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September 7, 2018

Mr. Philip Barlow
Chair, Life Risk-Based Capital (E) Working Group
National Association of Insurance Commissioners
Via Email: Dave Fleming (DFleming@naic.org)

Dear Philip,

The RBC Tax Reform Work Group of the American Academy of Actuaries[1] Life Practice Council is pleased to provide the attached document for National Association of Insurance Commissioners' (NAIC) Life Risk-Based Capital Working Group's (LRBCWG) benefit.

The document could serve as a starting point for a future communication from your working group to a broader group of state regulators. The purpose of the communication could be to assist those regulators in interpreting the results of year-end 2018 life risk-based capital calculations in light of tax reform.

We stand ready to assist your working group as you move forward.

Sincerely,

Wayne E. Stuenkel, MAAA, FSA, CERA
Chairperson, RBC Tax Reform Work Group
American Academy of Actuaries

[1] The American Academy of Actuaries is a 19,500-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.

Interpretation of 2018 Life Risk-Based Capital Results
in Light of the 2017 Tax Cuts and Jobs Act

Purpose and Intended Audience for this Document

This document is intended to assist financial examiners and other state regulators as they review the results of 2018 risk-based capital (RBC) calculations for life insurers in light of the 2017 Tax Cuts and Jobs Act (TCJA). It is intended to be a non-technical overview of changes that will affect 2018 RBC filings.

More detailed information about this topic is contained in letters to LRBCWG from the Academy's RBC Tax Reform Work Group dated March 16, April 24, and June 4, 2018. Changes to the Life RBC formula due to the TCJA were approved by the NAIC Capital Adequacy (E) Task Force in June 2018.

Executive Summary

The TCJA is effective for 2018. A widely known provision in the TCJA is a reduction in the corporate tax rate from 35 percent to 21 percent, which applies to life insurers as well as other corporate entities. There are also several items in the TCJA that specifically affect life insurers, including changes in tax reserves, deferred acquisition cost (DAC) tax, and the dividends received deduction.

Starting in early 2018, the LRBCWG examined Life RBC to see what changes should be made because of the TCJA. With assistance from the Academy and others, LRBCWG worked through the formula and proposed a number of changes to Life RBC. Those changes were adopted by both LRBCWG and its parent committee, the NAIC Capital Adequacy (E) Task Force, during June 2018. The changes to Life RBC will be effective for the 2018 filing year (that is, RBC reports that will be filed in the first quarter of 2019).

When life insurers file their 2018 annual statements and RBC reports, their Total Adjusted Capital (TAC) will reflect the impact of the TCJA. (Note that the impact of the TCJA will not be fully reflected in TAC for a number of years into the future.) Also, the Authorized Control Level (ACL) RBC (i.e., "required RBC"), which is a calculated result of the Life RBC formula, will be impacted by the changes to Life RBC that were made by LRBCWG.

Due to changes to Life RBC to reflect the TCJA, the LRBCWG expects that the Dec. 31, 2018, ACL RBC for most life insurers will be higher than it would have been under the 2017 Life RBC formula. The higher ACL RBC will increase the "Trigger Points for Level of Regulatory Action" (as defined in the instructions for the Life RBC calculation.) In turn, this is expected to decrease the amount of TAC in excess of ACL RBC for Dec. 31, 2018, filings compared to what such amount would have been under the previous tax law, even though the Dec. 31, 2018, TAC for some life insurers may increase due to the TCJA. An insurer's mix of assets and liabilities, business profile, and tax attributes will determine the impact of the TCJA on the Life RBC calculation for that company.

According to information summarized by the NAIC, the LRBCWG expects that an immaterial number of life insurers, if any, will breach an RBC threshold (Company Action Level, Authorized Control Level, etc.) due to the increase in ACL RBC. However, the LRBCWG expects that there is a potential for more life insurers to trigger the Life RBC Trend Test for Dec. 31, 2018, due to the TCJA-related changes to the Life RBC formula. Later in this document, suggestions are offered as to how regulators might analyze any breaches of an RBC threshold or triggering of the Trend Test in 2018.

This document examines the changes to ACL RBC, TAC, and RBC results due to the TCJA, including:

- Why does a reduction in tax rates cause an increase in ACL RBC?
- What are the changes in ACL RBC that will be effective for the 2018 filing year?
- How will TAC be affected by the TCJA?
- How should effects of the TCJA be factored into the interpretation of RBC results?
- How will elements of the TCJA affect the components of the Life RBC calculation in the future?

