occur.

Lastly, such a metric could be coupled with the “Opt-in Approach” proposed below, that would provide additional structure by requiring documentation and controls on prudent strategies for investment management, asset liability management or hedging deemed appropriate and against which future transactions could subsequently be verified as appropriate by the company’s domiciliary regulator.

We propose that negative IMR should only be allowed if it is included in AAT. This would replace assets that generate investment income in AAT when starting with statutory assets equal to statutory liabilities. Unless the remaining assets can earn a higher yield through reinvestment at higher rates, there will be negative impacts to the results, which could lead to additional asset adequacy reserves and a reduction in statutory surplus.

Fixed income investments that sit in surplus or non-product portfolios could be sold generating IMR. Therefore, we recommend the allowance of negative IMR only if it is included in AAT. This would further prevent any potential balance sheet manipulation, whether intentional or unintentional, through shifting assets with losses to non-insurance portfolios and admitting losses on assets that are not offset by matched liabilities.

This concept could also be coupled with the “Opt-in Approach” proposed below.

Limit based on the risk-based capital framework

One potential safeguard that was not mentioned by SAPWG at the fall national meeting is to allow negative IMR only if a company’s risk-based capital threshold showed that they were financially strong. This would have the following benefits:

- 1) Address regulator concerns on allowing negative IMR if a company was or was nearing being financially troubled,
- 2) Would not be arbitrary and would be based on an objective and verifiable threshold that would be available to regulators, potentially quarterly, and provide early warning to any concerns they may have in this regard, and
- 3) Would essentially achieve the same ends as shortening the amortization period, restricting capital, or creating an arbitrary limit.

We are willing to work with the NAIC to think through an appropriate threshold as well as what would occur if that threshold was subsequently crossed so there would not be inappropriate cliff effects.

This concept could also be coupled with the “Opt-in Approach” proposed below.

Create an “Opt-in Framework” with Structured Governance

An “Opt-in Framework”, similar to the framework included within SSAP No. 108 – Derivative Hedging Variable Annuity Guarantees (SSAP No. 108), could be developed.

SSAP No. 108 recognizes the prudence of hedging guarantees embedded within variable annuity contracts while also recognizing the non-economic volatility created (and therefore inappropriate under/overstatement of surplus). It also recognized that this volatility was created because derivatives used in a dynamic hedging approach were required to be reported at fair market value, as they would not meet the strict hedge accounting requirements, while the liabilities did not require marking to market of the hedged guarantees.

To not disincentivize this prudent dynamic hedging, SSAP No. 108 requires additional structure and governance to avoid misrepresentation. The allowance of negative IMR has similar parallels.

Key provisions of SSAP No. 108 that could be considered for a framework for negative IMR allowability include:

- Explicit approval of a company's domiciliary regulator prior to implementation,
- A clearly defined portfolio and asset liability management strategy (with documentation; analogous to SSAP No. 108 but tailored more appropriately for portfolio and asset liability management strategies),
- Actuarial certification of the asset liability management strategy, and
- Certification by a financial officer of the company (CFO, treasurer, CIO, or designated person with authority over the actual portfolio and asset liability management strategies).

This framework provides sufficient tools that allow for timely and appropriate regulatory review; additional tools could be specifically tailored for IMR.

In the context of a negative IMR, the approach could be tailored to incorporate documentation and controls of prudent strategies for investment management, asset liability management, and hedging strategies deemed appropriate and against which future transactions could subsequently be verified as necessary by the company's domiciliary regulator.

Achieving the "opt-in" in the context of negative IMR could require satisfying these documentation requirements, in addition to incorporating and complying with a combination of one or more of the other potential safeguards mentioned above. This package of requirements and safeguards would constitute a national standard for allowing negative IMR that can be consistently applied across all companies.

In the current interest rate environment, and with additional interest rate increases potentially on the horizon, the disallowance of negative IMR has become a serious and pressing issue for industry as we seek to execute prudent portfolio and risk management strategies that align with our economic realities. The ACLI looks forward to working with the NAIC to expedite a reasonable, permanent solution that fulfills the original intent of IMR and work on the appropriate additional safeguards that may be needed for year-end 2023 implementation. Lastly, ACLI recalls a specific question raised by regulators at the NAIC's fall national meeting. We would like to understand this question and/or concern more fully and discuss with regulators or NAIC staff.

