Note - Due to different interpretations of the exposed guidance, NAIC staff is working with industry to clarify the intent of the exposed issue paper. For this time, the issue paper will remain exposed, along with comment letters previously received. It is expected that revised interested party comments will be provided subsequent to the discussion with NAIC staff.

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July 9, 2018

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Discussion Draft of Issue Paper Ref #2016-20, Credit Losses

Dear Mr. Bruggeman:

Interested parties (“IPs”) appreciate the opportunity to provide comments regarding the NAIC Staff’s March 24, 2018 Discussion Draft (“DD”) of Issue Paper Ref #2016-20, Credit Losses. The DD proposes that certain aspects of the Financial Accounting Standards Board’s (“FASB”) ASU 2016-13, Credit Losses (Topic 326)-Measurement of Credit Losses on Financial Instruments (“FASB Credit Loss ASU”) be incorporated into regulatory reporting, including the adoption of an expected credit loss model (“ECL”). After significant discussion and analysis, much of which is discussed in this comment letter, the IPs recommend the NAIC retain the existing credit impairment guidance in the investment Statutory Accounting Principles (“SAPs”) (including valuation rules around carrying certain investments in the scope of SSAP No. 26R at lower of cost or market—“LOCOM”), the overall conceptual framework of Statutory accounting, Asset Valuation Reserves (“AVR”), Interest Maintenance Reserves (“IMR”), Statutory Reserves (“SR”), and Risk-Based-Capital (“RBC”), rather than adopt the proposals in the DD. Although there are many reasons provided in this memo as to why the IPs concluded ECL should not be incorporated into Statutory accounting for investments, one key reason is that the DD proposes that the ECL model be applied to debt securities that insurers have designated and manage as available-for-sale \(^1\) (“AFS debt securities”), which are out of scope of the ECL.

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\(^1\) Under FASB Codification Topic 320, available-for-sale debt securities are those that are not designated as either “trading securities” (i.e., those acquired with the intent of selling within hours or days) or “held to maturity” securities (i.e., those for which the reporting entity has the positive intent and ability to hold the securities to maturity).
guidance in the FASB Credit Loss ASU (i.e., US GAAP did not change with regards to the timing and measurement of credit losses for AFS debt securities). Accordingly, if Statutory accounting were to require ECL be applied to the most significant portion of insurers’ investment portfolios (AFS debt securities) it would result in a significant difference between Statutory and US GAAP because two different impairment models would be applied to AFS debt securities, which we do not believe would be an improvement and would not be cost-justified. Additionally, for non-public companies, that do not have a need to develop ECL for GAAP reporting, there would be a significant amount of work to develop ECL for Statutory reporting if ECL were adopted (e.g., the costs of developing ECL for mortgage loans also outweigh any perceived benefits).

- For the most significant asset type in insurers’ investment portfolios (i.e., AFS debt securities), the FASB Credit Loss ASU did not modify the existing incurred loss model either in terms of the triggering of credit losses or the measurement of credit losses (i.e., the existing measurement of credit losses remains as best estimate of incurred credit losses). Adopting ECL for Statutory purposes for AFS debt securities, as proposed in the DD, would result in a significant difference between US GAAP and Statutory accounting in that ECL would be applied for Statutory reporting and not for US GAAP. Both public and non-public insurance companies would be required to allocate significant resources to develop an ECL for AFS debt securities for Statutory purposes only. This would place considerable strain on smaller insurers that may not have the resources to internally develop or purchase sophisticated models necessary to estimate credit losses. We do not believe the different treatment for Statutory versus US GAAP is justified. Statutory reporting should not adopt ECL for AFS debt securities for the same reasons the FASB did not adopt ECL on a GAAP basis for AFS debt securities, which included the following:

- ECL (CECL on a GAAP basis) was designed for the banking industry’s loan portfolios. During the financial crisis, the FASB concluded that loss allowances for the banking industry’s loan portfolios were recorded “too little; too late”. The primary reason designated by the FASB was that banks lacked the ability to fully incorporate loss expectations both before a loss was incurred as well as beyond the loan operating cycle. Insurance companies monitor all assets in their investment portfolios on an individual basis, which is the primary reason “too little; too late” was not an issue during the financial crisis for insurance company investment portfolios. Individual monitoring is possible because of the significant amount of financial information available to investors.

- The FASB also did not adopt ECL for AFS debt securities because the measurement attributes of AFS securities are not like other assets that are intended to be held to maturity (i.e., for AFS debt securities, value may be realized either through collection or sale). The FASB recognized this in its
determination that a different credit impairment model is necessary for AFS debt securities. AFS debt securities were already reported at fair value on the GAAP balance sheet (i.e., fair value changes reported in other comprehensive income), thus if credit concerns existed for AFS debt securities, those credit related losses would already be captured on the GAAP balance sheet as unrealized losses. Although Statutory reporting rejected Topic 320 to report AFS debt securities at fair value, Statutory reporting for P&C companies requires AFS debt rated NAIC 3-6 to be reported at LOCOM, which captures all credit related declines in fair value in the balance sheet (NAIC 1 & 2 AFS debt securities would not be expected to have credit related unrealized losses). For Life companies, NAIC 6 AFS debt securities are reported at LOCOM, thus capturing a significant amount of credit related declines in fair value in the balance sheet. Additionally, provisions for AFS debt credit losses are already captured through the application of the incurred loss model in SSAP No. 26R, SR² and AVR, and all assets are subject to RBC charges.

- The FASB recognized that it was important to retain an impairment model that distinguished credit losses from non-credit losses for bonds. Per the Credit Loss ASU Basis for Conclusions “The Board acknowledged that fair value changes occur not only because of changes in expected credit losses but also because of non-credit-related factors, such as changes in liquidity in the market, general market volatility, industry-specific volatility, and changes due to interest rate movements. The CECL fair value floor model would have depended on many of those variables in the market place. Therefore, given the construct of the fair value model, expected credit losses could have been recorded when changes in non-credit-related factors occur in the market. For example, under a CECL fair value floor model, when fair value drops below cost because of changes in interest rates (or other variables mentioned above), the model would have required the recognition of expected credit losses and, therefore, changes in interest rates could have been a primary driver in the initial recognition as well as measurement of expected credit losses.”

The other key reason the IPs recommend not incorporating ECL into Statutory accounting is that the existing model (i.e., incurred losses, SAPs, SR, RBC, AVR, IMR, LOCOM) has worked very effectively, including through the financial crisis, and modifying the existing rules would neither be an improvement in terms of providing a more transparent, reliable estimate nor would it be cost-justified. The current integrated Statutory accounting and reporting model (i.e., incurred losses, SAPs, SR, RBC, AVR, IMR, LOCOM) has been in existence for many years with improvements made through collaboration among the regulators, NAIC staff, and various IPs. We view the current accounting, reporting, and capital models to be effectively integrated in that

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² Tabular reserve estimates include estimates of future expected credit losses up to the 67th percentile. AVR includes expected credit losses up the 85th percentile.
each component is independently appropriate and the combined model achieves the goal of appropriate balance sheet measurement and regulatory capital determination. Modifications to one aspect of the model would require modifications to other aspects of the model, which would be a significant undertaking to reconsider, retest and rebalance the financial accounting requirements with Statutory capital. For example, should ECL be adopted, the AVR and calculation of SR for Life insurers would need to be modified as they already include a provision for certain credit losses that may occur in the future. For P&C insurers, SSAP No. 26R investments are held at LOCOM if they are rated NAIC 3-6 (for Life insurers LOCOM is required on investments rated NAIC 6) and, as a result, the application of ECL would need to be specifically considered for this group of assets. Additionally, RBC ratios would require modification to integrate with ECL. We do not believe these significant modifications to the existing model are warranted.

