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Tim Antonelli is responsible for identifying, sharing, and acting upon the major business trends that affect global insurers and their investments across all asset classes. In this capacity, he is charged with synthesizing information on capital management, regulatory changes, and (increasingly) ESG and climate change implications that drive insurers' investment behavior and decisions.

Geoff Austein-Miller works closely with the Financial Reserves Management (FRM) Investment Team to help ensure the integrity of their investment approach by overseeing portfolio positioning, performance, and risk exposures. He also contributes to developing new products and client solutions, particularly on the fixed income side.

A US insurer's roadmap for navigating the new RBC regs

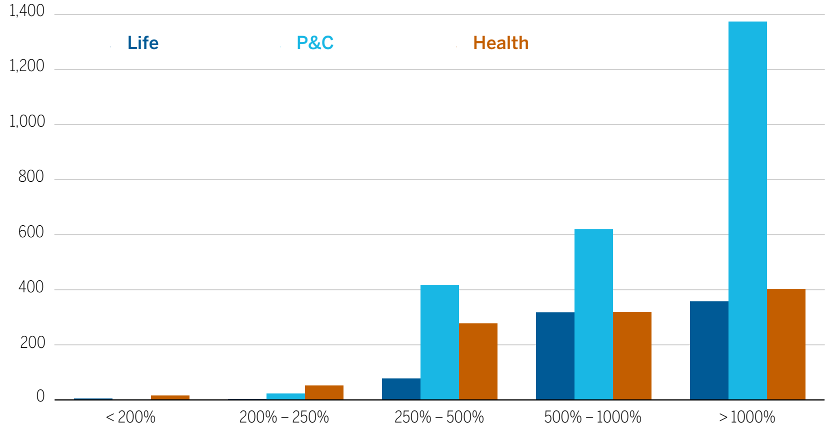
Changes in US industry regulations tend to proceed at a slow, sometimes glacial pace. The recent implementation of the National Association of Insurance Commissioners' (NAIC's) latest revisions to risk-based capital (RBC) charges for insurers' fixed income investments was no exception. While US insurers were required to start reporting more detail on their fixed income holdings as of year-end 2020, the NAIC's new bond risk charges did not fully take effect until year-end 2021 — but they're finally here.

What remains to be seen is the extent to which these regulatory changes will truly impact the day-to-day portfolio management of insurance company assets and/or their longer-term strategic asset allocation decisions. As of this writing, US insurers as a group are on strong footing in terms of their capital positions (**Figure 1**). And the NAIC noted that, in aggregate, it expects less than a 2% increase in authorized control level risk-based capital for US life insurers due to the latest changes. However, the NAIC added that a relatively small number of insurers will experience a much larger impact from their 2019 RBC filings being recalculated under the new RBC framework.

Figure 1

US insurers' RBC as of year-end 2020

Count of insurance companies



Source: National Association of Insurance Commissioners. Chart data as of 31 December 2020