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 "Monahan".

Mike Monahan
Senior Director, Accounting Policy

A handwritten signature in black ink, appearing to read "Paul A. Dunham" followed by a stylized monogram.

Paul Graham
Senior Vice President, Policy and Legal

Simplified Example – How AAT Works With Negative IMR in Different Reinvestment Scenarios

This example illustrates the effectiveness of the AAT safeguard in ensuring company solvency even with an admitted negative IMR. In particular, the Appendix also illustrates how AAT bolsters the reinvestment guardrail.

Assumptions:

- A 10-year zero-coupon bond with a par value of \$1,000 and interest rate of 3%.
- A 10-year endowment liability with a rate of 3% maturing for \$1,344.
- The corresponding formulaic reserves at “time zero” would be \$1,000 assuming a valuation rate of 3%.
- The assets and liabilities are cashflow matched and no AAT deficiencies are assumed. Investment income of \$344 earned over ten years is sufficient to cover the increase in liability in the same period.

Balance Sheet	12/31/22	12/31/32
Assets		
Bonds	1,000	1,344
Total Assets	1,000	1,344
Liabilities		
Policy Reserves	1,000	1,344
IMR Liability	0	0
Total Liabilities	1,000	1,344

Income Statement	12/31/22 – 12/31/32
Income	
Net Investment Income before IMR	344
IMR Amortization	0
Benefits and Expenses	
Benefits	0
Addition to Reserves	344
Net Income (Loss)	0

If interest rates immediately rise to 4%, the insurer could sell the bond and reinvest (assume no policy surrenders):

- Formulaic reserves remain unchanged at \$1,000 due to the valuation rate being locked in at 3% and no surrenders.
- The original bonds would be sold at a capital loss of \$92 and would be reinvested in a higher yielding asset (earning 4%).
- The capital loss of \$92 would be transferred into a negative IMR and amortized over ten years (remaining life).

In this scenario, even though the newly purchased bonds are recorded at \$908, appearing lower than before the sale, the higher investment income of \$436 is sufficient to cover the increase in liability and IMR amortization over ten years. No asset adequacy reserves would need to be established as part of the asset adequacy analysis¹.

Balance Sheet	12/31/22 Before Asset Sale	12/31/22 After Asset Sale	12/31/32
Assets			
Bonds	1,000	908	1,344
Total Assets	1,000	908	1,344
Liabilities			
Policy Reserves	1,000	1,000	1,344
IMR Liability	0	(92)	0
Total Liabilities	1,000	908	1,344

¹ Asset adequacy testing requires that assets included in testing be no greater than the reserves and liabilities being tested. Even if there were other assets in addition to the \$908 bonds, a robust AAT safeguard would require that admitted negative IMR be reflected in AAT, effectively constraining the income generating assets that can be used in AAT to support liabilities when testing for deficiencies. AAT pressures to set up asset adequacy reserves will increase unless reinvestment into higher yielding assets occurs.

Income Statement	12/31/22 – 12/31/32
Income	
Net Investment Income before IMR	436
IMR Amortization	(92)
Benefits and Expenses	
Benefits	0
Addition to Reserves	344
Net Income (loss)	0

Assume rates immediately rise to 4% and 50% of liabilities are immediately surrendered²:

- 50% of the liability surrenders, with a surrender value of \$500.
- Bonds are sold to fund withdrawals. Due to the rate increase, the book value of bonds sold (\$551) is higher than their market value of (\$500), resulting in a capital loss of \$51.
- As withdrawal activity is not deemed to be excessive, the capital loss of \$51 is transferred into negative IMR which is amortized over ten years.
- The remaining \$449 of bonds would continue to earn their original interest rate of 3%.

