SPECTRUM
Asset Management

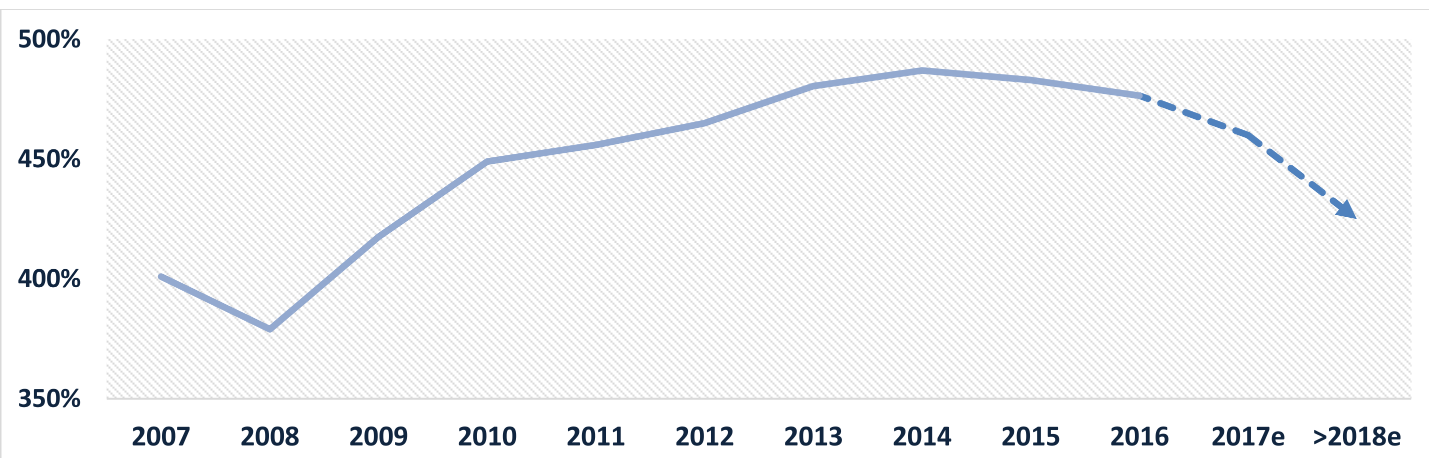
U.S. Life Insurance – Taxing Capital

April 30, 2018

The decline in the U.S. corporate tax rate from 35% to 21% is expected to be a longer-term positive for U.S. life insurance company earnings and cash flows. However, in the near-term life insurers' risk-based capital (RBC) ratios could drop meaningfully under the state-based regulatory framework of the National Association of Insurance Commissioners (NAIC). Thus far, insurers have had to write down deferred tax assets (DTAs) — used to offset future tax payments — to reflect the lower corporate tax rate and reduced ongoing benefit of those credits. Meanwhile, the NAIC construct allows for a portion of DTAs to be included in a company's total adjusted capital. As a result, a hit to life insurers' RBC ratios, albeit modest, was reflected in 2017 figures.

While the timeline and magnitude remain uncertain, there are additional factors that could negatively impact life insurers' RBC ratios. To be specific, the NAIC's RBC formula sets a "minimum capital requirement based on the types of risk to which a company is exposed" (*e.g.,* investment and underwriting risks). The higher the requirements, the more capital must be retained, though firms tend to hold multiples of these obligations to avoid tripping any regulatory action. In recent years, life insurers have maintained capital at ~400-500% of company action levels (CAL) — CAL is the point at which insurers might need to submit recapitalization plans. While varying by business focus, this level of excess capital has become somewhat of an industry norm, helping to satisfy key stakeholders such as rating agencies and distributors.

<u>RBC requirements for life insurers are calculated on an after-tax basis.</u> Therefore, as tax offsets decline due to the lower corporate rate, capital requirements could increase. The NAIC has yet to adjust its framework to reflect the new rate. Furthermore, the NAIC is set to adopt new, more granular risk-based charges for fixed income holdings, which may be onerous for insurers with general accounts invested in a large percentage of single A and BBB rated securities. The adoption of these changes, coupled with challenges such as legacy long-term care business and additional NAIC proposals (*e.g.,* adjustments to annuity reserving standards), could place added pressure on reported capitalization with RBC estimates falling as low as 300-400% of CAL.



Aggregate U.S. Life RBC (CAL) Ratio — dashed line represents Spectrum's estimates (Source: NAIC Financial Data Repository)

Despite these headwinds, our discussions with rating agencies and life insurance executives support our view that **moderately lower regulatory capital ratios should be manageable for U.S. life insurers**. S&P's framework sets capital requirements on a tax neutral basis and is thus less sensitive to reforms. Moody's and Fitch appear to be taking a measured approach — even for insurers facing the largest RBC impacts — to reflect longer-term earnings benefits as an offset to capital erosion. We will continue to monitor developments.

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