- We also note that, because of the refinements to the model throughout the years (e.g., recently updated mortgage factors and proposed updates to bond factors) and the many prescribed rules in the model (e.g., factors and formulas used to determine AVR, applying an incurred loss model which is dependent upon actual events occurring to record a credit loss), the extent of management judgment not subject to corroboration is minimized in the existing model and thus the results can be relied upon by regulators to compare one insurer to another and to assess solvency. The introduction of the ECL model substantially increases the amount of management judgment involved in estimating credit losses, which may or may not actually be incurred, over the life of an investment. We do not believe the significant increase in the amount of management judgment in measuring credit losses under ECL would be an improvement of the existing Statutory model that currently results in more consistent credit loss assessments among insurers.

For the reasons discussed above and discussed in the remainder of this letter, the IPs recommend not adopting ECL for Statutory reporting as it would not be an improvement to existing SAPs; would not faithfully represent credit losses on most insurer bond and other investments; and would result in less consistent credit loss assessments among insurers requiring a significant effort for regulators, NAIC staff and insurers. As a result, the costs of such a change will significantly outweigh any perceived benefits.

The following is a discussion of the general considerations that formed the basis for our recommendation. Following the discussion are detailed analyses related to the adoption of ECL for the primary asset types in both Life and P&C insurers’ investment portfolios.

**General Considerations:**

The following are general considerations related to our recommendation not to adopt the FASB Credit Loss ASU for Statutory purposes.

_Preamble for Statutory Accounting Principles (“SAPs”):_
The IPs considered the discussion in the preamble of the SAPs as follows:

- **Conservatism:** In both Section II.B. (Preamble-Statutory Accounting Principles) and Section III (Concepts), the preamble describes the concept of conservatism in the SAPs, which is applied to determine at the financial statement date an insurer’s ability to satisfy its obligations to its policyholders and creditors. The preamble notes that substantial judgment is used in deriving accounting estimates used by management. Specifically, the preamble states that “In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.”

The IPs discussed the concept of conservatism in light of the proposal to adopt ECL for Statutory reporting. In the DD, NAIC Staff stated that if ECL was not adopted for Statutory reporting, the Statutory basis of accounting would be less conservative than US GAAP basis of accounting. IPs believe the application of the existing incurred loss model is the more conservative approach. Today, insurance companies monitor the assets in their investment portfolios individually to determine if a credit loss has been incurred. These evaluations are very robust with the investment managers having the primary responsibility of monitoring each individual asset in their portfolio and the accounting areas performing independent analysis (e.g., various screening tests) to supplement the investment managers’ evaluations. This approach compares to the proposed ECL process, wherein investments with similar risk characteristics would be pooled together, historical statistics would be gathered and adjusted for current conditions and reasonable and supportable forecasts to estimate credit losses. Each step in this process involves significant amount of judgment.

A recent study performed by a group of Federal Reserve Board of Governors\(^3\) illustrates how small changes in certain assumptions associated with the ECL model may have significant impacts on the projected credit losses, reducing the ability to compare credit losses from one company to another. The study also notes that, because ECL incorporates future economic projections, there are circumstances where the ECL model may produce a lower credit loss allowance versus the incurred loss model. That is, the study notes that the incurred loss model is pro-cyclical and during a trough in home prices, it could over-provision for credit losses relative to the expected loss model. Although the study is specific to loan loss allowances, the key take-aways from the study are expected to be similar for any investments to which ECL is applied (especially when ECL is applied using a pooled methodology). IPs do not believe the introduction of a

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\(^3\) 2018 publication by the “Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board”, which is titled “The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves.”
significant amount of judgment in determining credit losses under the ECL model is more conservative than applying a robust individual impairment assessment to each investment in our portfolio. We also believe applying ECL could produce credit loss allowances that are lower than the existing incurred loss model (not more conservative). Moreover, the ECL estimates may also be less understandable and reliable and thus not decision useful information for financial statement users/investors or regulators.

- **Comparability, uniformity, consistency:** In both Section II.D. (Preamble-Purpose of Codification) and Section III (Concepts), the preamble discusses how the purpose of Codification is to provide a consistent and comprehensive basis of accounting and reporting that enables the Risk-Based Capital (“RBC”) tool that is used to measure solvency of insurers. It also notes that “The regulator’s need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles.”

The IPs discussed the concepts of comparability, uniformity, and consistency in terms of adopting ECL for Statutory reporting. As previously mentioned, ECL increases significantly the amount of management judgment incorporated into determining credit losses and adopting ECL would eliminate the benefits of the consistency embedded in the current model. The incurred loss model triggers an impairment when an actual credit event occurs, which involves less judgment compared to estimating future losses through the life of an investment. There is significant amount of judgment involved in estimating “expected” credit losses, which may or may not actually be incurred, over the life of an investment, when applying ECL. The incurred loss model provides more consistent and reliable recognition and measurement among insurers, thus facilitating regulators’ ability to measure and compare the strength of various insurance companies. The current integrated model also has incorporated various rules, such as LOCOM, AVR factors for Life insurers and RBC factors that are used in a uniform way by various insurance companies. The introduction of ECL would significantly reduce comparability, uniformity, and consistency among insurers compared to the existing model.

It is evident from the Federal Reserve Board of Governors’ study, that the application of the ECL model is quite complicated because companies must estimate lifetime credit losses for pools of investments. The IPs observe, consistent with the observations of the Federal Reserve Governors’ study, that ECL involves many complex judgments. Companies must identify investments and borrowers with similar risk characteristics, which may vary, such as by industry, rating, geographical location, type of asset, and type of collateral. As a result, pools of investments will not be comparable from one company to another. Insurers would then be required to use historical information (which could include third party information and their own historical experience) and modify the historical information for their interpretation of current conditions (e.g., identify where today’s economy is in relation to an economic cycle) and reasonable and supportable forecasts (e.g., economic forecasts of the future). If the forecast period is beyond a reasonable and supportable period, the company would revert to historical losses (e.g.,
using a reversion technique they believe is most appropriate for the existing facts and circumstances). The FASB intentionally allowed flexibility and judgment to be applied in the FASB Credit Loss ASU. Each of these key steps in the projection of ECL requires judgment and will result in inconsistent credit losses from one insurer to another.

One of the IPs is a member of the FASB’s Transition Resource Group (TRG) and some are involved in the AICPA Expert Panel for the FASB Credit Loss ASU, which are two groups focused on identifying issues and making recommendations related to the implementation associated with the ASU. These group members have observed that many significant judgment areas exist in the ASU for which adopters are submitting many questions and issues to both the TRG and AICPA Expert Panel. The FASB Staff is directly receiving several questions about implementation of the ASU. Again, we do not agree that an accounting standard, with such significant judgment as evidenced by the number of issues currently being addressed by these groups, should be introduced into Statutory reporting as it would not promote the desired consistency and comparability. It also would require significantly more time on the part of the regulators to evaluate the amount of management judgment incorporated into the process during financial examinations.

