

To: Financial Examiners and Other State Regulators

From: Philip Barlow, Chair of the Life Risk-Based Capital (E) Working Group

RE: Interpretation of 2018 Life Risk-Based Capital Results

Date: February 22, 2019

**Interpretation of 2018 Life Risk-Based Capital Results
in Light of the 2017 Tax Cuts and Jobs Act**

Purpose and Intended Audience for this Document

This document is intended to assist financial examiners and other state regulators as they review the results of 2018 risk-based capital (RBC) calculations for life insurers¹ in light of the 2017 Tax Cuts and Jobs Act (TCJA). It is intended to be a non-technical overview of changes that will affect 2018 RBC filings.

More detailed information about this topic is contained in letters to the Life Risk-Based Capital (E) Working Group (Working Group) from the American Academy of Actuaries' (Academy) RBC Tax Reform Work Group dated March 16, April 24, and June 4, 2018. Changes to the Life RBC formula due to the TCJA were adopted by the Capital Adequacy (E) Task Force in June 2018. Questions related to this document may be submitted to Dave Fleming (NAIC) at dfleming@naic.org.

Executive Summary

The TCJA is effective for 2018. A widely known provision in the TCJA is a reduction in the corporate tax rate from 35 percent to 21 percent, which applies to life insurers as well as other corporate entities. The TCJA also included numerous tax provisions for corporations, including life insurance companies, that are designed to partially offset the tax rate decrease. Additionally, several provisions were specifically directed at life insurance companies to further offset the tax rate decrease, such as changes in tax reserves, deferred acquisition cost (DAC) tax, and the dividends received deduction.

Starting in early 2018, the Working Group examined Life RBC to see what changes should be made because of the TCJA. With assistance from the Academy and others, the Working Group worked through the formula and proposed a number of changes to Life RBC. Those changes were adopted by both the Working Group and its parent committee, the Capital Adequacy (E) Task Force, during June 2018. The changes to Life RBC will be effective for the 2018 filing year (that is, RBC reports that will be filed in the first quarter of 2019).

The impact of the TCJA on life insurers' Total Adjusted Capital (TAC) was partially reflected in 2017 annual statements and RBC reports and will continue to affect TAC in 2018 and future years. Also, the Authorized Control Level (ACL), which is a calculated result of the Life RBC formula, will be impacted by the changes to Life RBC that were made by the Working Group.

¹ Life insurers are referenced throughout this document. While fraternal benefit societies are not subject to federal income tax, the fraternal RBC formula parallels the life formula by including explicit tax factors. Some of the items discussed in this document will not be applicable to fraternal, however, the changes in ACL resulting from lower tax factors will.

Due to changes to Life RBC to reflect the TCJA, the Working Group expects that the Dec. 31, 2018, ACL for most life insurers will be higher than it would have been under the 2017 Life RBC formula. The higher ACL will increase the “Trigger Points for Level of Regulatory Action” (as defined in the instructions for the Life RBC calculation.) As a consequence, this is expected to decrease the amount of TAC in excess of ACL for Dec. 31, 2018, filings compared to what such amount would have been under the previous tax law, even though the Dec. 31, 2018, TAC for some life insurers may increase due to the TCJA. An insurer’s mix of assets and liabilities, business profile, and tax attributes will determine the impact of the TCJA on the Life RBC calculation for that company.

According to information summarized by the NAIC, the Working Group expects that an immaterial number of life insurers, if any, will breach an RBC threshold (Company Action Level (CAL), ACL, etc.) due to the increase in ACL. However, the Working Group expects that there is a potential for more life insurers to trigger the Life RBC Trend Test for Dec. 31, 2018, due to the TCJA-related changes to the Life RBC formula. Later in this document, suggestions are offered as to how regulators might analyze any breaches of an RBC threshold or triggering of the Trend Test in 2018.

While the law and the instructions define the Life RBC calculation as TAC minus ACL, it is common to divide TAC by ACL (or by CAL) to derive an “RBC Ratio”. An increase in ACL will tend to decrease a life insurers’ RBC Ratio. The Working Group expects that the 2018 RBC Ratio for most life insurers will be lower than it would have been under the 2017 Life RBC formula. The percentage point reduction in RBC Ratio will tend to be larger for companies with higher RBC Ratios.

This document examines the changes to ACL, TAC, and RBC results due to the TCJA, including:

- Why does a reduction in tax rates cause an increase in ACL?
- What are the changes in ACL that will be effective for the 2018 filing year?
- How will TAC be affected by the TCJA?
- How should effect of the TCJA be factored into the interpretation of RBC results?
- How will elements of the TCJA affect the components of the Life RBC calculation in the future?

Why does a reduction in tax rates cause an increase in ACL?

