Finance/Investment: Industry Capital Update

ACLI 2018 Annual Meeting

Renaissance Washington, DC

October 8, 2018

Speakers:

- Philip Barlow
  - Associate Commissioner for Insurance, District of Columbia Department of Insurance, Securities and Banking
- Andrew Edelsberg
  - Managing Director, Insurance, Kroll Bond Rating Agency

Moderator:

- Brian Bayerle
  - Senior Actuary, American Council of Life Insurers

ACLI Presentation

Philip Barlow

Associate Commissioner for Insurance

District of Columbia Department of Insurance, Securities and Banking

AGGREGATED LIFE RBC DATA

	Year-End 2017	Year-End 2016	Year-End 2015
# of Companies Filed RBC	704	718	725
# of Companies Filed Annual Statement	729	739	750
% of RBC Companies	97%	97%	97%
Company Action Level - Trend Test at 300%	6	3	2
Company Action Level - Trend Test at 250%	4	2	1
Company Action Level	3	4	6
Regulatory Action Level	4	1	1
Authorized Control Level	0	1	1
Mandatory Control Level	3	3	4
Total	20	14	15
Percent at an Action Level	2.84%	1.95%	2.07%

AGGREGATED LIFE RBC DATA

	Year-End 2017	Year-End 2016	Year-End 2015
# of Companies with RBC Ratio > 10,000%	56	57	53
# of Companies with RBC Ratio >1000 & < 10,000%	311	319	338
# of Companies with RBC Ratio >500 & <1,000%	275	274	270
# of Companies with RBC Ratio >250 & < 500%	50	57	53
# of Companies with RBC Ratio > 200 & < 250%	5	3	4
# of Companies with RBC Ratio < 200% & > 0%	7	8	7
# of Companies with RBC Ratio of Zero	0	0	0
Total	704	718	725
Percent Above 500% RBC Ratio	91%	91%	91%

Upcoming and Proposed Life RBC Changes

- Tax Cuts and Jobs Act of 2017 (2018) - This will result in significant reduction in RBC ratios for 2018
- Operational Risk (2018) – Not likely to have a significant impact on RBC ratio
- C-1 Factors (2019 or 2020) – Bond factor changes likely to result in significant reduction in RBC ratio for most companies, other C-1 factor changes (e.g., real estate) may somewhat offset reduction
- Variable Annuities with Guarantees (2019?) – Likely to result in increase in RBC ratio for most companies
- Longevity (TBD) – This would be a new charge and result in slight reduction in RBC ratio
- Mortality (TBD) – This is the first update since the original development of RBC and it is too early to tell the impact

KBRA KROLL BOND RATING AGENCY

Finance/Investment: Industry Capital Update

Andrew Edelsberg, Managing Director
October 8, 2018

ACLI Annual Conference 2018

RBC DATA FOR YE 2017

NAIC RBC (CAL) By Asset Size				
Admitted Assets YE 17	**No. of Cos.**	**Avg RBC**	**Min RBC**	**Max RBC**
Less than $10 M	65	6596%	66%	9536%
Between $10 M and $25 M	64	3091%	109%	9746%
Between $25 M and $50 M	54	1173%	232%	7054%
Between $50 M and $100 M	51	1176%	166%	6596%
Between $100 M and $250 M	68	818%	148%	6390%
Between $250 M and $500 M	68	617%	50%	5600%
Between $500 M and $1 B	60	621%	106%	5562%
Between $1 B and $2 B	57	716%	187%	4093%
Between $2 B and $5 B	56	521%	71%	1480%
Between $5 B and $10 B	36	476%	267%	1048%
Between $10 B and $25 B	43	446%	187%	1034%
Between $25 B and $100 B	28	486%	283%	688%
Greater than $100 B	11	502%	336%	831%
TOTALS	661			

* Note: to more accurately represent the data, we removed 31 companies that were outliers

