Finance/Investment: **Industry Capital Update**

ACLI 2018 Annual Meeting

Renaissance Washington, DC

October 8, 2018



- 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

KROLL BOND RATING AGENCY



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 Modey's NDV's ratings bould go up as a result of it; SAAP return on capital (ROC) exceeds 5% on a sustained basis. 2) incrimined growth in probletik select of their summore are growing the fact clean; 3) instruct a exercise many a well below 30%; and 4) earnings coverage and cash flow coverage of 6 times and 4 times respectively. Given the positive outdook. It shot likely that the ratings will be downgreded, however, the following could lead to affirming the ratings are checking to be took back to stable. 1) CAAP ROC less than 85% () MACC company action level (CAL) (flow Reseal Ceptal (1900) below 3 for country capitals and or lank of organic relationsy operation; 3) financial leverage greater than 30%; or 4) earnings coverage and cash flow coverage brlow 5 times and 4 times, respectively.

RA MICHRISHES

The following factors bould lead to an upgrade of CNO's ratings: (1) steady profitability with a return on capital of at least 8% on a consistent takes excluding other time feater, (2) conserved example, coverage of bot. (3) and ened from the eff. (AEC not to Company Action Level, without diversification benefit) of at least 400%. (4) profitable sales growth and we I believed between the insurance and annuties, and (5) increasing the risk profit of the flacitities.

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) samings coverage of less than 4% or (4) combined NAIC RBC ratio (Company Action Level) will out diversification penelt) of less than 250%.

RATINGS DRIVERS, US OPERATION.

Given that the US ratings reflectione notion of until from parental support, an upgrade of the company's ratings is unitiely. Intest full explicit, support were provided. However, the stand alone precit profile of MFC US could be upgraded if a combination of the following were to occur. Material reduction of tagsby LTC, VA, and CUL, stocks of business, leading to susmanable reduction in earnings votatify; sustained earnings improvement with a stall tary return or capital of over the work significantly reduced votatify while maintaining current market position and product observations. A CIP REC ratio level at John Harspot of at least 375% (company potentially) while maintaining adequate depote the unitarity and capital states of the capital for an earning current agreement consciously the formal states and because the or a customer tagsby the capital states and because the or a customer tagsby the capital states.

Conversely, the roungs of the US operations dould be downgraded if one or more of the following occurs; significant deterioration in the legacy LTC, VA, or SUL blocks, deterioration in profitability with statutory return on capital below 45s on a sustained basis end/or increased earnings obtainly. MAIC 1893, ratio at LHTMS4 below 35th adjusted global capital rational terrorising agrees possibilities MHC adjusted financial leverage above 35% and earnings coverage below 5x on sustained basis; high risk asset ratio of 200% or more, with press asset imperments of \$750 million or more, reduction in the implied support or sharesic value of the U.S. operations to the Manufile organization.

RATING DRIVERS.

Morev's commented that the following could result in an upgrade of the neingalor forchmark's ratings: 1) estimated financial evertage between 20%; 2) credit pushing of the investment continuous process and that the exposure feed to the account forcide is recovered for the second of a feed from 10%; and 3) sustained consolidated NAIC RBC ratio of at least 375%. CAL, On the other hand, the rating agency said that one of more of the following obtained substantial of Torchmark's ratings. 1) consolidated NAIC RBC ratio below \$00% CAL, 2; sustained deterioration in promotently (e.g., returns on depth between 45%) or 3) adjusted financial teverage above 30% and earnings converge and calcinocamage below 0 and 4 times, respectively.

RECENT PRESS RELEASES

WATER SERSOMERS

Key oring resultance that could lead to an apprehing bullet.

- Improved capital adequacy that results in a Price coore approaching "Very Shring", or an RRC ratio above 160% with contained or improved capital quality.
- Financial lenerage of 20% or below and total financings commonweats ratio below 0.40%.
- -- GAAP surnings-based Prometr coverage raits 13 three or above.

Not raining penalthetics that sould lead to a downgrade include:

- -Between the experty of TOPs or here.
- A reduction in capitalization than results in a Priori score of Adequate or an IRSC ratio below.
 200% with contained or vicinored capital quality.
- -Financial leverage above 30% or total financings powentments ratio above 0.55s.
- -- DAMP surregul based manual conserage ratio before the

DATING SENSETWICES.

Ray rating drivers that could had to a downgrask include a dactive in Prior capital regist acres to hater 'Extremely Scieng,' a significant doctors to TAC, or an HBC ratio below 450%, stanzing marrings interest coverage believ 6x, a deterioration in disability charts experience country a significant operating or capital loss, and/or registery, or too law charges that furt the company's prostors in its primary whole the market.

Fitch model developade Grandlan's surplus notes if the ratio of surplus notes to TAC exceeds 19% on a sustained laurie.

HATING SENSITIVITIES:

Ray rating sensitivities that could result to a ruting upgrade metals:

- Significantly enhanced hadrons profile with ina superure to entered rate mentiled business;
- Monitorance of externely cross; capitalization at manuscrot by an RSC in occess of 450% and an Externels Scropy Priori capital resid outcome, story with fluencial loverage below 10%.

Yoy rating sensitivities that could result in a natings desingle include:

Sustained determination in capitalization metrics resoured by an REC tellow 400%, or a material determination in Fig.N. Priori capital model, falling below the Tantanely Strong Harshold.

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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