

# EFFECT OF TAX REFORM ON NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS' (NAIC) LIFE RISK-BASED CAPITAL (RBC)



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# Introduction

- Federal tax reform is effective for 2018
  - ▣ Corporate tax rate reduced from 35% to 21%
  - ▣ Several other provisions affecting life insurers
- Questions for NAIC to answer
  - ▣ Change Authorized Control Level (ACL) RBC due to tax reform?
  - ▣ If so, what changes should be made, and when should changes be effective?



# Tax Reform Effects on RBC

- NAIC Life RBC compares two calculated items -
  - Total Adjusted Capital (TAC) is compared to -
  - ACL RBC
- Our letter focuses on possible changes to RBC factors within ACL RBC
- Additionally, TAC is affected in many ways by tax reform



# Tax Reform Effect on TAC

- TAC changes from tax reform (all in effect for 2018)
  - Tax rate changes from 35% to 21%
  - Tax reserve redefined; difference spread over 8 years
  - Deferred acquisition cost tax – higher capitalization, longer amortization
  - Dividend received deduction changed
  - Deferred tax asset/liability revalued
  - Asset adequacy testing uses lower tax rate



# Should ACL RBC Be Changed?

- Underlying premises
  - ACL RBC estimates surplus needed for “stress” events
    - Examples of stress event – bond default, high mortality
  - In general, RBC factors were developed on a post-tax basis
    - Most life insurers are assumed to be profitable and pay taxes
    - When stress event happens, net surplus impact to insurer is cushioned by reduction in tax expense



# Should ACL RBC Be Changed?

- Because RBC is on a post-tax basis, there is solid logic to change RBC factors as tax rates change
- Illustrative example
  - Assume a \$100 pre-tax “stress” event
  - At 35% tax rate, after-tax cost (and RBC) is \$65
  - Same event at 21% tax rate has after-tax cost of \$79
  - So ACL RBC should go up



# ACL RBC Effective Date Considerations

- Possible date to implement proposed changes
  - For 2018 RBC filings
  - For 2019 RBC filings
  - Some type of phase-in
- Effective date decision is a regulator decision, taking into account public policy considerations



# ACL RBC Change Date Considerations

- RBC factors should change as tax rates change
- “Discontinuities” in the trend of ACL RBC
  - Items that will likely raise ACL RBC
    - C-1 bond changes (targeting 2019)
    - RBC tax factor changes (date TBD)
  - NAIC should consider whether ACL RBC trend discontinuities should be focused in one year, or graded in



# ACL RBC Effective Date Considerations

- As ACL RBC rises, more companies could be flagged as “weakly capitalized”
  - Suggest deeper monitoring of insurers with low ratios of TAC to ACL RBC until RBC changes are fully made
- RBC “Trend Test” will need careful interpretation
- Tax items that impact TAC are generally effective in 2018



# Recommendations if ACL RBC Is Changed for Relevant Year \*

<b>C-1 bonds</b>	<b>For 2018 RBC filing – Multiply pre-tax RBC factors by 0.97 Change tax factor to 0.1575 or 0.1680</b>  <b>For 2019+ RBC filing – Use IRBC-updated bond factors, recalculated with 21% tax rate Change tax factor to 0.1680</b>
C-1 other than bonds	Change 0.35 tax factors to 0.21 (for 2018 and 2019+ RBC filing) Change 0.2625 tax factors in line with C-1 bond tax factors



# Recommendations if ACL RBC Is Changed for Relevant Year \*

<b>C-2 life insurance</b>	<b>For 2018 RBC filing – Multiply pre-tax RBC factors by 0.97 Change tax factor to 0.21</b>  <b>For 2019+ RBC filing – Until underlying RBC factors are updated – same pre-tax RBC factor and tax factor changes as for 2018 When underlying RBC factors are updated – use updated pre-tax RBC factor and tax factor of 0.21</b>
<b>C-2 A&amp;H</b>	<b>To be determined in consultation with the Academy’s Health Solvency Subcommittee</b>



# Recommendations if ACL RBC Is Changed for Relevant Year \*

<b>C-3</b>	<b>For all RBC filing years – Change pre-tax minimum factors to 0.0063, 0.0127, and 0.0253 Change tax factor to 0.21</b>  <b>(Note that C-3 Phase 1 and C-3 Phase 2 calculations should use current tax rate)</b>
C-4	For all RBC filing years – Change 0.35 tax factor to 0.21



# Additional Information

- Much more detail contained in March 16, 2018, letter to NAIC Life RBC Working Group
- We stand ready to assist the NAIC going forward



# Contact Information

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