RBC IMPACT STUDIES

- Impact of major changes to statutory capital calculation:
  - Deferred tax asset write-downs (2017) → NEGATIVE
  - Change in required capital (2018) → NEGATIVE
  - Higher asset charges (2019) → NEGATIVE
  - Variable annuity capital (2019) → POSITIVE
- Various asset managers, equity analysts, actuaries and industry observers have developed estimates (or ranges of estimates):
  - DTA write-down – approx. 20 point decline (already reflected)
  - Greater required capital due to lower tax rate – 20-70 points; average ~50
  - Potential impact of C-1 asset factors – 20-50 points; average ~30
  - Variable annuity capital -- TBD
- In summary, RBC ratios will likely decline approx. 100 points across the board, which will somewhat erode life insurers' strong buffers

CAPITAL MODELS

- Rating agencies all have differing views of capital
  - Several have proprietary capital models
  - How is NAIC RBC factored in?
    - “The risk-based capital ratio is the most widely used measure of capital adequacy” -- Morgan Stanley equity research
  - Two of the four competitor rating agencies are very specific in their press releases about potentially taking rating actions if the company’s RBC exceeds or falls below certain levels

RECENT PRESS RELEASES

RATING DRIVERS

According to Moody's, NLV's ratings could go up as a result of: 1) GAAP return on capital (ROC) exceeds 8% on a sustained basis; 2) continued growth in profitable sales of life insurance and growing market share; 3) financial leverage remains well below 30%; and 4) earnings coverage and cash flow coverage of 6 times and 4 times, respectively. Given the positive outlook, it is not likely that the ratings will be downgraded, however, the following could lead to affirming the ratings and changing the outlook back to stable: 1) GAAP ROC less than 6%; 2) NAIC company action level (CAL) Risk Based Capital (RBC) below 375% (including captives) and/or lack of organic statutory capital generation; 3) financial leverage greater than 30%; or 4) earnings coverage and cash flow coverage below 5 times and 4 times, respectively.

RATING DRIVERS

The following factors could lead to an upgrade of CNO's ratings: (1) steady profitability with a return on capital of at least 8% on a consistent basis excluding one-time items; (2) consistent earnings coverage of 6x; (3) sustained combined NAIC RBC ratio (Company Action Level, without diversification benefit) of at least 400%; (4) profitable sales growth and well balanced between life insurance and annuities; and (5) increased market share in life insurance and annuity businesses, without increasing the risk profile of the liabilities.

The following factors could lead to a downgrade of CNO's ratings: (1) ROC of less than 4%; (2) adjusted financial leverage consistently over 30%; (3) earnings coverage of less than 4x; or (4) combined NAIC RBC ratio (Company Action Level, without diversification benefit) of less than 350%.

RATINGS DRIVERS - US OPERATION

Given that the US ratings reflect one notch of uplift from parental support, an upgrade of the company's ratings is unlikely unless full explicit support were provided. However, the stand alone credit profile of MFC US could be upgraded if a combination of the following were to occur: Material reduction of legacy LTC, VA, and GUL blocks of business, leading to sustainable reduction in earnings volatility; sustained earnings improvement with a statutory return on capital of over 8%, with significantly reduced volatility while maintaining current market position and product diversification; NAIC RBC ratio level at John Hancock of at least 375% (company action level), while maintaining adequate capitalization at reinsurance captives; consolidated MFC adjusted financial leverage below 30% and earnings coverage above 8x on a sustained basis.

Conversely, the ratings of the US operations could be downgraded if one or more of the following occurs: significant deterioration in the legacy LTC, VA, or GUL blocks; deterioration in profitability with statutory return on capital below 4% on a sustained basis and/or increased earnings volatility; NAIC RBC ratio at JHUSA below 350% adjusting for adequate capitalization at reinsurance captives; consolidated MFC adjusted financial leverage above 35% and earnings coverage below 5x on sustained basis; high risk asset ratio of 200% or more, with gross asset impairments of $750 million or more; reduction in the implied support or strategic value of the U.S. operations to the Manulife organization.

