



AMERICAN ACADEMY *of* ACTUARIES

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June 25, 2018

Mr. Kevin Fry
Chair, Valuation of Securities (E) Task Force
National Association of Insurance Commissioners

Re: VOSTF Proposal to Add Comprehensive Instructions for Fund Investments to the P&P Manual

Mr. Fry,

The C1 Work Group (C1WG) of the American Academy of Actuaries,¹ appreciates the opportunity to comment on the National Association of Insurance Commissioners (NAIC) Valuation of Securities Task Force's (VOSTF) Proposal to Add Comprehensive Instructions for Fund Investments to the Purposes and Procedures (P&P) Manual (Proposal). The stated purpose of this Proposal is "to prepare a comprehensive proposal to ensure all funds that hold underlying fixed income assets as portfolio assets are treated consistently irrespective of the NAIC Schedule on which the asset is reported." If adopted, this Proposal could have unintended effects on the calculation of a life insurer's Risk-Based Capital (RBC) by significantly decreasing the capital requirements for certain bond funds. Because of the potential unintended effects on RBC, we have concerns with this Proposal. We suggest that the issue of capital requirements for Fund Investments be referred to the NAIC's Capital Adequacy Task Force (CADTF), and that this VOSTF Proposal be deferred pending the outcome of the CADTF analysis.

Our reservations about the Proposal are twofold: (1) We have a procedural concern that any proposal that fundamentally impacts capital should be considered by CADTF, and (2) we are concerned that the Proposal may reduce the capital requirements for fund investments below regulators' stated statistical level.

The term "consistent treatment" is not explicitly defined in the Proposal, yet the result of the Proposal is to rate certain funds as having identical risks to a portfolio of individual bonds. As described in the Proposal, the SVO staff has proposed the use of a speculative risk analysis to rate bond funds. The result of this speculative risk analysis is the assignment of an NAIC bond rating to the fund. In turn, this bond rating would be used in the calculation of Life Risk-based Capital (LRBC) charges. Instead of the current base 30% LRBC C-1 factor for mutual funds in general (subsequently raised to 45% or lowered to 22.5% through the Beta Adjustment), these

¹ The American Academy of Actuaries is a 19,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

rated funds would receive a C-1 factor based on the same scale as corporate bonds, where the lowest C1 factor is 0.4%.

If this Proposal is adopted by VOSTF, it is possible that the C-1 RBC factor for a fund would be reduced from 45% to 0.4%. We believe that a proposal such as this should be reviewed by CADTF prior to adoption.

We note that the CADTF has not considered the possibility of using the C-1 bond factors for any purpose other than for assessing a capital requirement for credit risk for individual bonds. Further, funds include risks other than credit risks. If VOSTF adopts this Proposal, LRBC calculations will be affected until or unless CADTF and other NAIC groups take action to exempt these rated funds from corporate bond treatment. Given the potential for a material reduction in the capital charges for rated funds, VOSTF should consider the impact of adoption of this proposal in advance of the CADTF's review of the risks and appropriate LRBC charges.

The C1WG has been working with the NAIC's Investment RBC Working Group to update the LRBC C-1 bond charges. We have concerns where the Proposal states that "If you look through the fund to the financial dynamic of its portfolio, the portfolio cash flow to the insurer should have the same predictability, periodicity and credit quality as when a non-fund entity directly holds the individual bonds of that issuer in its portfolio."

Essentially, funds do not contain the same characteristics and risks as a portfolio of bonds because funds do not promise repayments of principal, and thus cannot be evaluated by "credit risk" analysis. For a fund (a bond exchange-traded fund (ETF) or a bond fund), risk to statutory surplus is measured by price volatility if the fund is carried at fair value. In contrast, for an individual bond, the risk to statutory surplus is measured by the change in value due to credit risk (i.e., the risk that the creditor will default on its obligation to pay back the borrowed funds according to the specified terms) because bonds are carried at amortized cost. Further analysis of the risks of the different types of bond funds will help illustrate how funds affect statutory surplus.

Devising a process to modify the LRBC treatment of these funds by looking through to their holdings requires further analysis to preclude the proposed change from unintentionally undermining the LRBC calculation, in particular the intended statistical coverage level of the C1 bond factors. We note the following differences between funds and individual bonds should be considered in the analysis of risks and LRBC charges:

- a. The investor has no creditor relationship with a fund;
- b. A fund does not produce a contractually guaranteed stream of cash flows from coupon income and maturities; a five-year ETF will always be a five-year ETF whereas a five-year corporate bond can only 1) prepay, 2) default on its promise to pay, or 3) mature;
- c. The investment objective for managing a fund containing slices of bonds is different from the investment objective for managing a portfolio of bonds;
- d. A fund is not homogeneous and its composition can vary, including assets other than bonds.

- e. Using a rating process that weights the credit rating of the underlying bonds results in a weighted rating that is based on the average credit risk, but C-1 bond factors are designed to capture the full quality range of credit risk in a portfolio which can perform differently than an average rating;
- f. LRBC C-1 bond charges are based on statutory loss, defined relative to the statutory carrying value of amortized cost. The charges do not consider current fair value effects on surplus; and
- g. LRBC C-1 bond charges are based on the observed credit experience for corporate bonds. The default and recovery rates have been derived from published studies. There is no basis in research for applying these bond factors to a fund, and, if done, the resulting capital charge may not be appropriate.

The C1WG understands the need to reconsider the RBC factors for certain funds. While it is possible that the current C1 treatment for funds could be refined, it would be premature to adopt a credit rating methodology that could trigger materially lower, and potentially inadequate, LRBC charges without proper analysis and consideration of the issues. We are concerned that this proposed change in reporting and rating funds could present an indirect way of reducing capital requirements without proper and robust discussion of the risks to statutory surplus. Adopting this rating methodology at this time would undermine the LRBC calculation and the established procedures for reviewing and refining the LRBC formula.

We welcome the opportunity to discuss our concerns with the VOSTF. Please contact American Academy of Actuaries Senior Life Fellow Nancy Bennett (bennett@actuary.org) with any questions.

Sincerely,

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