In this scenario, the total assets included in asset adequacy analysis are \$449 of original bonds (yielding 3%) and negative IMR at \$51. However, these would be insufficient to cover the total remaining liability requirement of \$672 after 10 years. Therefore, an AAT reserve of \$51 would be established to cover this inadequacy, resulting in a P&L impact and ultimately a reduction to statutory surplus. Inclusion of the negative IMR in AAT accurately portrays the company's surplus and results in additional reserves of \$51. The additional assets (assumed to also earn 3% like the original bonds) backing the AAT reserves combined with the \$449 of original bonds are now sufficient to cover the remaining liability requirement of \$672 after 10 years.

Balance Sheet	12/31/22 Before Asset Sale and Surrender	12/31/22 After Asset Sale and Surrender, but before AAT	12/31/22 After Asset Sale, Surrender, and AAT	12/31/32
Assets				
Bonds	1,000	449	449	672
Extra Assets for AAT	0	0	51 ³	0
Total Assets	1,000	449	500	672
Liabilities				
Policy Reserves	1,000	500	500	672
AAT Reserves	0	0	51	0
IMR Liability	0	(51)	(51)	0
Total Liabilities	1,000	449	500	672

² Assumes that a 50% surrender does not constitute Excess Withdrawal Activity as defined in the Life, Accident & Health/Fraternal Annual Statement Instructions. If it did constitute Excess Withdrawal Activity, deferring losses to IMR would cease and result in an instant hit to statutory surplus.

³ Extra assets of \$51 would be a reduction to surplus in the year of testing when the additional AAT reserves are recorded.

Income Statement	12/31/22 – 12/31/32
Income	
Net Investment Income before IMR	172
IMR Amortization	(51)
Benefits and Expenses	
Benefits	0
Addition to Reserves	121
Addition to AAT Reserves on 12/31/22	51
Net Income (loss)	(51)

Appendix II

Other Potential Safeguards

Shorten Amortization Period

As negative IMR is included in AAT, shortening the amortization period arguably would not be needed but also contradicts the theory of IMR. We believe that shortening the amortization period asymmetrically would obviate one of the objectives of IMR – to keep the relationship of anticipated investment yield consistent with that needed to support the liabilities. Further it would introduce a host of practical challenges.

Examples of practical challenges from shortening the amortization period include:

- Shorten the amortization period only when net negative balances occur?
- If so, in what discrete period?
- For the year?
- What happens when the balance switches from negative to positive (or vice versa) during the year and amortization had already been shortened at the start of the year?

We also wanted to address a further potential concern that has been raised and is best illustrated in the following example:

- There is a \$1 billion IMR gain with a 20-year amortization period
- Subsequently it is offset to zero by a \$1 billion loss with a 1-year amortization period.
- Does this accelerate the gain recognition which was really the impetus behind IMR in the first place?

This would not be the case as gains and losses are amortized separately regardless of whether the gross balances offset one another. While it is true that on day 1, there would be an offset to zero, both the gains and losses are amortized separately, and in this case, in year two approximately \$950 million (assuming straight line amortization for simplicity) would be the total credit IMR balance representing the gains that still need to be amortized.

As shortening the amortization period:

- contradicts the theory and objectives of IMR,
- is arbitrary,
- would create practical challenges to implement,
- would penalize strong companies the same as weakly capitalized companies, and
- would be unduly punitive to companies with strong and weak AAT practices alike.

We do not believe this solution to be appropriate, or in line with prudent best practices.

Limit as a percentage of surplus, etc.

Limiting negative IMR to a percentage of surplus would again be an arbitrary limit that contradicts the theory of IMR and would penalize strong and weak companies alike, similar to shortening the amortization period, and we believe it does not best serve an appropriate safeguard.

While we are not against further safeguards, we believe any additional safeguards should address a very specific concern of regulators and/or a concern that is not already adequately addressed by existing safeguards or are more tailored to specific concerns such as with the “Opt-in Approach” recommended.

Restrict Surplus via the special surplus fund

The effect of AAT requiring additional reserves is equivalent to restricting surplus available for dividends to stockholders or participating policyowners. Thus, restricting surplus (the special surplus fund) for an amount equal to allowable negative IMR would be redundant when AAT requires additional reserves. Further, because dividends are governed by varying state laws, restricting surplus would provide inconsistent treatment, which is a suboptimal solution. The same ends could be achieved elsewhere such as with a limit based on the risk-based capital framework in combination with the “Opt-in Approach” recommended.