Other Relevant Considerations:

The IPs also considered the following when evaluating ECL for Statutory reporting:

- The preamble of the SAPs notes that “Operating performance is another indicator of the enterprise’s ability to maintain itself as a going concern.” We do not agree that recording expected losses for any investment, which may or may not be incurred by an insurer, provide the regulators with a reliable indication of the operating performance of the insurer. Alternatively, we believe the existing incurred loss model in the various SAPs is consistent with the concept of “operating performance” of an insurer because incurred losses are recorded when an actual loss has occurred (i.e., the operations have experienced a loss) and the losses are reliably determinable.

- NAIC Staff noted in the DD that RBC and AVR are not a replacement for proper reporting on the balance sheet. IPs agree with that statement. The preamble to the SAPs notes that “The principal focus of solvency measurement is determination of the financial condition through analysis of the balance sheet.” IPs believe the balance sheet is a “snapshot” of the current financial condition of a company and should not consider projections of future credit losses that may or may not occur. Measuring the current financial condition against RBC (which considers what may happen in the future to the financial condition of a company) is a model that has existed in the insurance regulatory framework for years and has worked well. As we believe one of the primary objectives of the NAIC and regulators is to ensure the solvency and financial stability of insurers, one of the key tools used by the regulators is RBC (i.e., for life companies, actual
company capital plus AVR divided by the calculated RBC C1-C4 risks). Since the calculated RBC C1-C4 risks already incorporate expected credit losses (up to the 92nd to 95th percentile), we do not see the benefit of introducing lifetime expected credit losses into the Statutory balance sheet. Moreover, we believe that for risks that are not “probable” of occurring the appropriate treatment is an allocation of capital versus the alternative, which is an unreliable, highly judgmental, accounting estimate. If ECL were used in measuring investment carrying values on the balance sheet of insurers, the amount of expected credit losses would likely be added back to Statutory capital (as AVR is added back today) to compare to RBC C1-C4 risks. As a result, we do not see any benefit to the Statutory balance sheet reflecting additional expected credit losses beyond what is already incorporated through AVR, SR, LOCOM, etc.

Additionally, NAIC Staff noted in the DD that the ECL concept does not require any additional losses to be recognized than what is recognized under the incurred loss model. While this may be true over the entire life of an investment it is not true for any single reporting period or period end. The pooled approach to determine ECL may result in insurance companies recording an allowance on many investments, most of which may never experience a credit loss.

Analysis of Primary Investment Types:

**AFS Debt Securities:**
The DD proposes that ECL be applied to all investments held at amortized cost (including AFS debt securities) with a fair value floor (i.e., the net of the amortized cost and credit loss allowance would never be below fair value). The FASB Credit Loss ASU did not modify the trigger or measurement for AFS debt for US GAAP reporting (i.e., best estimate of credit losses based on an incurred loss model). We do not agree that the application of ECL to AFS debt securities for Statutory purposes is justified for the reasons already discussed in this comment letter.

The IPs developed a few examples of the application of ECL to AFS debt securities for Statutory reporting and compared the results to US GAAP. The examples are attached to this comment letter and were developed for both Life and Property and Casualty (“P&C”) insurance companies. We note the following observations from analyzing the examples:

- **Example 1-Life and P&C-**
  - When a debt investment is rated 2 and there is no evidence of credit loss, however the investment has an unrealized loss wholly related to the interest rate environment or other non-credit factors, the application of ECL on a Statutory basis would result in a credit loss being reported in Statutory income with no loss recorded in US GAAP income. We do not believe, absent a credit event occurring, reporting a credit loss on a Statutory basis provides a faithful representation of an insurer’s operating results for the period. Retaining the
existing incurred credit loss model for Statutory reporting would result in consistent income statement reporting as US GAAP.

- When a debt investment in a P&C Company is rated 2 and the rating later declines to a 3, depending on the circumstances, converting from CECL to LOCOM could result in an increase in Statutory income (as the example illustrates; IPs made assumptions about the financial statement reporting geography in the example provided). The same could occur for a Life company asset if the rating declines from a 5 to 6. We do not agree with such a result as it is not intuitive given the worsening condition of the investment. This example illustrates that the application of ECL, with the existing integrated Statutory model, may result in counter-intuitive impacts on the income statement and Statutory surplus.

- In the Life company example provided, we assume the AVR is set at the Maximum Reserve. Given that both the credit losses in the ECL model and the credit losses provisioned for in AVR are estimates of expected credit losses, we believe there would be duplicative provisions for expected credit losses in the Statutory financial statements if AVR is not modified. Also, if credit losses recognized under the ECL model are to be deferred through AVR (i.e., offset by a reduction in AVR), an estimate of lifetime credit losses will be reported through the ECL model (through the income statement) and some portion of expected credit losses will be provisioned in AVR (through a direct decrease in surplus).

- Example 2- Life and P&C-

  - The examples for both Life and P&C illustrate that, as interest rates increase; however, the credit quality of the portfolio remains the same, additional credit losses may be recognized in the Statutory income statement. This may be as a result of an asset moving from an unrealized gain to unrealized loss or when the fair value floor is decreasing, rather than as a result of an increase in credit risk. That is, Statutory income and surplus would be reduced from an increase in interest rates and not from deteriorating credit. The IPs observe that there have been many instances throughout the years where unrealized losses have increased significantly (even doubled in size) due to increasing interest rates and not from increases in credit risk.

The IPs are providing the examples attached to illustrate how the application of the ECL model to AFS debt securities could result in non-intuitive results. Additionally, because the existing regulatory model is integrated, each component of the model would need to be re-evaluated and perhaps modified significantly to produce results that are meaningful to a regulator (i.e., faithful representation of the operating results for an insurer and results that are comparable from one
insurer to another) if ECL were adopted. Finally, the examples illustrate that applying ECL on a Statutory basis will significantly diverge from the application of the incurred loss model for AFS debt securities on a US GAAP basis.

**Mortgage Loans:**

The DD proposes that ECL be applied to investments held at amortized cost with a fair value floor. Although public companies, but not necessarily non-public companies, will be required to apply ECL to mortgage loans for US GAAP purposes, US GAAP does not have a similarly integrated model as Statutory (i.e., incurred losses, SAPs, SR, RBC, AVR, IMR, LOCOM). The IPs do not believe revisiting the existing integrated model is cost justified or an improvement as discussed earlier in the comment letter. It is also important to note that insurers monitor incurred losses for mortgage loans, like AFS debt securities, on an individual basis and therefore the statistical methodology in ECL would not be an improvement to the current method. The IPs studied the application of ECL to mortgage loans for Statutory purposes and noted that applying the fair value floor would provide the same, or materially the same, results as the application of existing SSAP No. 37, *Mortgage Loans* (assuming the fair value of the collateral is used as the fair value floor). That is, when the current fair value of the collateral (less cost to sell) is more than the loan balance, no credit loss allowance would be recorded under the proposal in the DD (i.e., the fair value floor). When the fair value of the collateral is less than the loan balance, the shortfall would be reported as a credit loss. The results are materially the same as SSAP No. 37 and, therefore, we do not see a compelling reason for a change in the existing incurred loss model and integrated models related thereto.