Why does a reduction in tax rates cause an increase in ACL RBC?
It may seem counterintuitive that a lower tax rate causes ACL RBC to be higher. However, an example can illustrate why this is the case:

- Life RBC factors are developed to cover risks that could materialize in “stressed” conditions. For example, an economic downturn might cause an increase in defaults on bonds, or a pandemic could cause death claims to increase. ACL RBC is intended to calculate the minimum capital that a life insurer should hold to provide for “stress” events, such as an economic downturn or a pandemic, recognizing that statutory policy reserves cover “moderately adverse” risk conditions.
- As an illustration, assume that a pandemic would increase a life insurer’s death benefits by $1 million, net of policy reserves and reinsurance. The death benefit increase would reduce the insurer’s taxable income by $1 million.
- Assuming that the insurer is paying federal taxes, the insurer’s tax bill under the previous tax law would have been reduced by $350,000 (35 percent of $1 million). Therefore, the net loss to the insurer would be $650,000; that is, $1 million of death benefits offset by a $350,000 reduction in taxes. TAC would decrease by $650,000.
- Due to the TCJA, the same “stress” event under the new tax law would reduce taxes by only $210,000 (21 percent of $1 million), leaving the net loss (and TAC impact) to the insurer at $790,000. It is this impact that requires a higher RBC requirement to cover the risk. **In other words, under this example ACL RBC would increase by 21.5 percent; that is, [($790,000 divided by $650,000) minus one].**
- This phenomenon is what leads to the increase in Life RBC factors for 2018.

There are hundreds of factors in the Life RBC formula. The adopted changes to Life RBC increased some of the factors, net of tax, by 21.5 percent. However, for technical reasons, some RBC factors were decreased as a result of the TCJA, while others remained unchanged. The net result is that the majority of post-tax RBC factors increased by less than 21.5 percent. **Therefore, ACL RBC for life insurers is expected to generally be increased as a result of the TCJA, but by less than 21.5 percent.** The actual increase in ACL RBC is company-specific, depending on each company’s mix of assets, liabilities, risk factors, and tax strategies.

What are the changes in ACL RBC that will be effective for the 2018 filing year?
There are numerous changes to Life RBC factors due to the TCJA. A high-level summary of the changes to the RBC factors follows. Life RBC factors not mentioned below were unaffected by the TCJA.

- Most of the factors in LR030 (Tax Offset) for the 2017 RBC filing year were 0.35. Those factors are changed to 0.21 for the 2018 Life RBC filing year. Certain of the tax factors for bonds, preferred stocks, and similar instruments for the 2017 RBC filing year were 0.2625 (that is, 75 percent of 0.35), and those factors are changed to 0.1575 (that is, 75 percent of 0.21).
- C1 pre-tax RBC factors for bonds, preferred stocks, and similar instruments, and C2 RBC factors for individual and group life, were reduced by 3 percent, reflecting a higher post-tax discount rate.
- C2 RBC factors for health insurance, the C3 "base" factors, and the C4-0 factor were adjusted downward so that the net post-tax RBC factor is unchanged.

A complete set of updated factors has been prepared by NAIC staff, and can be referenced using the above hyperlink.

How will TAC be changed by the TCJA?
If the change in the corporate tax rate from 35 percent to 21 percent were the only tax law change affecting life insurers, TAC would be higher in the future than under the prior tax law for companies with taxable income, because income tax expense would be reduced.

This increase to TAC from a lower tax rate is offset by a number of factors. The extent to which there is an offset is company-specific, as each life insurer's tax situation is different. The offset is also time-specific, as the offset factors could be larger than the benefit of a lower tax rate for Life RBC filings in 2018 and immediately following years, with the size of the offset reducing as time goes on. The offset factors are as follows:

- Some life insurers have a net deferred tax asset (DTA) on their balance sheets. Accounting rules require that the DTA be recalculated using the lower tax rates. We understand that most life insurers that have a DTA reported this reduction to DTA, which reduced TAC, in their 2017 annual statements.
- The TCJA changed the tax deduction for reserves to the greater of the cash surrender value or 92.81 percent of the statutory reserve (with certain prescribed adjustments such as eliminating deficiency reserves and asset adequacy reserves). For most products, this is expected to reduce the deductible tax reserve, which increases taxable income and tax expense for a growing company, and therefore reduces TAC. Additionally, the TCJA requires that the difference between "old basis" and "new basis" tax reserves as of Dec. 31, 2017, be amortized into taxable income over eight years, further increasing taxable income and tax expense and further reducing TAC.
- The TCJA increased the capitalization rate and lengthened the amortization period for the DAC tax. These changes will accelerate taxable income and tax expense, and therefore reduce TAC.

