American Academy *of* Actuaries

Recommendation concerning the Calculation of the Asset Risk (C-1) Required Capital for Preferred Stock

Presented by the American Academy of Actuaries' Life Capital Adequacy Subcommittee to the National Association of Insurance Commissioners' Capital Adequacy Task Force

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The credit rating practices of the Nationally Recognized Statistical Rating Organizations (NRSOs), relative to preferred stock, have changed since the development by the National Association of Insurance Commissioners (NAIC) of the Life Risk Based Capital (LRBC) formula. The current NRSRO practice utilizes the concept of "notching." This concept results in bonds and preferred stocks being rated on the same scale with the unique characteristics of the financial instruments incorporated into the NRSRO credit rating of the instrument.

The current LRBC formula assumes that bonds and stocks are rated on separate scales. The RBC factors in the current formula are larger for preferred stock than for bonds. While the relationship between the two sets of factors has changed over time to reflect better understanding of the default loss characteristics of each class of financial instrument, it is still the case that, for example, the factor for an NAIC 2 preferred stock is larger than the factor for an NAIC 2 bond. The current credit rating system, i.e., notching, used by the NRSROs when used as the basis for the LRBC required capital calculations results in a "double hit."

The American Academy of Actuaries (Academy) Life Capital Adequacy Subcommittee (LCAS) recommends that the current factors in the LRBC formula for preferred stock be replaced with the factors used for bonds. The recommendation reflects our understanding that preferred stocks will continue to be reported in the statutory financial statements in the same way that they currently are reported.

The LCAS also recommends that the appropriate NAIC group responsible for maintaining the Asset Valuation Reserve (AVR) consider the recommendation above and make comparable changes to the AVR. We feel this is important for two reasons:

1. From a risk evaluation standpoint, the calculation of the AVR should be based on methodology consistent with the rating practices used by NRSROs.
2. The RBC Total Adjusted Capital is calculated by adding the AVR to an entity's capital and surplus.

The NAIC Capital Adequacy Task Force (Task Force) may want to consider the need to synchronize the implementation of the LCAS's recommendation with changes to the AVR calculation instructions that appear in NAIC Annual Statement Instructions.

The Task Force may also want to consider the need for the appropriate NAIC group to review the Purposes and Procedures of the Securities Valuation Office to determine whether modifications are needed to reflect the concept of "notching" as used by the NRSROs.

In reviewing various documents that discussed the practice of notching, the LCAS discussed the desirability of increasing the granularity of the current 1 – 6 system used by the NAIC. Material in the reports from the NRSROs suggested that the lower rating classes (NAIC 3 and lower) may do a better job of reflecting anticipated losses if additional subdivisions were introduced into the system. The Task Force may want to request the LCAS to undertake a project of evaluating the desirability of increasing the granularity of the NAIC 1-6 rating system.