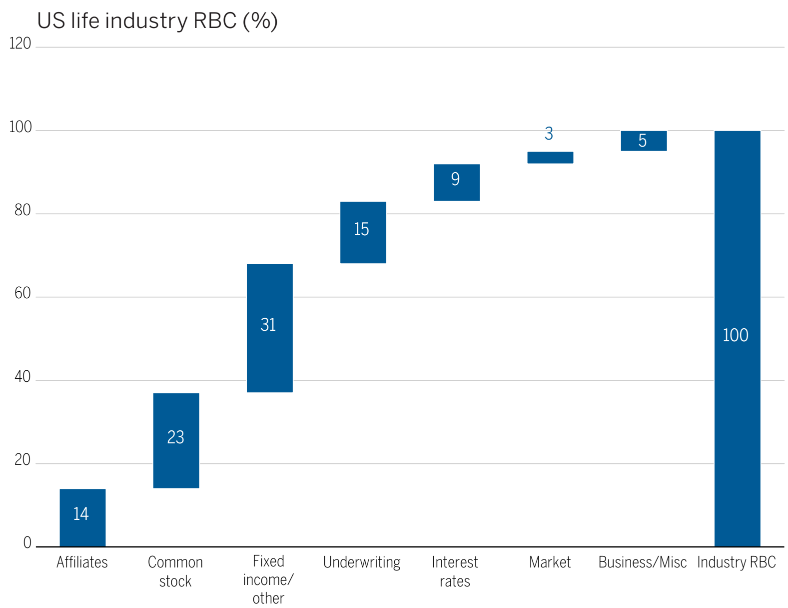
The importance of investment risk

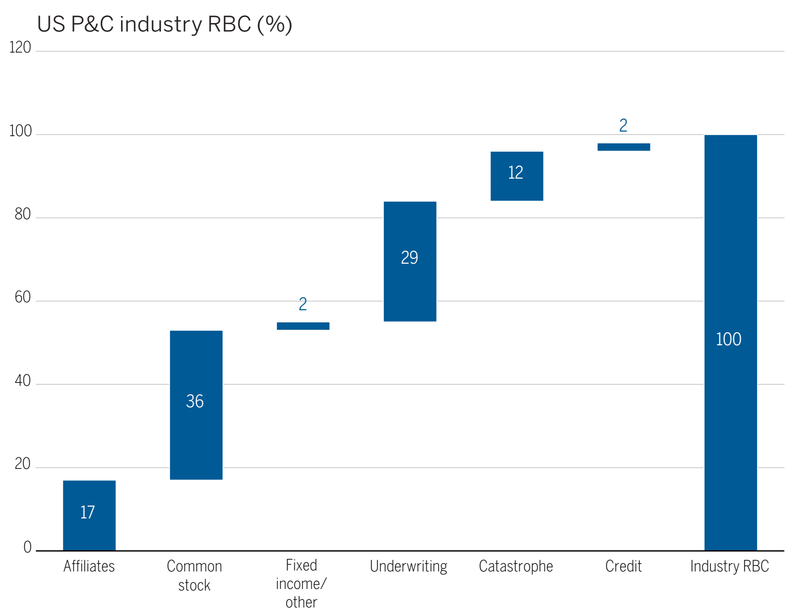
With these recent changes impacting most US insurers (life, property & casualty, and health) to one degree or another, it is critical to understand just how much investment risk contributes to the overall regulatory RBC calculation for a US-based insurer. A general rule of thumb we use is that a life insurer has roughly two-thirds of its total risk related to its investment assets, as compared to around one-third for P&C and health insurers. Given the nature of the liability profiles across insurance companies, these seem to be reasonable guidelines, but let's take a closer look. Based on year-end 2020 RBC filings, we see that assets, interest rates, and market risk make up approximately 66% of total risk for life insurers, 39% for the P&C industry, and 15% for health insurers (**Figure 2**).

With the significant proportion of asset risk in a typical life insurer's RBC, it is clear that any changes to the underlying capital charges will be much more consequential for insurers in this particular channel.

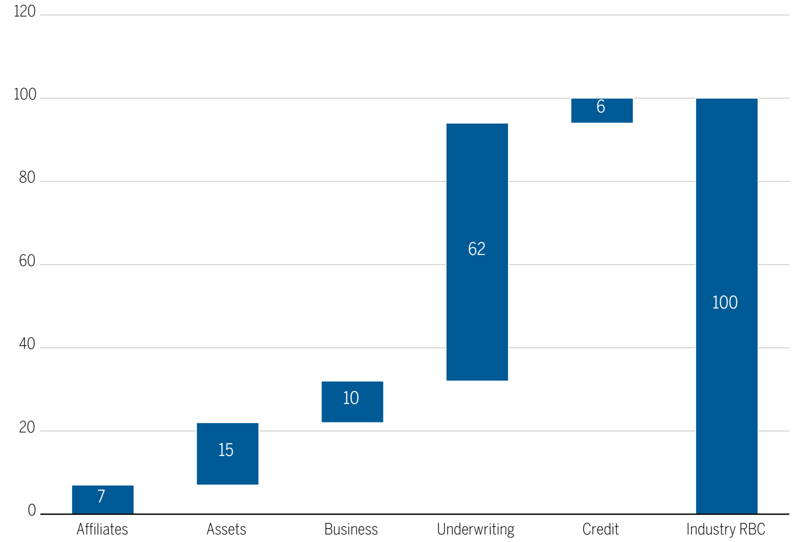
Figure 2

Decomposition of US RBC ratios as of year-end 2020





US health industry RBC (%)