**Equity Securities and Limited Partnerships/Limited Liability Companies (LPs/LLCs):**

The DD proposes that, for assets carried at fair value, the incurred loss model in US GAAP would continue to be applied. Although ASU 2016-01 was adopted for US GAAP resulting in all equity securities (including LPs/LLCs for which equity-method of accounting has not been applied) being reported at fair value with periodic changes in fair value reported in net income, the NAIC rejected the guidance for various valid reasons, which the IPs agree with. As a result of the adoption of ASU 2016-01, an equity impairment model is no longer relevant for US GAAP.

We assume the DD is implying that today’s incurred loss model in SSAP No. 30 and SSAP No. 32 for equity securities and SSAP No. 48 for LPs/LLCs would be retained. IPs agree with that recommendation.

**Other Investments:**

The IPs believe instruments such as derivatives (SSAP No. 86) and miscellaneous receivables (e.g., accounts receivable, interest receivables, etc.) would not be in scope of the ECL model. Derivatives are complex and have their own model for when fair value changes are reported in the income statement versus unrealized gains and losses. Miscellaneous receivables are generally short-term in nature, are generally subject to conservative non-admission requirements.
and are evaluated for recoverability during the period they are outstanding. Additionally, due to their short-term nature, even if ECL were applied, we would not expect to record any credit losses. As a result, applying a different model than today’s model is not cost justified.

**Purchased Financial Assets with Credit Deterioration Proposal:**

In the DD, IPs were asked to comment on the application of the purchased financial assets with credit deterioration model (“PCD”) for Statutory reporting. The PCD model results in investments purchased in the secondary market, that are in scope, being reported using a “gross-up model”. The gross-up model grosses up the carrying value of an investment in scope for the amount of credit losses expected for assets carried at amortized cost (ECL model used to calculate credit losses) and for the best estimate of credit losses (incurred loss model used to calculate credit losses) for assets carried at fair value. The gross-up amount is then reported as a contra-asset, resulting in the net carrying amount for an asset being equal to purchase price on the date of purchase.

It is important to consider that one of the key reasons the FASB introduced the PCD model was for banks’ secondary market purchases of distressed loans. The PCD model allows banks to record a credit loss allowance on purchase date without impacting capital as the purchase price of the asset already reflects a discount due to more than insignificant expected credit losses. Given that the IPs do not believe that the application of the ECL model is appropriate for Statutory reporting, for the several reasons detailed in this comment letter, we also do not believe that the PCD model should be adopted for Statutory reporting for the same reasons.

Interested parties appreciate the opportunity to comment on the DD and welcome further conversation on this important topic for the insurance industry.

* * * *

Thank you for considering interested parties’ comments. We look forward to working with you and the Working Group on this topic. If you have any questions in the interim, please do not hesitate to contact either one of us.

Sincerely,

D. Keith Bell     Rose Albrizio

cc: Julie Gann, NAIC staff
Robin Marcotte, NAIC staff
Interested parties
Statutory Reporting under the NAIC Draft Issue Paper on Ref #2016-20, Credit Losses

Examples based on Issue Paper "Possible SAP Concepts"

Example #1-Life Insurer

The examples below demonstrate the statutory reporting and operational implications of a Life insurer’s bond investment that is downgraded from an NAIC 5 rating to an NAIC 6 rating, using the accounting suggested by NAIC staff. In the examples below, assume the difference between cost and fair value is attributable to higher interest rates.

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<th>Quarter period impact June 30, 2020</th>
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<td>FV</td>
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<td>AFS - non-credit loss (higher interest rates)</td>
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<td>Bond net carrying value</td>
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<td>AVR impact (Maximum reserve)</td>
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<td>Statutory Surplus/GAAP equity impact</td>
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<td>Impairment model - Statutory accounting</td>
<td>ASU 2016-13 CECL model</td>
<td>ASU 2016-13 AFSc model</td>
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<td>Impairment model - GAAP accounting</td>
<td>ASU 2016-13 AFSc model</td>
<td>ASU 2016-13 AFSc model</td>
</tr>
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</table>

Notes
1) For the quarters ended March 31 and June 30, the decrease in fair value is entirely attributable to an increase in interest rates.
2) Under the CECL model, because of the requirement to estimate credit losses over the life of the contractual maturity of the investment even if that risk is remote, statutory accounting results in a credit impairment when the bond is carried at amortized cost. The estimated lifetime loss shown above is for illustrative purposes only.
3) The same bond does not have a credit impairment for GAAP reporting under the AFS impairment guidance of ASU 2016-13.
4) When the bond is downgraded to an NAIC 6 and is valued under LOCOM, the CECL credit loss is reversed through income.
5) AVR, income and surplus/equity impacts are shown for the quarterly period (i.e., not cumulative or year-to-date).
6) The AVR impact is simply represented by the maximum reserve contribution (i.e., this example assumes the total AVR for bonds is adjusted down to the maximum reserve level).
7) The example above is simplified (assuming no credit event even though the bond rating is 6).

Conclusion
For bonds carried at amortized cost, the NAIC staff suggestion results in an impairment based on estimated losses expected over the life of the exposure, even when a lower fair value is the result of non-credit events (such as higher interest rates), the bond may be sold before the contractual maturity, or an impairment may never be realized.

The NAIC staff suggestion also results in a significant difference in the impairment model used on the same security for GAAP accounting.

Statutory surplus is also additionally impacted by the increase in the AVR attributable to the change in NAIC rating.
Combined Comment Letters - Credit Losses

Statutory Reporting under the NAIC Draft Issue Paper on Ref #2016-20, Credit Losses

Examples based on Issue Paper "Possible SAP Concepts"

<table>
<thead>
<tr>
<th>Example #2-Life Insurer</th>
</tr>
</thead>
</table>

The examples below demonstrate the statutory reporting and operational implications of a Life insurer’s bond investment using the accounting suggested by NAIC staff. In the examples below, assume the difference between cost and fair value is attributable to higher interest rates and the bond is rated investment grade (NAIC2).

<table>
<thead>
<tr>
<th>Assumptions (Life insurer)</th>
<th>Quarter period impact</th>
<th></th>
<th>Quarter period impact</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>March 31, 2020</td>
<td>GAAP</td>
<td>June 30, 2020</td>
<td>GAAP</td>
</tr>
<tr>
<td>Purchase date of January 2, 2020</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>FV</td>
<td>101</td>
<td>101</td>
<td>97</td>
<td>97</td>
</tr>
<tr>
<td>NAIC rating</td>
<td>2</td>
<td>n/a</td>
<td>2</td>
<td>n/a</td>
</tr>
<tr>
<td>Valuation basis</td>
<td>Amortized cost</td>
<td>Fair value</td>
<td>Amortized cost</td>
<td>Fair value</td>
</tr>
<tr>
<td>CECL (lifetime) impairment loss</td>
<td>2</td>
<td>n/a</td>
<td>2</td>
<td>n/a</td>
</tr>
<tr>
<td>AFS - credit loss</td>
<td>n/a</td>
<td>-</td>
<td>n/a</td>
<td>-</td>
</tr>
<tr>
<td>AFS - non-credit loss (higher interest rates)</td>
<td>n/a</td>
<td>-</td>
<td>n/a</td>
<td>4</td>
</tr>
<tr>
<td>Allowance</td>
<td>-</td>
<td>-</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td>Bond net carrying value</td>
<td>100</td>
<td>101</td>
<td>98</td>
<td>97</td>
</tr>
<tr>
<td>AVR impact (Maximum reserve)</td>
<td>(0.90)</td>
<td>n/a</td>
<td>0.02</td>
<td>n/a</td>
</tr>
<tr>
<td>P&amp;L impact - income (loss) - pre-tax</td>
<td>-</td>
<td>-</td>
<td>(2.0)</td>
<td>-</td>
</tr>
<tr>
<td>Statutory Surplus/GAAP equity impact</td>
<td>(0.90)</td>
<td>1.0</td>
<td>(1.98)</td>
<td>(4.0)</td>
</tr>
<tr>
<td>Impairment model - Statutory accounting</td>
<td>ASU 2016-13 CECL model</td>
<td></td>
<td>ASU 2016-13 CECL model</td>
<td></td>
</tr>
<tr>
<td>Impairment model - GAAP accounting</td>
<td>ASU 2016-13 AFS model</td>
<td></td>
<td>ASU 2016-13 AFS model</td>
<td></td>
</tr>
</tbody>
</table>