- The TCJA modified the dividends received deduction (DRD), which will increase taxable income and tax for some life insurers. The DRD allows a life insurer that receives a dividend from another company to deduct a portion of that dividend from taxable income.

The reduction in tax rates would be expected, by itself, to result in higher TAC for many life insurers. However, this reduction in tax rates will be offset, by some degree that will vary by company, by the changes discussed above, which broadened the life insurance company tax base. While the impact of the tax changes will flow in over time, the reduction in the DTA and changes to ACL RBC are fully effective for 2018. Consequently, the anticipated impact of these changes for most life insurers will be a reduction in the amount of TAC in excess of ACL RBC for life insurers for 2018 and immediately following years.

How should effects of the TCJA be factored into the interpretation of RBC results?
The Life RBC Trend Test (LR035) will be affected by the TCJA. The Trend Test calculates a margin, which is the difference between TAC and ACL RBC, for each of the current year, the prior year, and the third prior year. To the extent that the current year margin is lower than the prior year or third prior year margin, regulatory action may be indicated.

For the 2018 Trend Test, the margin for 2018 is compared to the margins for 2017 and 2015. As noted above, a company’s ACL RBC is expected to be increased for 2018 compared to prior years, and TAC may be reduced. The changes to ACL RBC and TAC due to the TCJA may cause some companies to trigger the Trend Test, solely because of the TCJA.

Also, as noted above, the amount of TAC in excess of ACL RBC is expected to decrease for Dec. 31, 2018, RBC filings compared to what such amount would have been under the previous tax law, even though the Dec. 31, 2018, TAC for some life insurers may increase due to the TCJA. The decrease may be large enough to push a life insurer below an Action Level.

If regulators find that a life insurer has triggered the Trend Test or triggers an Action Level for 2018, they could have additional discussions with the company and request additional calculations. It is likely that life insurers themselves would have done some analysis of significant changes in ACL RBC and the excess of TAC over ACL RBC, and that analysis could be shared with regulators.

How will the elements of the TCJA affect the components of the Life RBC calculation in the future?
As described above, some of the elements of the TCJA were effective for Dec. 31, 2017, annual statements, some are fully effective for the Dec. 31, 2018, annual statements and RBC filings, and others are partially effective for 2018 filings and will become fully effective over time.

- <u>Authorized Control Level RBC</u>—The changes to ACL RBC are fully effective for the Dec. 31, 2018, RBC filing.
- <u>Total Adjusted Capital</u>—There are a number of tax-related items that affect TAC, with timing that varies by item. Items that increase taxable income generally increase tax expense and therefore reduce TAC, while those that decrease taxable income generally reduce tax expense and therefore increase TAC.

- DTA—As noted above, we understand that most life insurers have already recalculated their DTA using the new lower tax rate on their 2017 annual statement. For insurers with a net DTA, this recalculation reduced TAC in 2017.
- Tax Rate—The 21 percent tax rate, which is a reduction from the previous 35 percent rate, is effective for the 2018 tax year. For life insurers with taxable income, this will reduce tax expenses in 2018 and future years and therefore increase TAC.
- Tax Reserves—As noted above, tax reserves are generally reduced under the TCJA. For life insurers with increasing reserves (that is, generally companies that are growing), that will reduce the tax deduction for reserves for 2018 and future years, and therefore increase taxable income. Also, the difference between "old method" and "new method" tax reserves as of Dec. 31, 2017, will be amortized over eight years from 2018 to 2025, which will increase taxable income in the future.
- DAC Tax—As noted above, DAC tax capitalization is increased starting in 2018. For example, the factor for individual life insurance premiums increases from 7.70 percent to 9.20 percent, which will increase taxable income. Also, the amortization period is increased from 10 years to 15 years, which will further increase taxable income for 2018–2032.
- Dividends Received Deduction—The deduction is reduced effective in 2018. For some companies, this change increases taxable income.

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