Sources: NAIC, Wellington Management. | Chart data as of 31 December 2020

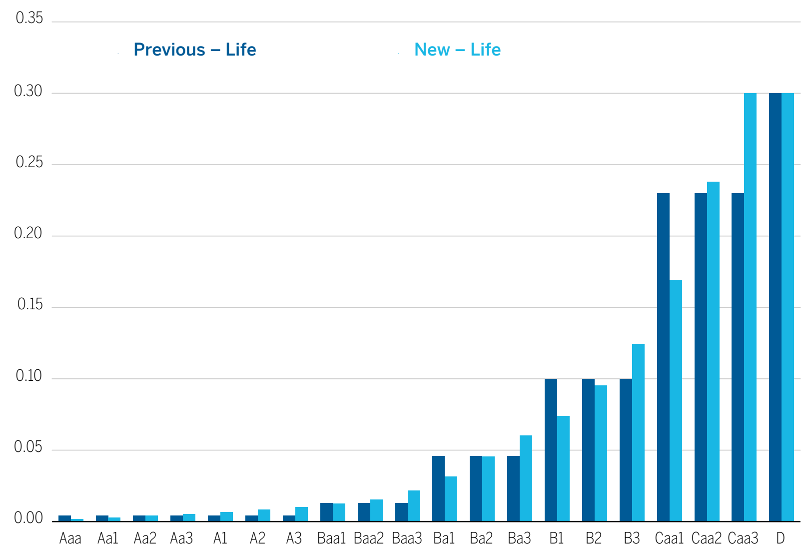
With that as the backdrop, what should US insurers be focused on moving forward? And how do the relative value propositions across asset classes generally, and within fixed income investments specifically, shift as a result of the NAIC's recent modifications?

Fixed income assets

For the first time ever, P&C and health insurers will be subject to distinct bond risk charges. And while their risk factors have been updated accordingly, the upshot is that the vast majority of said factors have increased versus history. The implications of the revisions for the life insurance industry are much more nuanced, making sweeping generalizations difficult and unhelpful (**Figure 3**).

Figure 3

Life insurance industry bond risk factors



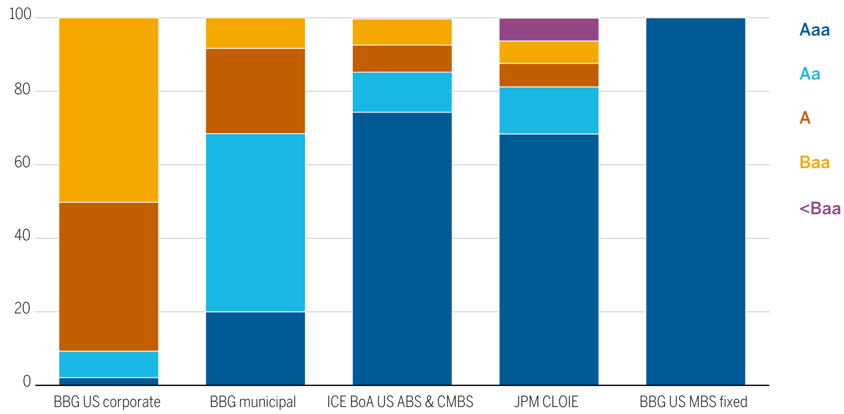
Sources: NAIC, Wellington Management. | Chart data as of 31 December 2021

For starters, on a relative basis, double B and single B rated bonds have become more attractive versus their former charges, while single A rated debt issuers have lost some of their luster now in the absence of the type of "catch-all" charge that encompassed A through AAA rated names under the NAIC's old RBC framework.

Insurers that are seeking to add incremental yield in a more capital-efficient manner could consider allocating a portion of fixed income assets to BB/B rated high-yield bonds, while "barbelling" this higher-risk exposure with areas of the market that still offer a considerable supply of AAA/AA rated bonds. Broadly speaking, all flavors of the securitized sector and most municipal bonds should effectively serve this need for greater yield in a capital-efficient manner (**Figure 4**).

Figure 4

Credit rating distribution of select indices (%)



Sources: Bloomberg, ICE, JP Morgan. | Chart data as of 31 December 2021

Over 90% of the BBG US Corporate Index resides in the single A or BBB rating buckets, while the BBG Municipal Bond Index is comprised of nearly 70% AAA and AA rated bonds. And as we have discussed elsewhere, the AAA rated exposure available across the securitized space is quite significant.

