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May 7, 2019

Commissioner David Altmaier
Chair, Capital Adequacy (E) Task Force
National Association of Insurance Commissioners (NAIC)

Re: Commentary on the Exposed Risk-Based Capital (RBC) Preamble

Dear Commissioner Altmaier,

The Life Capital Adequacy Committee (LCAC) of the American Academy of Actuaries[1] Life Practice Council offers comments on the exposed RBC Preamble in the attached marked-up version. In addition to the modest clarification and typographical changes, I wanted to highlight the following changes:

- In the "Purpose of Risk-Based Capital" section, added that the purpose of RBC is to identify potentially weakly capitalized companies.
- Moved paragraph 13 to the "History" section.
- In the "Critical Concepts of Risk-Based Capital" section, included conceptual description of RBC from the 1991 "Report of the Industry Advisory Committee to the Life Risk Based Capital Working Group."

Thank you for the opportunity to provide input. If you have any questions or would like to further discuss these comments, please contact Ian Trepanier (trepanier@actuary.org), Academy life policy analyst.

Sincerely,

Chris Trost, MAAA, FSA
Chairperson, Life Capital Adequacy Committee
American Academy of Actuaries

Cc: Jane Barr, Company Licensing and RBC Manager, NAIC
Philip Barlow, Chair, NAIC Life RBC Working Group

[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.

Risk-Based Capital
Preamble

History of Risk-Based Capital by the NAIC

A. Background

1. The NAIC, through its committees and working groups, facilitated many projects of importance to the insurance regulators, industry and users of statutory financial information in the early 1990s. That was evidenced by the original mission statement and charges given to the NAIC Capital Adequacy (E) Task Force of the Financial Condition (E) Committee.

2. The mission of the Capital Adequacy (E) Task Force was to determine the minimum amount of capital an insurer should be required to hold to avoid triggering regulatory action. The risk-based capital formula largely consists of a series of risk factors that are applied to selected assets, liabilities or other specific company financial data to establish the minimum capital needed to bear the risk arising from that item.

3. To carry out the mission, the Capital Adequacy (E) Task Force was charged with carrying out the following initiatives:

- Evaluate emerging "risk" issues for referral to the risk-based capital (RBC) working groups/subgroups for certain issues involving more than one RBC formula. Monitor emerging and existing risks relative to their consistent or divergent treatment in the three RBC formulas.

- Review and evaluate company submissions for the schedule and corresponding adjustment to total adjusted capital (TAC).

- Monitor changes in accounting and reporting requirements resulting from the adoption and continuing maintenance of the revised *Accounting Practices and Procedures Manual* (AP&P Manual) to ensure that model laws, publications, formulas, analysis tools, etc., supported by the Task Force continue to meet regulatory objectives

4. The Risk-based Capital forecasting and instructions were developed and are now maintained in accordance with the mission of the Capital Adequacy (E) Task Force as a method of measuring the minimum amount of capital appropriate for an insurance company to support its overall business operations in consideration of its size and risk profile.

B. Purpose of Risk-Based Capital

5. The purpose of risk-based capital is to identify potentially weakly capitalized companies. –This facilitates regulatory actions that in most cases ensure policyholders will receive the benefits promised without relying on a guaranty association or taxpayer funds.- Consequently, the RBC system calculates capital level trigger points~~capital level~~ that enable regulatory intervention in the operation of weakly capitalized companies. ~~to determine the minimum capital (RBC levels) an insurer needs to operate its business and insurers should seek to maintain capital above the RBC levels.~~

6. RBC Instructions, RBC reports and adjusted report(s) are intended solely for use by the commissioner/state in monitoring the solvency of insurers and the need for possible corrective action with respect to insurers and are considered confidential. All domestic insurers are required to file an RBC report unless exempt by the Commissioner. There are no state permitted practices to modify ~~for~~ the RBC formula and all insurers are required to abide by the RBC instructions.

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Preamble

7. Comparison of an insurer's TAC to any RBC level is a regulatory tool which may indicate the need for possible corrective action with respect to the insurer and is not intended as a means to rank insurers generally. Therefore, except as otherwise required under the provisions of *Risk-Based Capital (RBC) for Insurers Model Act* (#312) or *Risk-Based Capital (RBC) for Health Organizations Model Act (#315)* (Model Laws), the making, publishing, disseminating, circulation or placing before the public, or causing, directly or indirectly to be made, published, disseminated, circulated or place before the public, in a newspaper, magazine or other publication, or in a form of a notice, or in any other way, an advertisement, announcement or statement containing an assertion, representation or statement with regard to the RBC levels of any insurer or of any component derived in the calculation by any insurer is~~n~~ prohibited.