It may seem counterintuitive that a lower tax rate causes ACL to be higher. However, an example can illustrate why this is the case:

- Life RBC factors are developed to cover risks that could materialize in “stressed” conditions. For example, an economic downturn might cause an increase in defaults on bonds, or a pandemic could cause death claims to increase. RBC is intended to calculate the minimum capital that a life insurer should hold to provide for such “stress” events, recognizing that statutory policy reserves cover “moderately adverse” risk conditions.
- As an illustration, assume that a pandemic would increase a life insurer’s death benefits by \$1 million, net of policy reserves and reinsurance. The death benefit increase would reduce the insurer’s taxable income by \$1 million.
- Assuming the increased death benefit results in a federal income tax benefit, the insurer’s tax bill under the previous tax law would have been reduced by \$350,000 (35 percent of \$1 million).

Therefore, the net loss to the insurer would be \$650,000; that is, \$1 million of death benefits offset by a \$350,000 reduction in taxes. TAC would decrease by \$650,000.

- Due to the TCJA, the same “stress” event under the new tax law, the insurer’s tax bill would be reduced by only \$210,000 (21 percent of \$1 million), leaving the net loss (and TAC impact) to the insurer at \$790,000. It is this impact that requires a higher RBC requirement to cover the risk. **In other words, under this example ACL would need to increase by 21.5 percent to cover the new after-tax impact to TAC of the stress event; that is, [(\$790,000 divided by \$650,000) minus one].**
- This phenomenon is what leads to the increase in Life RBC factors for 2018.

There are hundreds of factors in the Life RBC formula. The adopted changes to Life RBC increased some of the factors, net of tax, by 21.5 percent. However, for technical reasons, some RBC factors were decreased as a result of the TCJA, while others remained unchanged. The net result is that the majority of post-tax RBC factors increased by less than 21.5 percent. **Therefore, ACL for life insurers is expected to generally be increased as a result of the TCJA, but by less than 21.5 percent.** The actual increase in ACL is company-specific, depending on each company’s mix of assets, liabilities, risk factors, and tax strategies. Some sampling has shown that increases are generally between 5 and 15 percent, but individual company increases may be outside the range.

What are the changes in ACL that will be effective for the 2018 filing year?

There are numerous changes to Life RBC factors due to the TCJA. A high-level summary of the changes to the RBC factors follows. Life RBC factors not mentioned below were unaffected by the TCJA.

- Most of the factors in LR030 (Calculation of Tax Effect for Life RBC) for the 2017 RBC filing year were 0.35. Those factors are changed to 0.21 for the 2018 Life RBC filing year. Certain of the tax factors for bonds, preferred stocks, and similar instruments for the 2017 RBC filing year were 0.2625 (that is, 75 percent of 0.35), and those factors are changed to 0.1575 (that is, 75 percent of 0.21).
- C1 pre-tax RBC factors for bonds, preferred stocks, and similar instruments, and C2 RBC factors for individual and group life, were reduced by 3 percent, reflecting a higher post-tax discount rate, because these RBC factors are calculated assuming future losses.
- C2 RBC factors for health insurance, the C3 “base” factors, and the C4-a factors were adjusted downward so that the net post-tax RBC factor is unchanged.

A complete set of [updated factors](#) has been prepared by NAIC staff, and can be referenced using the above hyperlink.

How will TAC be changed by the TCJA?

If the change in the corporate tax rate from 35 percent to 21 percent were the only tax law change affecting life insurers, TAC would be higher in the future than under the prior tax law for companies with taxable income, because income tax expense would be reduced.

This increase to TAC from a lower tax rate is offset by a number of factors. The extent to which there is an offset is company-specific, as each life insurer’s tax situation is different. The offset is also time-specific, as the offset factors could be larger than the benefit of a lower tax rate for Life RBC filings in 2018 and immediately following years, with the size of the offset reducing as time goes on. The offset factors are as follows:

- Some life insurers have a net deferred tax asset (DTA) on their balance sheets. Accounting rules require that the DTA be recalculated using the lower tax rates. We understand that most life insurers that have a DTA reported this reduction to DTA, which reduced TAC, in their 2017 annual statements. The elimination of net operating loss carrybacks also had a significant impact (reduction) on the calculation of the DTA in many life insurers' 2017 annual statements.
- The TCJA changed the tax deduction for non-variable product reserves to the greater of the cash surrender value or 92.81 percent of the statutory reserve (with certain prescribed adjustments such as eliminating deficiency reserves and asset adequacy reserves). For variable contracts, the 92.81% factor is applied only to the excess of statutory reserves over the greater of the separate account reserve or total cash surrender value. For most products, this is expected to reduce the deductible tax reserve, which increases taxable income and tax expense for a growing company, and therefore reduces TAC. Additionally, the TCJA requires that the difference between "old basis" and "new basis" tax reserves as of Dec. 31, 2017, be amortized into taxable income over eight years, further increasing taxable income and tax expense and further reducing TAC. Companies had to establish a deferred tax liability for this 8-year spread in 2017, which may not have been offset in full by a corresponding DTA.
- The TCJA increased the capitalization rate and lengthened the amortization period for the DAC tax. These changes will accelerate taxable income and tax expense, and therefore reduce TAC.
- A portion of the higher current income tax expense resulting from the new tax reserve and DAC calculations generally will be offset in part by additional admitted DTAs, which will increase statutory surplus and TAC.
- The TCJA modified the dividends received deduction (DRD), which will increase taxable income and tax for some life insurers and decrease taxable income and tax for others. The DRD allows a life insurer that receives a dividend from another company to deduct a portion of that dividend from taxable income.

