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CLIENT ALERT

NAIC Exposes *INT 23-01T — Net Negative (Disallowed) Interest Maintenance Reserve (IMR)* for Public Comment

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AUTHORS

Kara Baysinger | Allison J. Tam | Claire Walsh | Brendan M. Smith

On July 5, 2023, the Statutory Accounting Principles (E) Working Group ("SAPWG") of the National Association of Insurance Commissioners (the "NAIC") exposed *INT 23-01T — Net Negative (Disallowed) Interest Maintenance Reserve (IMR)* ("INT 23-01T") for a public comment period ending Friday, July 21. The exposure follows SAPWG's June 28 discussion of comments received on a prior exposure of the same and is expected to be considered for possible adoption at the upcoming 2023 NAIC Summer National Meeting in August 2023 (the "Summer National Meeting").

We previously reported on SAPWG's new agenda item relating to statutory accounting treatment for negative interest maintenance reserve ("IMR") in our reports of the 2022 NAIC Fall National Meeting and 2023 NAIC Spring National Meeting, available here and here, respectively, and provide below a brief background on the issue and an update on the NAIC's current exposure.

Background

IMR is a statutory accounting concept applicable to short- and long-term fixed-income investments by life and accident and health insurers. The underlying rationale of IMR is to prevent fluctuations in prevailing interest rates from having an outsize impact on an insurer's apparent financial position, as presented on its statutory financial statements. Gains and losses from the sale of applicable fixed-income investments resulting from interest rate changes are applied to an insurer's IMR balance and amortized over the remaining term to maturity of the investments sold, rather than being reflected in income immediately.

For most years since statutory accounting's introduction of IMR in 1992, interest rates were in decline. Bond prices rise as yields fall, meaning that insurers selling bonds in a declining interest rate environment would accumulate positive IMR balances from their gains on bond sales. In recent years, this trend has rapidly reversed as the Federal Reserve Board has raised its benchmark rate by 500 basis points since March 2022, with further increases still anticipated. Insurers selling bonds amid rising interest rates face diminishing net positive IMR balances and, in some cases, a net negative IMR balance, even as proceeds of bond sales are reinvested in equivalent, higher-yielding investments.

Under existing statutory accounting principles, a net negative IMR balance is treated as a non-admitted asset. This treatment has impacts for insurers both in terms of financial position as presented on the statutory financial statements and for risk-based capital ("RBC") calculations. In response to an October 2022 letter from the American Council of Life Insurers ("ACLI") to SAPWG requesting urgent action to address industry concerns with non-admittance of negative IMR, in December 2022, SAPWG exposed a new agenda item (Ref #2022-19) to consider IMR and any guardrails that would be appropriate in a decision to admit a net negative IMR balance, as we reported here. Despite industry requests for relief by year-end 2022, no immediate action was taken by SAPWG, which instead encouraged affected insurers to seek a permitted accounting practice from their domestic state regulator.

Concurrent with SAPWG's work on IMR, the NAIC's Life Actuarial (A) Task Force developed and promulgated Valuation Manual guidance for purposes of asset adequacy testing and principle-based reserving with respect to IMR, noting that IMR allocation in applicable sections of the Valuation Manual should be "principle-based," "appropriate," and "reasonable," and that companies should not be required to allocate any non-admitted portion of IMR for purposes of these sections unless granted a relevant permitted practice.

Throughout early 2023, SAPWG heard industry presentations on IMR in regulator-only sessions and received an additional comment letter from the ACLI. As we reported here, the group reconvened at the 2023 NAIC Spring National Meeting to discuss possible interim steps to address the IMR issue, pending development of a long-term solution. Since then, SAPWG has held multiple meetings to address IMR. In April, SAPWG voted to expose INT 23-01T as a limited-time, optional statutory accounting interpretation that would allow insurers to admit net negative IMR in the general account up to 5% of capital and surplus (with certain adjustments) subject to specified guardrails.