RATING DRIVERS

Moody's commented that the following could result in an upgrade of the ratings of Torchmark's ratings: 1) adjusted financial leverage below 25%; 2) credit quality of the investment portfolio improves such that the exposure level to Baa-rated bonds is reduced (i.e. less than 40%); and 3) sustained consolidated NAIC RBC ratio of at least 375% CAL. On the other hand, the rating agency said that one or more of the following could result in a downgrade of Torchmark's ratings: 1) consolidated NAIC RBC ratio below 300% CAL; 2) sustained deterioration in profitability (e.g., return on capital below 8%); or 3) adjusted financial leverage above 30% and earnings coverage and cash coverage below 6 and 4 times, respectively.

RECENT PRESS RELEASES

RATING SENSITIVITIES

Key rating sensitivities that could lead to an upgrade include:

--Improved capital adequacy that results in a Prism score approaching 'Very Strong', or an RBC ratio above 350% with sustained or improved capital quality;

--Financial leverage of 20% or below and total financings commitments ratio below 0.40x;

--GAAP earnings-based interest coverage ratio 12 times or above.

Key rating sensitivities that could lead to a downgrade include:

--Return on equity of 12% or less;

--A reduction in capitalization that results in a Prism score of 'Adequate' or an RBC ratio below 290% with sustained or worsened capital quality;

--Financial leverage above 30% or total financings commitments ratio above 0.55x;

--GAAP earnings-based interest coverage ratio below 8x.

RATING SENSITIVITIES

Key rating drivers that could lead to a downgrade include a decline in Prism capital model score to below 'Extremely Strong', a significant decline in TAC, or an RBC ratio below 450%, statutory earnings interest coverage below 6x, a deterioration in disability claims experience causing a significant operating or capital loss, and/or regulatory or tax law changes that hurt the company's position in its primary whole life market.

Fitch could downgrade Guardian's surplus notes if the ratio of surplus notes to TAC exceeds 15% on a sustained basis.

RATING SENSITIVITIES

Key rating sensitivities that could result in a rating upgrade include:

-- Significantly enhanced business profile, with less exposure to interest rate-sensitive business, combined with;

--Maintenance of extremely strong capitalization as measured by an RBC in excess of 450% and an 'Extremely Strong' Prism capital model outcome, along with financial leverage below 10%.

Key rating sensitivities that could result in a ratings downgrade include:

--Sustained deterioration in capitalization metrics measured by an RBC below 400%, or a material deterioration in Fitch's Prism capital model, falling below the 'Extremely Strong' threshold.

CAPITAL MODELS REVISITED

- Rating agencies all have differing views of capital
  - Several have proprietary capital models
  - How is NAIC RBC factored in?
    - "The risk-based capital ratio is the most widely used measure of capital adequacy" -- Morgan Stanley equity research
  - Two of the four competitor rating agencies are very specific in their press releases about potentially taking rating actions if the company's RBC exceeds or falls below certain levels
- KBRA's IFSR methodology does <u>not</u> utilize an internal capital model
  - Fosters thorough financial analysis
  - Consider various financial metrics (Statutory, GAAP, IFRS)
  - Stress testing
  - Qualitative rating determinants
  - Ratings are based on a company's unique characteristics

KBRA OBSERVATIONS

- Our near to medium term outlook for the U.S. life insurance sector is stable
  - Solid capitalization
  - Proactive inforce management
  - Thoughtful asset allocation
  - Benign credit environment
- However, if we face a more challenging macroeconomic environment, some life insurers may have less of a cushion to absorb losses
- Capital calculations are becoming even more sophisticated
  - In Canada, the Life Ins Capital Adequacy Test (LICAT) replaced the MCCSR
  - More advanced risk-based techniques to measure credit, market and insurance risks
- KBRA believes the focus should be on the overall quality of capital

QUALITY OF CAPITAL

- Surplus notes
- Captives
- Permitted practices
- Intercompany loans
- Financial reinsurance
- Reserving practices
- Contingent capital
- Hidden equity in assets
- Interest maintenance reserve

QUESTIONS?

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