While the initial impact of the tax law changes on TAC began in 2017 with changes in DTAs and will flow in over time, changes to ACL are fully effective for 2018. Consequently, the anticipated impact of these changes for most life insurers will be a reduction in the amount of TAC in excess of ACL for life insurers for 2018 and immediately following years.

How should the effects of the TCJA be factored into the interpretation of RBC results?

The Life RBC Trend Test (LR035) will be affected by the TCJA. The Trend Test calculates a margin, which is the excess of TAC over ACL, for each of the current year, the prior year, and the third prior year. To the extent that the current year margin is lower than the prior year or third prior year margin, regulatory action may be indicated.

For the 2018 Trend Test, the margin for 2018 is compared to the margins for 2017 and 2015. As noted above, a company's ACL is expected to be increased for 2018 compared to prior years, and TAC may be reduced. The changes to ACL and TAC due to the TCJA may cause some companies to trigger the Trend Test for 2018, solely because of the TCJA.

Also, as noted above, the amount of TAC in excess of ACL is expected to decrease for Dec. 31, 2018, RBC filings compared to what such amount would have been under the previous tax law, even though

the Dec. 31, 2018, TAC for some life insurers may increase due to the TCJA. The decrease may be large enough to push a life insurer below an Action Level.

Further, a life insurer may experience a significant decrease in RBC Ratio as calculated from its 2018 RBC filing compared to the RBC Ratio in 2017. While the life insurer could remain well-capitalized in 2018, the absolute change in the RBC Ratio from 2017 to 2018 could raise concern with regulators.

If regulators find that a life insurer or fraternal has triggered an Action Level event for 2018, either directly or due to the Trend Test, or has a significant decline in RBC Ratio from 2017 to 2018, they should consider having additional discussions with the company and request additional calculations. It is likely that the life insurer or fraternal would have done some analysis of their results, and that analysis could be shared with regulators. For a life insurer or fraternal with a CAL event for 2018 due to the Trend Test, the one-time TCJA changes to the RBC formula would impact that result and regulators may consider whether the Trend Test is correctly identifying a life insurer or fraternal that is trending toward CAL.

How will the elements of the TCJA affect the components of the Life RBC calculation in the future?

As described above, some of the elements of the TCJA were effective for Dec. 31, 2017, annual statements, some are fully effective for the Dec. 31, 2018, annual statements and RBC filings, and others are partially effective for 2018 filings and will become fully effective over time.

- Authorized Control Level—The changes to ACL are fully effective for the Dec. 31, 2018, RBC filing.
- Total Adjusted Capital—There are a number of tax-related items that affect TAC, with timing that varies by item. Items that increase taxable income generally increase tax expense and therefore reduce TAC, while those that decrease taxable income generally reduce tax expense and therefore increase TAC.
 - DTA—As noted above, we understand that most life insurers have already recalculated their DTA using the new lower tax rate and elimination of net operating loss carrybacks on their 2017 annual statement. For insurers with a net DTA, this recalculation reduced TAC in 2017.
 - Tax Rate—The 21 percent tax rate, which is a reduction from the previous 35 percent rate, is effective for the 2018 tax year. For life insurers with taxable income, this will reduce tax expenses in 2018 and future years and therefore increase TAC.
 - Tax Reserves—As noted above, tax reserves are generally reduced under the TCJA. For life insurers with increasing reserves (that is, generally companies that are growing), that will reduce the tax deduction for reserves for 2018 and future years, and therefore increase taxable income. Also, the difference between “old method” and “new method” tax reserves as of Dec. 31, 2017, will be amortized over eight years from 2018 to 2025, which will increase taxable income in the future.
 - DAC Tax—As noted above, DAC tax capitalization is increased starting in 2018. For example, the factor for individual life insurance premiums increases from 7.70 percent to 9.20 percent, which will increase taxable income. Also, the amortization period is increased from 10 years to 15 years, which will adjust taxable income for a period of years.
 - Dividends Received Deduction—The deduction was modified beginning with 2018.

- New Timing Differences - A portion of higher current income tax expense resulting from the new Tax Reserve and DAC calculations generally will be offset in part by additional admitted DTAs, which will increase statutory surplus and TAC.
- RBC Ratios – The expected impact of TCJA on RBC ratios will vary widely by company, given the varied impacts on the TAC and ACL described above.