Notes

1) For the quarters ended March 31 and June 30, the decrease in fair value is entirely attributable to an increase interest rates.
2) Under the CECL model, because of the requirement to estimate credit losses over the life of the contractual maturity of the investment even if that risk is remote, statutory accounting results in a credit impairment when the bond is carried at amortized cost. The estimated lifetime loss shown above is for illustrative purposes only.
3) The same bond does not have a credit impairment for GAAP reporting under the AFS impairment guidance of ASU 2016-13.
4) AVR, income and surplus/equity impacts are shown for the quarterly period (i.e., not cumulative or year-to-date).
5) The AVR impact is simply represented by the maximum reserve contribution (i.e., this example assumes the total AVR for bonds is adjusted down to the maximum reserve level).

Conclusion

For bonds carried at amortized cost, the NAIC staff suggestion results in an impairment based on estimated losses expected over the life of the exposure, even when a lower fair value is the result of non-credit events (such as higher interest rates), the bond may be sold before the contractual maturity, or an impairment may never be realized.

The NAIC staff suggestion also results in a significant difference in the impairment model used on the same security for GAAP reporting.

Statutory surplus is also additionally impacted by the increase in the AVR attributable to the change in NAIC rating.
The examples below demonstrate the statutory reporting and operational implications of a PC insurer’s bond investment that is downgraded from an NAIC 2 rating to an NAIC 3 rating, using the accounting suggested by NAIC staff. In the examples below, assume the difference between cost and fair value is attributable to higher interest rates.

### Assumptions (PC insurer)
- **Purchase date of January 2, 2020**
- **Cost**
- **FV**
- **NAIC rating**
- **Valuation basis**
- **CECL (lifetime) impairment loss**
- **AFS - credit loss**
- **AFS - non-credit loss (higher interest rates)**
- **Allowance**
- **Bond net carrying value**
- **P&L impact - income (loss) - pre-tax**
- **Statutory Surplus/GAAP equity impact - pre-tax**
- **Impairment model - Statutory accounting**
- **Impairment model - GAAP accounting**

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Quarter period impact March 31, 2020</th>
<th>Quarter period impact June 30, 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Statutory</td>
<td>GAAP</td>
</tr>
<tr>
<td>Purchase date of January 2, 2020</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Cost</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td>NAIC rating</td>
<td>2</td>
<td>n/a</td>
</tr>
<tr>
<td>Valuation basis</td>
<td>Amortized cost</td>
<td>Fair value</td>
</tr>
<tr>
<td>CECL (lifetime) impairment loss</td>
<td>7</td>
<td>n/a</td>
</tr>
<tr>
<td>AFS - credit loss</td>
<td>n/a</td>
<td>-</td>
</tr>
<tr>
<td>AFS - non-credit loss (higher interest rates)</td>
<td>n/a</td>
<td>10</td>
</tr>
<tr>
<td>Allowance</td>
<td>7</td>
<td>-</td>
</tr>
<tr>
<td>Bond net carrying value</td>
<td>93</td>
<td>90</td>
</tr>
<tr>
<td>P&amp;L impact - income (loss) - pre-tax</td>
<td>(7)</td>
<td>-</td>
</tr>
<tr>
<td>Statutory Surplus/GAAP equity impact - pre-tax</td>
<td>(7)</td>
<td>(10)</td>
</tr>
<tr>
<td>Impairment model - Statutory accounting</td>
<td>ASU 2016-13 CECL model</td>
<td>ASU 2016-13 CECL model</td>
</tr>
<tr>
<td>Impairment model - GAAP accounting</td>
<td>ASU 2016-13 AFS model</td>
<td>ASU 2016-13 AFS model</td>
</tr>
</tbody>
</table>

### Notes
1. For the quarters ended March 31 and June 30, the decrease in fair value is entirely attributable to an increase in interest rates.
2. Under the CECL model, because of the requirement to estimate credit losses over the life of the contractual maturity of the investment even if that risk is remote, statutory accounting results in a credit impairment when the bond is carried at amortized cost. The estimated lifetime loss shown above is for illustrative purposes only.
3. The same bond does not have a credit impairment for GAAP reporting under the AFS impairment guidance of ASU 2016-13.
4. When the bond is downgraded to an NAIC 3 and is valued under LOCOM, the CECL credit loss is reversed through income.
5. Income and surplus/equity impacts are shown for the quarterly period (i.e., not cumulative or year-to-date).

### Conclusion
For bonds carried at amortized cost, the NAIC staff suggestion results in an impairment based on estimated losses expected over the life of the exposure, even when a lower fair value is the result of non-credit events (such as higher interest rates), the bond may be sold before the contractual maturity, or an impairment may never be realized. The NAIC staff suggestion also results in a significant difference in the impairment model used on the same security for GAAP accounting.

When a bond’s valuation moves from amortized cost to LOCOM, the insurer is forced to use an entirely different impairment valuation model, which may likely result in unintended consequences (e.g., the recognition of income in the example above).
Statutory Reporting under the NAIC Draft Issue Paper on Ref #2016-20, Credit Losses
Examples based on Issue Paper "Possible SAP Concepts"

Example #2-PC Insurer

The examples below demonstrate the statutory reporting and operational implications of a PC insurer's bond investment using the accounting suggested by NAIC staff. In the examples below, assume the difference between cost and fair value is attributable to higher interest rates and the bond is rated investment grade (NAIC 2).