Following that initial exposure period ending in May, at its most recent meeting on June 28, SAPWG directed NAIC staff to further revise the interpretation for a subsequent exposure, to allow further consideration and possible adoption of the interpretation at the Summer National Meeting. Key aspects of the revised INT 23-01T, which was exposed for comment on July 5, are described below.

NAIC Exposes *INT 23-01T — Net Negative (Disallowed) Interest Maintenance Reserve (IMR)* for Public Comment

Current Exposure of INT 23-01T

INT 23-01T is intended to provide a temporary, optional exception to existing guidance set forth in *SSAP No. 7 — Asset Valuation Reserve and Interest Maintenance Reserve* and current annual statement instructions requiring non-admittance of net negative IMR. The interpretation as currently exposed would permit insurers to admit net negative IMR subject to certain restrictions:

1. An otherwise qualifying insurer may admit net negative IMR up to 10% of the insurer's capital and surplus, following adjustments to capital and surplus to exclude various "soft assets" (any net positive goodwill, electronic data processing equipment and operating system software, net deferred tax assets, and the admitted net negative IMR balance itself).

2. To qualify to apply this interpretation, an insurer must have an RBC ratio of 300% authorized control level RBC after an adjustment to total adjusted capital (TAC) to exclude the "soft assets" listed above. The insurer must affirm its compliance with this RBC requirement for all financial statements on which net negative IMR is reported as an admitted asset in the general account or recognized as an asset in the separate accounts (discussed further below), and provide supporting documentation to state regulators upon request.

3. To include losses from derivatives that were reported at fair value prior to derivative termination in admitted net negative IMR, the insurer must have documented, historical evidence of having followed the same process for interest-rate hedging derivatives terminated in a gain position (i.e., unrealized gains were added to IMR and amortized).

Process for General and Separate Accounts

Although the prior exposure of INT 23-01T was specific only to general account treatment, the revised exposure addresses both general and separate accounts. The proposed admittance process first admits net negative IMR in the general account until the 10% adjusted capital and surplus limit is reached. If the 10% limit has not yet been reached and all general account net negative IMR has been fully admitted, the insurer may then report net negative IMR as an asset in the separate accounts, allocated proportionately between insulated and non-insulated statements where applicable, until the 10% limit is reached.

Reporting

The exposure requires net negative IMR in the general account to be reported on the asset page as an aggregate write-in to miscellaneous other-than-invested assets and reported as an aggregate write-in for special surplus funds on the liabilities and surplus page. Similar treatment is to be applied when net negative IMR is recorded as an asset in the separate account.

The exposure details certain disclosure requirements, including that insurers admitting net negative IMR must provide a note disclosure attesting that asset sales complied with the insurer's investment policies and were not compelled by liquidity pressures, among other facts underlying the negative IMR generation.

Future Action Anticipated

The public comment period for the revised exposure of INT 23-01T ends on Friday, July 21. The exposure is accessible on SAPWG's website, available here.

We anticipate that SAPWG will consider comments when it meets on August 13 as part of the Summer National Meeting to be held next month in Seattle. Because INT 23-01T overrides existing statutory accounting guidance, it will require a two-thirds supermajority vote by SAPWG to be implemented. We will continue to monitor and report on this topic, including any updates on SAPWG's discussion, possible revisions to INT 23-01T and potential adoption of the interpretation at the Summer National Meeting.

INT 23-01T is intended as a short-term solution to SAWPG's ongoing efforts to establish statutory accounting guidance specific to net negative IMR. As currently drafted, it would expire automatically on January 1, 2026 and, if implemented, would be subject to future amendment or replacement by SAPWG as the group continues to consider a permanent solution to the net negative IMR issue.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Kara Baysinger	**Allison J. Tam**	**Claire Walsh**	**Brendan M. Smith**
415 858 7425	212 728 8282	312 728 9071	212 728 3645
kbaysinger@willkie.com	atam@willkie.com	cwalsh@willkie.com	bsmith@willkie.com