Here are some high-level thoughts on the above opportunity sets as of this writing:

- **Long term,** we believe many insurers can benefit from structural allocations to securitized credit, municipal bonds, and below-investment-grade securities. The exact optimal allocations will vary over time with changing market conditions, but we believe the reasons to hold these security types remain "evergreen":
  - The **securitized asset** universe as a whole may offer security selection and relative value opportunities within corporate-heavy portfolios. The sector is diverse, with many underlying collateral types (e.g., RMBS, CMBS, CLOs, consumer ABS) from which to pick the securities with the strongest underlying fundamentals and valuations. High-quality securitized has historically exhibited a lower credit beta than corporates, while the lower-quality space can be used to add risk and income to portfolios when appropriate.
  - **Municipal bonds,** relative to comparably rated corporates, have tended to experience lower default rates and higher recovery values, often signaling stronger underlying fundamentals. It is also a wide

and diverse security universe with many small issuers to help diversify corporate portfolios. Municipals also may offer relative value, either on a tax-adjusted basis for tax-exempt bonds, or outright versus corporates for taxables.

  - A small allocation to **below-investment-grade** securities could be reserved for downgraded assets so as not to be a "forced seller" at the time of a credit rating downgrade, which is typically the worst time to sell. Perhaps even better, insurers can use their high-yield bucket for security selection by choosing a small number of preferred names that they think could potentially add increased income to the portfolio

- Broadly speaking, insurers might also consider **moderate pro-risk positioning** in today's fixed income market environment, which is characterized by generally healthy fundamentals but correspondingly tight valuations. Against that backdrop, there may continue to be potential opportunities in securitized credit and taxable municipal bonds.

  In particular, higher-quality CLOs may offer potentially attractive income, with further coupon upside possible if the US Fed hikes interest rates, as widely anticipated. The same may also apply to non-agency RMBS amid continued housing market strength and availability of income-producing shorter-dated structures. Recent valuations between corporate bonds and taxable municipals were comparable, but we think municipals tend to have stronger fundamentals. We are more cautious on high-yield corporates due to tight valuations (but acknowledge that those may be justified by sound fundamentals in some instances).

The portfolio adjustment factor: Out with the old, in with the new

Another piece of the fixed income puzzle that has received far less coverage, in my opinion, is the NAIC's latest update to the portfolio adjustment factor. As a quick refresher, the portfolio adjustment factor rewards increased diversification of an insurer's fixed income portfolio by performing a weighted-average calculation and then applying a corresponding adjustment to the total bond risk charge. Issuer count is determined by using the first six digits of the CUSIP and excludes exempt US government bonds. The legacy calculation required a count of >1,300 to receive a reduction to the bond risk (a charge of <1.0), while the new methodology rewards >650 issuers (**Figure 5**). That being said, further increasing the issuer count provides a net benefit to the total calculation, with the sectors mentioned earlier also contributing to the total (e.g., BBG rated municipal bonds have 1,362 issuers).

Figure 5
Comparing portfolio adjustment factors

New calculation

Issuers	Count	# of issuers	Factor	Weighted issuers
First	10	10	5.87	59
Next	90	90	1.54	139
Next	100	100	0.85	85
Next	300	300	0.84	251
Over	500	150	0.82	123
Total		**650**		**656**
Size factor (tot weight issuers/tot number of issuers)				1.0

Legacy calculation

Issuers	Count	# of issuers	Factor	Weighted issuers
First	50	50	2.50	125
Next	50	50	1.30	65
Next	300	300	1.00	300
Over	400	900	0.90	810
Total		**1300**		**1300**
Size factor (tot weight issuers/tot number of issuers)				1.0

Sources: NAIC, Wellington Management. | Chart data as of 31 December 2021

Other types of investments

The RBC adjustments to fixed income assets also have a "trickle down" effect of sorts with respect to the risk charges applied to other types of investments. As noted, the P&C and health insurance risk factors for fixed income increased across virtually every bond rating category, while the charges for directly owned equities (15%) and Schedule BA funds (20%) remained the same as before. On the margin, this new framework could make an allocation to non-fixed income risk assets more attractive in 2022 and beyond as insurers look to generate investment returns.