C. History of Risk-Based Capital

8. From the inception of insurance regulation in the middle 1800s, the limitation of insurance company insolvency risk has been a major goal of the regulatory process. The requirement of adequate capital has been a major tool in limiting insolvency costs throughout the history of insurance regulation. Initially, ~~the~~ individual states enacted statutes requiring a specified minimum amount of capital and surplus for an insurance company to enter the business or to remain in business.

9. Fixed minimum capital requirements were~~had been~~ largely based on the judgement of the drafters of statutes and varied widely ~~amoung~~among~~t~~ the states. Those fixed minimum capital and surplus requirements had served to protect the public reasonably well for over a century. Beginning in the 1960's rapidly rising inflation brought rapidly rising interest rates that caused concerns about the fixed minimum capital requirements *(paragraph moved from "Critical Concepts of Risk-Based Capital" section).*

~~8.~~

~~9.~~10. In 1992, the NAIC adopted the life risk-based capital formula with an implementation date of year-end 1993. The formula was developed for specific regulatory needs. Four major categories were identified for the life formula: Asset Risk, Insurance Risk, Interest Rate Risk and All other Business Risk. The property and casualty and health formulas were implemented in 1994 and 1998, respectively. The focus of these formulas is Asset Risk, Underwriting Risk, Credit Risk and Business Risk (Health).~~.~~

~~10.~~11. The total risk-based capital needed by an insurer to avoid being taken into conservatorship is the Authorized Control Level Risk-Based Capital, which is 50 percent of the sum of the risk-based capital for the categories, adjusted for covariance (i.e., Company Action Level). The covariance adjustment is meant to take into account that problems in all risk categories are not likely to occur at the same time.

~~B.~~ D. Objectives of Risk-Based Capital Reports

~~11.~~12. The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute. ~~to provide an adequate margin of safety.~~

~~C.~~ E. Critical Concepts of Risk-Based Capital

~~12. Fixed minimum capital requirements have been largely based on the judgement of the drafters of statutes and varied widely amount the states. Those fixed minimum capital and surplus requirement have served to protect the public reasonably well for over a century. Beginning in the 1960's rapidly rising inflation brought rapidly rising interest rates.~~

13. Over the years, various financial models have been developed to try to measure the "right" amount of capital that an insurance company should hold. ~~Risk-based capital seeks to modify the risk profile of all insurance companies to the point where they all have an equal probability of insolvency.~~ "No single formula or ratio can give a complete picture of a company's operation, let alone the operation of an entire industry. However, a properly designed formula will help in the early identification of companies with inadequate capital levels and allow corrective action to begin sooner. This should ultimately lower the number of

company failures and reduce the cost of any failures that may occur." (Page 6- Report of the Industry Advisory Committee to the Life Risk Based Capital Working Group 11/27/91)~~. (Industry Advisory Committee, 1991)~~

14. Because the NAIC formula develops ~~a~~ minimum levels of capitalization rather than a target level, it is impractical to use the RBC formula to compare the minimum RBC level developed by one insurance company to the minimum level developed by another. Comparisons of amounts that exceed the minimum standards do not provide a definitive assessment of their relative financial strength. For this reason, the Model Law prohibits insurance companies, their agents and others involved in the business of insurance using the company's RBC results to compare competitors.

15. The principal focus of solvency measurement is determination of financial condition through analysis of the financial statements and risk-based capital. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern.

16. The Capital Adequacy Task Force and its RBC Working Groups are charged with evaluating refinements to the existing NAIC risk-based capital formula and considering improvements and revisions to the various RBC blanks to 1) conform the RBC blanks to changes made in other areas of the NAIC to promote uniformity (when it is determined to be necessary); and 2) oversee the development of additional reporting formats within the existing RBC blanks as needs are identified.

17. The Capital Adequacy (E) Task Force and its RBC Working groups will monitor and evaluate changes to the Annual Statement Blanks and *Purposes and Procedure Manual of the NAIC Investment Analysis Office* to determine if assets or specifically investments evaluated by the Security Valuation Office are relevant to the Risk-Based Capital formula in determining the minimum capital and surplus for all insurance companies or whether reporting available to the regulator as a more appropriate means to addressing the risk. The Task Force will consider different methods of determining whether a particular risk should be added as a new risk to be studied and selected for a change to the applicable RBC formula, but due consideration will be given to the materiality of the risk to the industry as well as the very specific purpose of the RBC formulas to develop regulatory minimum capital levels.

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