SUMMER 2017 REGULATORY UPDATES

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INCREASED GRANULARITY OF NAIC BOND FACTORS

The NAIC continues to refine and develop its plan for changing the calculation of investment risk-based capital charges, particularly with respect to increasing the granularity of ratings categories for bond investments. In June, a revised set of new factors were issued that were somewhat lower than those presented in August 2015, though still a mix of higher and lower compared to current factors. In addition, a change was proposed to the Portfolio Adjustment Factors (which increase or decrease the capital charge based on the total number of issuers held) that would tend to increase the capital charge, especially for insurers with less-diversified portfolios. Finally, separate new sets of bond factors were presented for P&C and Health insurers, acknowledging that these groups differ in certain key characteristics (e.g. taxes, treatment of sub-IG bonds) and may merit different factors. However, given the relatively small impact of bond holdings on P&C and Health RBC, it may be simpler to continue using a single set of factors across all company types.

Numerous companies and industry groups responded to the new proposals, and the IRBC Working Group agreed to consider additional modifications to the bond factors and portfolio adjustment formula, with a new version to be presented in coming weeks. Additionally, a joint conference between the Life, Health, and P&C RBC Working Groups was planned for the fall to obtain approval across industries for the increased granularity of bond ratings, even if the specific factors for each category are yet to be finalized. The current goal is to implement the new ratings framework in the 2018 RBC calculations for all three industries.

AM BEST BCAR

In July, AM Best released additional materials regarding its proposed changes to the BCAR formula. To briefly recap, these changes are broad-based and include the use of statistical models to calculate capital charges for a variety of balance sheet risks (which currently use static factors), the implementation of five separate BCAR scores per company tailored to different statistical confidence levels, and a variety of revisions to the potential ratings impact of qualitative and quantitative factors other than the BCAR score.

The latest round of changes to the Best's Credit Rating Methodology (BCRM) includes adjustments to the degree of ratings lift/drag companies can receive from their Business Profile or ERM assessments, or from the presence of a non-insurance parent. Best also provided additional detail regarding their ERM assessment process, to help rated companies understand how they evaluate this important component. Perhaps most crucially, Best also confirmed that, subject to the volume of comments received on the latest BCRM draft, they intend to implement the new ratings process in early Q4 2017. Additional detail on the timing and transition process should be expected in weeks and months to come

REGULATION 68

In 2015, Rhode Island amended Regulation 68 to become the first state to allow non-distressed insurers to transfer run-off blocks of business with legal finality, fully eliminating any liability for the transferring company. Previously such transactions were generally restricted to financially troubled insurers that had been placed in runoff. Since the amendment of this law (which is based on a similar regulation in England, which has created a thriving market for insurance business transfers in that country), several companies have applied to commence operations in Rhode Island focused on purchasing and managing such runoff blocks. Regulators are taking care to ensure that any such transfers fully protect policyholders and do not represent attempts to "dump" undesirable business into Rhode Island, but they also acknowledge that such transactions can free up capital and improve the efficiency of insurance markets. In March, ProTucket became the first Rhode Island insurer licensed to perform these transfers, and others are likely to follow soon. Although additional time is needed before transactions actually start flowing, over the long run this regulation has the potential to dramatically reshape the US insurance industry, and create new strategic possibilities for companies looking to wind down legacy books of business.

ASU 2016-01

Although it was passed last year, we are now approaching the 12/15/17 implementation date for this update to FASB financial reporting standards for financial instruments held by public companies, including insurers. Key provisions of this update include the elimination of the Trading/Available-for-Sale classifications for investments (though the equity method will still be used for >20% stakes in affiliated equity), with the corresponding result that changes in fair value will be included on the income statement and flow through net income. The major exception is securities with no readily determinable fair market value, which will be carried at cost less impairments (as determined by a qualitative assessment). Additionally, entities that are not public companies that carry investments at amortized cost will no longer be required to disclose the fair value of investments held.

This policy will be effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

MISCELLANEOUS:

- The NAIC Blanks Working Group has discussed combining the Fraternal and Life statutory blanks into a single template. A proposal will be drafted for exposure and comment at a future meeting.
- The Blanks Working Group also adopted a proposal to reduce the number of collateral types in Schedule D Part 1 from 21 to 10, and provide additional detail and examples for each category. Among other benefits, this will solve the longstanding issue of RMBS and CMBS securities being grouped with corporate bonds in the "Industrial" category.
- The outstanding proposal to create a mid-year Schedule of Owned Holdings ran into industry concerns about cost and complexity of implementation, especially for smaller insurers. The possibility of having AM Best provide this data on behalf of rated insurers was discussed, though it would not cover all insurers. Ultimately, it was decided this proposal required more analysis and discussion before it could be implemented.

- The NAIC approved a "fair value or systematic value" approach to classifying approved Bond ETFs. Effective December 31, 2017, all insurers holding such ETFs must make an irrevocable election to report each ETF at either fair value or systematic value (a calculation that uses the underlying cash flows and yields of the securities in the ETF to estimate the periodic amortization/accretion to be applied to the ETFs' carrying value). This enables bond ETFs to continue being reported on Schedule D Part 1 while providing for a more appropriate carrying value than the current method (typically original cost).

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