In recent years, commercial mortgage loans (CMLs) have continued to grow as a percentage of insurers' total assets (nearly 15% of life insurers' portfolios as of year-end 2020) and are now being utilized by longer-duration-liability P&C insurers as well, although the latter industry's exposure is still around 1% in aggregate. The charges remain favorable for life insurers, but with a flat 5% charge across all varieties of CMLs for P&C and health insurers, one could argue for a selective allocation to the "mortgage-in-good-standing" part of the mortgage loan market.

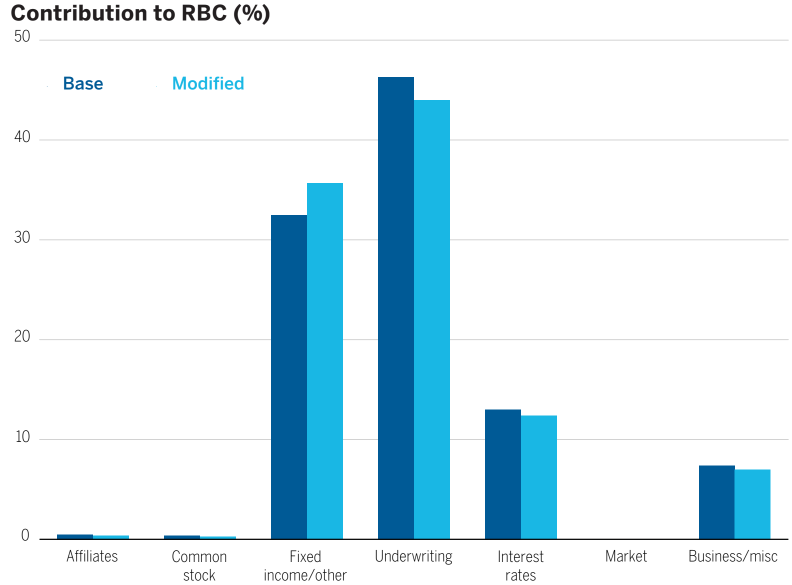
Additionally, the NAIC implemented capital relief for life insurers holding real estate equity, reducing the charge for Schedule BA real estate equity holdings from 23% to 13%.

Putting it all together

Let's examine the entire picture under the NAIC's new regulations using a hypothetical generic US life insurer, with a 950% authorized control level RBC. Just by applying the new risk factors and the updated portfolio adjustment factor, we see this insurer's aggregate RBC fall to 901%, with the total asset risk now 2% higher versus the baseline (**Figure 6**).

Figure 6

Contribution to RBC (%)



Sources: NAIC, Wellington Management. | Chart data as of 31 December 2021

However, if this insurer were to thoughtfully implement some of the investment ideas discussed herein (namely reallocating 10% of A- rated corporate debt to 5% in BB+ high-yield bonds and the other 5% in AAA structured securities), the company could theoretically capture a yield advantage, while only reducing its RBC by 10% (to 890%). This impact could potentially be further minimized by assuming an increase in total issuer count.

In the wake of all these recent regulatory changes, we believe it should be a best practice for most insurers (life insurers in particular) to think about and manage their invested asset allocations within the context of capital consumption. We've already begun, and will continue, partnering with our US insurance clients to that end.

What's next on the regulatory front?

As if the recent ones weren't enough, we believe the potential for further regulatory changes in a few key areas is worth watching in the months ahead.

For example, the NAIC recently opened a "request for comment" period for feedback on its RBC treatment of asset-backed securities (ABS), including collateralized loan obligations (CLOs). The NAIC is trying to determine if a revision to such charges is needed, specifically if ABS should be treated similarly to other structured securities (RMBS/CMBS) and modeled outside of just using the filing-exempt rating process. In this vein, we have already seen S&P propose a change to its capital model that has split out fixed income charges into sectors, including adjustments for securitized assets.

Prior to the bond factor review, the NAIC had also discussed the possibility of formulating a new way to risk charge Schedule BA assets, versus the "catch-all" charge for funds that exists today. It is safe to say the US insurance industry would welcome an approach that attempts to risk charge based on the actual economics of the investment strategy, as opposed to just using a flat rate. Could the NAIC take a page from Europe's Solvency II regulations and the Bermuda Solvency Capital Requirement (BSCR) by permitting partial or full "look-through" to the investment exposures underlying insurers' assets? Time will tell. In the interim, US insurers will (and should) be keeping a vigilant eye on the evolving regulatory landscape.

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New risk-based framework: Another reason to like high-quality securitized (October 2021)

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