<table>
<thead>
<tr>
<th>Assumptions (PC insurer)</th>
<th>Quarter period impact</th>
<th></th>
<th>Quarter period impact</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase date of January 2, 2020</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost</td>
<td>Statutory 100</td>
<td>GAAP 100</td>
<td>Statutory 100</td>
<td>GAAP 100</td>
</tr>
<tr>
<td>FV</td>
<td>101</td>
<td>101</td>
<td>97</td>
<td>97</td>
</tr>
<tr>
<td>NAIC rating</td>
<td>2</td>
<td>n/a</td>
<td>2</td>
<td>n/a</td>
</tr>
<tr>
<td>Valuation basis</td>
<td>Amortized cost</td>
<td>Fair value</td>
<td>Amortized cost</td>
<td>Fair value</td>
</tr>
<tr>
<td>CECL (lifetime) impairment loss</td>
<td>2</td>
<td>n/a</td>
<td>2</td>
<td>n/a</td>
</tr>
<tr>
<td>AFS - credit loss</td>
<td>n/a</td>
<td>-</td>
<td>n/a</td>
<td>-</td>
</tr>
<tr>
<td>AFS - non-credit loss (higher interest rates)</td>
<td>n/a</td>
<td>-</td>
<td>n/a</td>
<td>4</td>
</tr>
<tr>
<td>Allowance</td>
<td>-</td>
<td>-</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td>Bond net carrying value</td>
<td>100</td>
<td>101</td>
<td>98</td>
<td>97</td>
</tr>
<tr>
<td>P&amp;L impact - income (loss) - pre-tax</td>
<td>-</td>
<td>-</td>
<td>(2)</td>
<td>-</td>
</tr>
<tr>
<td>Statutory Surplus/GAAP equity impact - pre-tax</td>
<td>-</td>
<td>1</td>
<td>(2)</td>
<td>(4)</td>
</tr>
<tr>
<td>Impairment model - Statutory accounting</td>
<td>ASU 2016-13 CECL model</td>
<td></td>
<td>ASU 2016-13 CECL model</td>
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<td></td>
</tr>
</tbody>
</table>

Notes

1) For the quarters ended March 31 and June 30, the decrease in fair value is entirely attributable to an increase in interest rates.
2) Under the CECL model, because of the requirement to estimate credit losses over the life of the contractual maturity of the investment even if that risk is remote, statutory accounting results in a credit impairment when the bond is carried at amortized cost. The estimated lifetime loss shown above is for illustrative purposes only.
3) The same bond does not have a credit impairment for GAAP reporting under the AFS impairment guidance of ASU 2016-13.
4) For the quarter ended June 30, the decrease in fair value, attributable entirely in interest rates, results in an additional credit loss for statutory accounting.
5) Income and surplus/equity impacts are shown for the quarterly period (i.e., not cumulative or year-to-date).

Conclusion

For bonds carried at amortized cost, the NAIC staff suggestion results in an impairment based on estimated losses expected over the life of the exposure, even when a lower fair value is the result of non-credit events (such as higher interest rates), the bond may be sold before the contractual maturity, or an impairment may never be realized. The NAIC staff suggestion also results in a significant difference in the impairment model used on the same security for GAAP accounting.
July 9, 2018

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Discussion Draft of Issue Paper Ref #2016-20, Credit Losses – Reinsurance Receivables

Dear Mr. Bruggeman:

Interested parties (“IPs”) appreciate the opportunity to provide comments regarding the NAIC Staff’s March 24, 2018 Discussion Draft (“draft”) of Issue Paper Ref #2016-20, Credit Losses, as applied to reinsurance receivables.

Reinsurance Receivables

The draft requests comments from industry for purposes of beginning a discussion regarding the application of specific ECL concepts to the statutory accounting for reinsurance receivables. At this time, interested parties recommend that consideration of ECL for reinsurance receivables be deferred until the issues described below can be resolved. We make this recommendation because we believe various issues associated with applying the FASB Credit Loss ASU to reinsurance receivables need to be resolved before an informed evaluation and recommendation can be made regarding the applicability to statutory reporting. These issues are as follows:

There is still uncertainty as to how ECL will be applied to reinsurance receivables for GAAP reporting. The American Institute of Certified Public Accountants (AICPA) is currently evaluating the implementation issues associated with applying ECL to reinsurance receivables from an audit perspective and those discussions are preliminary.

We also note that the application of the ECL model to reinsurance receivables gives rise to
additional complexities beyond the issues associated with investments carried at amortized cost. For example:

- There is limited public data on credit default experience on reinsurance receivables, as well as data regarding recoverability rates.

- The application and interplay of ECL with regard to collateral is unclear, and potentially complex (i.e., an insurer expects the reinsurer to pay its claim, and the reinsurer would have to fail before any collateral can be utilized).

- The existence of disputes over the amount of reinsurance receivables due complicates the issue of evaluating and/or using data on reinsurance receivable write-offs and default experience. Disputes over the amount due introduce a much different dynamic to the application of ECL for reinsurance receivables as opposed to investments, as disputes are generally not an issue for the latter asset type.

- The interaction of an ECL accounting model with the Schedule F penalty as well as risk-based capital for property-casualty insurers needs to be considered. With regard to risk-based capital, the new R3 charge for reinsurance credit risk is based on a tail expectation, not a mean expectation (i.e., not on an ECL basis but rather a more conservative loss measure). Therefore, any change to the credit loss model for accounting for reinsurance receivables would need to be coordinated with potential changes to the risk-based capital model and potentially the Schedule F penalty.

- There is uncertainty as to current practice within the industry for estimating potentially uncollectible reinsurance, and the extent to which some insurers may already be using an ECL model.

We note that, following the February 20, 2018 public hearing on the Covered Agreement, the Financial Condition (E) Committee recommended adding a charge to the Working Group to:

- Review and possibly modify Schedule F and any corresponding annual financial statement pages to determine how best to reflect the expected changes to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786).

- Give due consideration to alternatives, including whether an allowance for doubtful accounts is appropriate.

Interested parties believe that clarity regarding the interaction of this charge and the work on the draft is needed before an evaluation of ECL can be considered by the Working Group and interested parties.

Although interested parties recommend that consideration of applying ECL concepts to the statutory accounting for reinsurance receivables be deferred, we believe that certain structural issues relevant to statutory accounting for reinsurance credit risk could be reviewed now for potential improvements, e.g., the interplay between the provision for reinsurance in SSAP No.

* * * *

Thank you for considering interested parties’ comments. We look forward to working with you and the Working Group on this topic. If you have any questions in the interim, please do not hesitate to contact either one of us.

Sincerely,

D. Keith Bell  
Rose Albrizio

cc: Julie Gann, NAIC staff  
Robin Marcotte, NAIC staff  
Interested parties
July 10, 2018

Dale Bruggeman  
Chair, Statutory Accounting Principles (E) Working Group  
National Association of Insurance Commissioners  
VIA Email Transmission: jgann@naic.org

RE: 2016-20 – FASB ASU 2016-13 Credit Losses

Dear Mr. Bruggeman:

The following comments are submitted on behalf of the member companies of the National Association of Mutual Insurance Companies regarding the Discussion Draft on FASB ASU 2016-13, Credit Losses dated March 24, 2018.

NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies representing 40 percent of the total market. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country’s largest national insurers. NAMIC member companies serve more than 170 million policyholders and write more than $253 billion in annual premiums. Our members account for 54 percent of homeowners, 43 percent of automobile, and 35 percent of the business insurance markets. Through our advocacy programs we promote public policy solutions that benefit NAMIC member companies and the policyholders they serve and foster greater understanding and recognition of the unique alignment of interests between management and policyholders of mutual companies.

