

Julie Garber  
National Association of Insurance Commissioners  
1100 Walnut Street  
Suite 1500  
Kansas City, MO 64106-2197  
Via e-mail: jgarber@naic.org

**Comment Submission on the American Academy of Actuaries Recommendation of Corporate Bond Risk-Based Capital (RBC) Factors**

Dear Ms. Garber,

The North American CRO Council (“CRO Council” or “Council”) appreciates the opportunity to comment on the proposed updates to the credit risk (“C1”) component of Risk Based Capital (“RBC”). The CRO Council is a professional association of Chief Risk Officers (“CROs”) from leading insurers based in the United States, Canada, and Bermuda. Member CROs currently represent 31 of the largest Life, and Property and Casualty insurers in North America. As a body formed to promote sound practices in risk management, the CRO Council appreciates the opportunity to submit its comments and concerns regarding the proposed revisions.

The Council understands and supports state regulators’ desire for a continuing dialogue between insurers and their regulators regarding insurers’ key risks and their risk management programs. Although the Council believes that good progress has been made on the base bond factors in the June 2017 proposal from the American Academy of Actuaries (“Academy”), we are concerned that significant modeling issues have not been addressed. Most notably:

- The model is not a true portfolio model, distorting both the magnitude of capital requirements as well as the trade-off from investment grade to below investment grade
- The model double-counts risks already covered by reserves
- The model assumes that a credit portfolio only earns enough spread to cover expected losses
- The model treats all debt as if it were senior unsecured public corporate exposure

These issues have been highlighted through industry letters and discussions since the publication of base factor methodology in August 2015. In the June 2017 proposal, the impact of these issues is most visible in the portfolio adjustment.

An update to the portfolio adjustment framework was not part of the initial August 2015 proposal and methodology document. Instead, it was published over a year later in December 2016, and the industry did not have the opportunity to discuss the methodology underlying this adjustment in detail as the Academy was developing the new June 2017 proposal. The proposed portfolio adjustment framework is material and deserves proper documentation and review.

Our initial concern with the June 2017 portfolio adjustment framework is that it does not match intuition and it seems to be a drastic departure from the current framework. The current framework is built on a

representative portfolio of 1,300 issuers that receives a bond size adjustment (new terminology is 'portfolio adjustment') of 1.00. The June 2017 proposal is built on a representative portfolio of 988 issuers that receives a portfolio adjustment of 1.22. The following table summarizes portfolio adjustment factors for a sample of portfolio sizes:

# ISSUERS	CURRENT	DEC-16	JUN-17
250	1.36	1.40	1.84
500	1.16	1.10	1.44
750	1.07	1.00	1.29
1,000	1.03	0.94	1.21
1,250	1.00	0.90	1.16
1,500	0.99	0.88	1.13
1,750	0.97	0.86	1.10
2,000	0.97	0.84	1.08
2,250	0.96	0.83	1.07
2,500	0.95	0.83	1.06
5,300	0.92	0.79	1.00