The purpose of these comments is to respond to the Statutory Accounting Principles Working Group’s request for feedback on the Discussion Draft (DD) and specifically how NAMIC members view an Expected Credit Loss (ECL) model as it would apply to statutory accounting for reinsurance receivables. NAMIC supports the comment letter from Interested Parties as it relates to invested assets; therefore, the focus of these comments will be on reinsurance receivables, which we feel should be rejected and not deferred. While our focus is on reinsurance, it might be helpful to explain our overall position about why we propose to reject both the investment and reinsurance pieces of the proposal. Fundamental to our position is the interplay between the balance sheet and Risk-Based Capital. NAMIC members believe the balance sheet should not be used to project/estimate future credit losses, as the purpose of the balance sheet is to review the current financial condition of a company. RBC is a tool designed to consider prospective risks and to help regulators understand how a company’s financial condition may be impacted based on those future risks.

NAMIC members believe that the current incurred loss model for reinsurance receivables is more appropriate to statutory accounting and that an ECL model introduces complexity and uncertainty. Complexity is introduced when you consider how little data is available for companies to make their estimates. In addition, it becomes more complex as you consider the low probability of a credit event, which exacerbates the problem of not enough reliable data when it comes to credit default experience. Uncertainty is a concern for companies whenever you introduce something new that goes against a framework that has served the industry well for decades. That framework - regulatory accounting integrated with a capital measurement model that already addresses remote risk – is a model that works well and should not be altered.
Current statutory accounting already provides guidance for insurers on how to measure reinsurance receivables. The current framework includes guidance on how to measure for the collectability of reinsurance receivables under SSAP No. 5R – **Liabilities, Contingencies and Impairments of Assets**. In addition, there is guidance which provides for adjustments to surplus for uncollectible reinsurance receivables in the form of the Schedule F penalty. Schedule F is a straightforward formulaic calculation that is well understood by industry and is relatively easy to compute. NAMIC members submit that the incurred loss model is time tested and is supported by decades of historical experience.

To further support the measurements on the balance sheet and the adjustments to surplus, RBC addresses reinsurance credit risk in the form of a capital charge. Introducing additional balance sheet measurements without addressing the capital already set aside, results in double-counting of the credit risk for reinsurance receivables. The statutory accounting framework coupled with RBC produces a framework that is more conservative than GAAP reporting and results in a more reliable estimate.

The current incurred loss model is also more consistently applied across the industry than would be in an ECL model. An ECL model introduces more managerial judgement and therefore can lead to volatile swings in estimates from quarter to quarter. From a small company perspective this means more resources must be dedicated to calculating these estimates and explaining them to management and external parties. Introducing additional managerial judgement results in a less consistent framework and a more unreliable measurement.

Thank you for your consideration of these comments on this matter of importance to NAMIC, its member companies and their policyholders. If there are any questions, please feel free to contact me at 317-876-4206.

Sincerely,

[Signature]

Jonathan Rodgers  
Financial Regulatory Manager  
National Association of Mutual Insurance Companies
July 9, 2018

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Issue Paper Ref. #2016-20, Credit Losses

Dear Mr. Bruggeman:

The Allstate Corporation (“Allstate”) appreciates the opportunity to comment on the Statutory Accounting Principles Working Group (“SAPWG”) exposure, Issue Paper Ref. #2016-20, Credit Losses which proposes that certain aspects of FASB’s ASU 2016-13 (“CECL”) be considered for regulatory reporting. Allstate is the largest publicly held personal lines insurer in the U.S., offering both property-casualty (“P&C”) insurance and life insurance.

Allstate’s letter is primarily focused on responding to NAIC staff’s specific request for industry comments related to reinsurance receivables as requested in the excerpt from the exposure below:

“SAP specific ECL concepts for reinsurance receivables. NAIC staff recognizes that specific SAP consideration may need to occur for reinsurance receivables. Comments from industry are requested to begin this discussion.”

The draft comment letter from the Interested Parties with respect to the applicability of FASB’s CECL model to the statutory reporting and measurement of investment assets included in the scope refers to the integrated nature and suitability of the NAIC’s existing regulatory conceptual framework established to measure investment assets. Similarly, there is an existing framework for the reporting and measurement of reinsurance receivables which includes statutory accounting for the collectibility of reinsurance receivables under the reinsurance Statements of Statutory Accounting Principles (“SSAPs”), Annual Statement Instructions and SSAP 5R, Liabilities, Contingencies and Impairments of Assets. The statutory accounting framework includes surplus adjustments for reinsurance receivables related to non-collateralized, unauthorized reinsurance transactions and minimum reserves for uncollectible reinsurance derived from formulaic calculations applied to paid and unpaid reinsurance recoverables\(^1\) (excluding state or federally created residual market mechanisms) based on the timing and amounts of the recovery of paid losses\(^2\). In addition, the overall regulatory framework includes Risk Based Capital

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\(^1\) The terms reinsurance receivables and reinsurance recoverables are used interchangeably.

\(^2\) The statutory accounting framework for P&C reinsurance includes a formulaic calculation of minimum reserves for uncollectible reinsurance and permits reserves over the minimum amount to be recorded. The minimum reserve is calculated in Columns 1-10 of Schedule F, Part 7 and reported in total by reinsurer in Schedule F, Part 7 Column 11. Some insurers estimate uncollectible amounts based on historical experience and the notion that some level of credit losses in their portfolio of reinsurance receivables has been incurred. If the insurer’s calculation exceeds the minimum reserve required, insurers are permitted to recognize the additional amounts by reversing the accounts previously utilized to establish the reinsurance recoverable. Per the 2017 Annual Statement instructions, the higher amounts are to be entered in Schedule F Part 7, Column 11, however, some insurers prefer not to report the additional amounts by reinsurer in Schedule F and have raised this as an issue.
("RBC") formulas which capture remote credit risk related to paid and unpaid reinsurance receivables, an appropriate method for considering remote credit risk in a regulatory framework as compared to recognizing remote credit risk on the balance sheet through unreliable measurements.

Allstate recommends the NAIC retain the existing credit adjustment accounting framework in the reinsurance SSAPs, Annual Statement Instructions and SSAP 5R. Justification does not exist for replacing the existing framework which has evolved and improved over time by incorporating input from industry experts and regulators. The existing framework was developed in compliance with the conservatism principle which underpins regulatory reporting as well as a basic objective of allowing only reliable measurements to be included in statutory financial statements. The existing individual elements are working effectively to capture reinsurance counterparty credit risk.

The introduction of the expected loss model in U.S. GAAP reporting substantially increases the amount of management judgment involved in estimating credit losses. Introducing a significant amount of management judgment in measuring credit impairment would not improve the reliability of estimates of credit loss exposure attributable to reinsurance receivables. Under the existing incurred loss model, prior to recognizing a credit loss, an event must occur which is subject to independent substantiation to support a reliable estimate of loss. This is contrasted to the CECL model which requires no specific event or the breaching of any threshold before an allowance is recognized.

Evaluation of the collectibility of reinsurance receivables, including disputed, litigated and defaulted claims are unique as they relate to the insurance industry and due to the nature and remoteness of the credit risk, a lifetime loss model is not likely to produce a reliable output. A lifetime loss model is also not preferable over an incurred loss model which relies on actual facts and circumstances available at the time of the evaluation and future expectations that are “probable” to occur. Given that insurers manage reinsurance counterparties individually, the industry has adequate credit specific financial information from which to develop a reliable estimate of credit losses on an incurred basis.