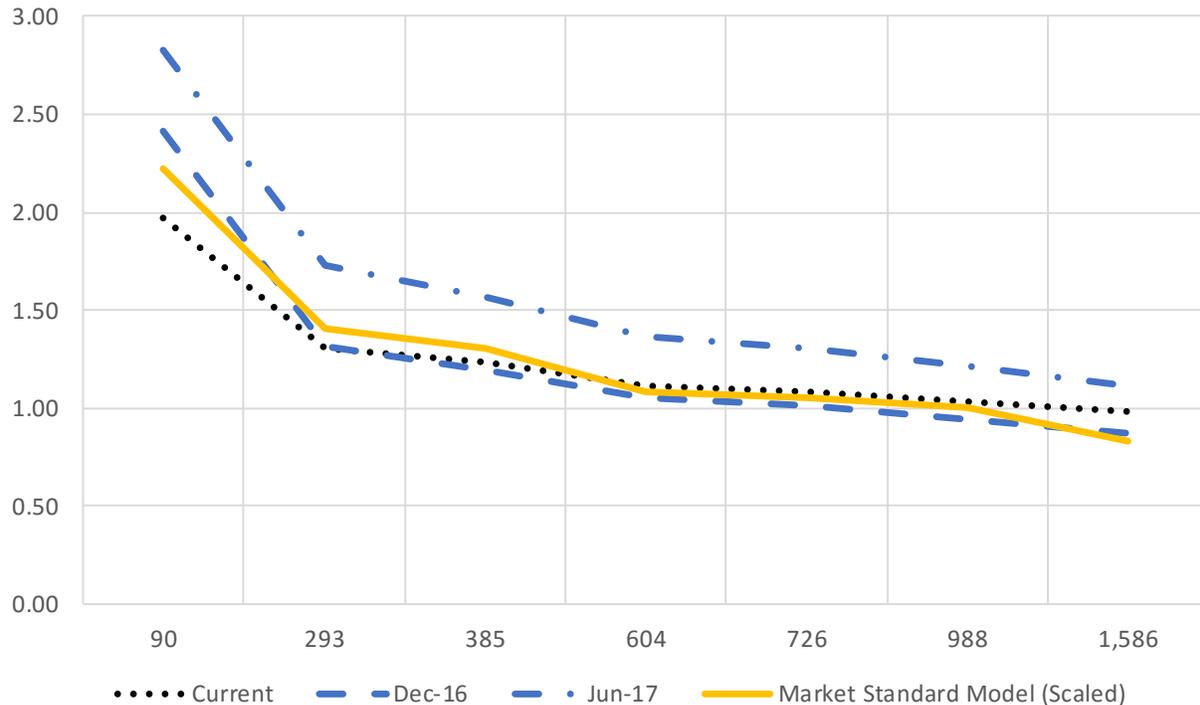
The June 2017 proposal requires 5,300 issuers to receive an adjustment factor of 1.00. The December 2016 portfolio adjustment only required 750 issuers to receive an adjustment factor of 1.00. Changes of this nature would constitute fundamental shifts in how diversification impacts bond portfolios. To our knowledge, no such shift has been observed or even suggested by market participants over the past 25 years. Furthermore, the largest life insurers hold about half the number of proposed issuers. The Council asserts that the portfolio adjustments do not pass a simple reasonability test.

For an improved benchmark of diversification benefit, we ran the Academy's 7 portfolios through a market standard credit portfolio model. We modeled 96<sup>th</sup> percentile losses using the Academy's stated portfolios and default expectations.<sup>1</sup> The resulting losses were then scaled to a base portfolio of 988 issuers to provide a pure portfolio adjustment centered around the Academy's representative portfolio. The resulting portfolio adjustment line (solid yellow line below) tracks closely to both the current and December 2016 portfolio adjustments:

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<sup>1</sup> **Model Assumptions:**

- 96th Percentile
- Probability of Defaults and Loss Given Defaults: Academy assumptions
- Industries: No industry treatment to match Academy model
- Coupon Rate: 0.96%, CDX IG Basket 10yr
- Tenor: 10yr



This shows that while the shape of the proposed curves may be generally reasonable, attempting to adjust percentile in this calculation materially distorts the results and represents a departure from the original model. Since no material portfolio modeling changes have occurred in the June 2017 proposal, the June 2017 reduction of base factors necessarily means that the portfolio adjustment must increase to an unintuitive level.

Beyond the unintuitive nature of the results, there are a few practical reasons that the CRO Council believes the new proposal to be untenable. If the proposed model accurately represents reality, the entire industry will require a large increase in required capital. The current proposal for portfolio adjustment would yield three detrimental effects to the health of the industry:

- 1) Such an adjustment factor would severely impact small companies by requiring additional capital above and beyond what is actually necessary based on historical default and the size of their balance sheets.
- 2) The number of bonds required would create an incentive to raise issuance counts in an artificial manner. This could result in portfolios which are not representative of what is actually contained in the balance sheet of insurers, and could result in operational risk greater than the risk lowered by the higher bond count.
- 3) The diversification parameter would also create an incentive for insurers to add issuers beyond their regular investable universe. This has the potential to increase risk as insurers are forced into investing in less safe or less well understood bonds.

In closing, the CRO Council wishes to reiterate its support for the ongoing attempt to refine RBC C1 factors. However, due to the implication of substantially higher default rates, the creation of capital inefficiencies

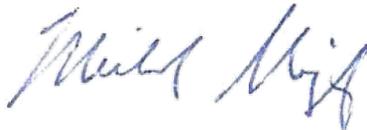
of smaller insurers, incentivizing artificially raised issuance counts, and incentivizing investment outside of the regular investable universe, the CRO Council recommends that the current proposal from The Academy be revisited, specifically with regards to the magnitude of the portfolio adjustment factors or the number of securities required to achieve these factors. We believe this would best be accomplished through creation of a working group that includes technical representatives from the NAIC, the Academy, and industry.

Thank you again for the opportunity to respond to your efforts and we would welcome the opportunity to meet to discuss and answer any questions you may have.

Sincerely,



Mark Verheyen, Chair  
*North American CRO Council*



Michael Slipowitz, Chair  
*CRO Council – State Regulatory Working Group*