**Summary of Position**

The CECL model does not produce measurements that more reliably reflect, as compared to the existing framework, the credit risk inherent in reinsurance receivables and should not be included in statutory accounting. The reporting of operating results under the CECL model would incorporate an unreliable estimate of credit risk in reinsurance receivables. Reinsurance is sufficiently different from lending activities, the activity for which CECL was designed, and should not be applied to reinsurance receivables.

A ceding company does not incur an economic loss on the day a reinsurance transaction is executed. The NAIC monitors the capital position of insurers through the RBC capital measurement process; the goal of regulators is to assure that policyholders are paid when an insurance event occurs. Insurers in the U.S. have additional protections through the availability of state sponsored pools of funds collected or through the states’ right to collect funds from other insurers through the Guaranty Fund Assessments mechanism.

Today’s incurred loss model appropriately reflects in the statement of financial performance losses related to reinsurance receivables that were incurred during the period and the allowance balance reflects an estimate of existing probable losses even if specific receivables have not yet been written down.
In contrast, the CECL model requires recognition of lifetime “expected” losses for reinsurance receivables before losses are incurred. Under the CECL model, actual credit deterioration is not reflected in the income statement in the period of that deterioration unless it differs from the previously determined estimates. Moreover, periodic loss provisions recognized in the income statement reflect expectations of future credit losses in the period of origination whereas changes in expectations are reflected in later periods. For the reinsurance receivables reflected in insurance industry financial statements, due to the subjectivity and estimation error underlying CECL estimates, we do not believe the CECL model would represent reliable, decision-useful information about credit losses on reinsurance receivables included in the statutory balance sheet.

**Overall Applicability of FASB’s CECL Model to Statutory Reporting**

Allstate’s position contained herein regarding the applicability of the CECL model to the measurement of reinsurance receivables for statutory reporting, together with Allstate’s full support of the industry’s positions included in comment letter from the Interested Parties with respect to the application of the CECL model to the measurement of investment assets, results in Allstate’s opposition to the consideration of FASB’s CECL model for statutory reporting in its entirety.

Kevin Spataro  
Senior Vice President, Corporate Accounting Research  
Ph: 847-402-0929

Copies to:  
DiAnn Behrens  
Director, Corporate Accounting Research  
Ph: 847-402-7036

Diane Bellas  
Director, Corporate Accounting Research  
Ph: 847-402-5732

Julie Gann, NAIC Staff

Robin Marcotte, NAIC Staff
July 31, 2018

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Issue Paper Ref. #2016-20, Credit Losses

Dear Mr. Bruggeman:

The Cincinnati Insurance Company (“Cincinnati”) appreciates the opportunity to provide comments on the Statutory Accounting Principles Working Group (“SAPWG”) exposure, Issue Paper Ref. #2016-20, Credit Losses (“the Issue Paper”). We understand that the official deadline for comments on the Issue Paper was July 9th, 2018; however, we are hopeful that the SAPWG is able to take our comments into consideration. Cincinnati’s property casualty group is among the 25 largest groups in the United States, based upon net written premium.

The Issue Paper contemplates incorporation of the FASB’s ASU 2016-13, Measurement of Credit Losses on Financial Instruments into the statutory accounting and reporting framework. The Issue Paper conceptually proposes following the FASB’s expected credit loss model for financial assets measured at amortized cost and following the FASB’s available-for-sale security impairment model for assets measured at fair value. Cincinnati’s comments will primarily focus on the application of the expected credit loss model to fixed income securities and reinsurance receivables.

Fixed Income Securities

The Issue Paper proposes that statutory accounting principles would follow US GAAP concepts related to application of the expected credit loss model to fixed income securities carried at amortized cost and an incurred loss model with establishment of an allowance for fixed income securities carried at fair value. Cincinnati believes that following the US GAAP model is not practicable within the statutory accounting and reporting framework for fixed income securities as the concept of classification of securities as held-to-maturity, available-for-sale and trading does not exist in statutory accounting.

Under US GAAP, the expected credit loss model would only apply to fixed income securities measured at amortized cost, which would be those securities classified as held-to-maturity. Fixed income securities measured at fair value and classified as available-for-sale would continue to be evaluated for impairment using an incurred loss model where an allowance for credit losses is established when a credit impairment has been incurred.

Cincinnati’s fixed income portfolio is classified as available-for-sale and measured at fair value for US GAAP reporting. Under the statutory reporting framework Cincinnati’s fixed income securities are carried at either amortized cost or fair value depending on the NAIC designation of the particular security. If the SAPWG were to adopt a model requiring application of an expected credit loss model to fixed income securities measured at amortized cost and an incurred loss model for those measured at fair value this would result in the same securities being measured for impairment under different models for statutory reporting and US GAAP reporting. This is counter to the notion that the proposed changes would better align statutory accounting and US GAAP.

Accordingly, Cincinnati believes that existing impairment models within SSAP 26R and SSAP 43R should be retained for fixed income securities as the models better align with the incurred loss model retained under US GAAP for available-for-sale securities.
Reinsurance Receivables

In the Issue Paper, NAIC staff requests feedback from industry related to the application of the expected credit loss model to reinsurance receivables (commonly referred to as reinsurance recoverables in practice).

Reinsurance recoverables fall within the scope of the FASB’s expected credit loss model as these are financial assets measured at amortized cost. Under this model, insurers are required to establish at inception an allowance for credit losses for reinsurance recoverables reflecting the insurers’ expectations of lifetime credit losses based upon historical experience, current conditions and reasonable and supportable forecasts of the future.

The current statutory accounting and reporting framework applies an incurred loss model in which reinsurance recoverable balances deemed uncollectible are written off through the accounts, exhibits and schedules in which they were initially recorded. Statutory accounting and reporting also incorporates concepts such as authorized, unauthorized and certified reinsurers, which requires application of provisions to offset credit taken for reinsurance when certain conditions are not met, minimum reserves for uncollectible reinsurance and a Risk-Based Capital framework that incorporates the credit risk of the reinsurance recoverables into the insurers’ capital requirements.

Cincinnati believes that the current statutory accounting framework related to recognition of credit losses for reinsurance recoverables should be retained as it results in more accurate recognition of credit losses. Historical credit loss experience related to reinsurers is insignificant and would not lend itself well to modeling an expectation of lifetime credit losses for a pool of reinsurance recoverables. More accurate loss recognition occurs when recoverables are evaluated on an individual basis when the facts and circumstances indicate that it is probable a credit loss has occurred. The Issue Paper alludes to the notion that if statutory accounting principles do not adopt an expected credit loss model then US GAAP would be more conservative. Cincinnati believes that when considering current safeguards in place to offset credit taken for reinsurance, collateral requirements for reinsurers, minimum reserves for uncollectible reinsurance and Risk-Based Capital requirements in conjunction with the incurred loss model, statutory accounting principles are sound and conservative.

In conclusion, Cincinnati believes that current statutory accounting principles pertaining to recognition of credit losses for fixed income securities and reinsurance recoverables should be retained. As it relates to fixed income securities, an expected loss model would create unnecessary differences between statutory accounting principles and US GAAP. Credit losses related to reinsurance recoverables are more accurately reflected using the existing model under statutory accounting principles whereas expected credit loss estimates would require significant management judgement.

Sincerely,

Theresa A. Hoffer
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