Capital Adequacy (E) Task Force

RBC Proposal Form

[X] Capital Adequacy (E) Task Force	[ ] Health RBC (E) Working Group	[X] Life RBC (E) Working Group
[ ] Catastrophe Risk (E) Subgroup	[ ] Investment RBC (E) Working Group	[ ] Operational Risk (E) Subgroup
[ ] C3 Phase II/ AG43 (E/A) Subgroup	[ ] P/C RBC (E) Working Group	[ ] Stress Testing (E) Subgroup

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Agenda Item # 2017-03-L-MOD

Year ____________

DISPOSITION

[X] ADOPTED 3-25-18

[ ] REJECTED

[ ] DEFERRED TO

[ ] REFERRED TO OTHER NAIC GROUP

[ ] EXPOSED

[ ] OTHER (SPECIFY)

IDENTIFICATION OF SOURCE AND FORM(S)/INSTRUCTIONS TO BE CHANGED

[ ] Health RBC Blanks	[ ] Property/Casualty RBC Blanks	[X] Life RBC Instructions
[X] Fraternal RBC Blanks	[ ] Health RBC Instructions	[ ] Property/Casualty RBC Instructions
[X] Life RBC Blanks	[X] Fraternal RBC Instructions	[ ] OTHER ______________

DESCRIPTION OF CHANGE(S)

Life RBC currently has a C-0 charge for collateral held for FHLB advances of 1.30% computed on LR017. ACLI proposes that this be changed to be 0 for the collateral equal to the amount advanced when that liability is part of C-3 modeling, and a factor based on the risk of the FHLB for any collateral in excess. The factor will be based on an NAIC 2 bond factor if the FHLB funded advance liabilities associated with funding agreement activities exceed 5% of total net admitted assets. Attached as Appendix B is a mark-up of LR017 and Appendix C outlines the instructions to show the specific changes needed.

REASON OR JUSTIFICATION FOR CHANGE **

A detailed description of this proposal and the background is included as Appendix A

This proposal is specific to Life RBC. Health and P&C insurers may be FHLB members, and the RBC formulas may have parallel issues for which a parallel change may be appropriate. This proposal also references where FHLB advances are included in the C-3 component, which is unique to Life RBC.

Additional Staff Comments:

- 01-27-17: Proposal was exposed for 45 days ending March 14, 2017 (DBF)
- 06-09-17: Exposed revised proposal for 45 days ending July 24, 2017 (DBF)
- 08-06-17: Discussed proposal and directed NAIC staff to provide requested report by 10-1-17 (DBF)
- 10-31-17: Re-exposed for comment on issues raised ending Nov. 22, 2017 (DBF)

- 12-18-17: Revised proposal to remove domiciliary authorization aspect (DBF)
- 3-1-18: Proposal adopted by the Life Risk-Based Capital (E) Working Group
- 3-24-18: Adopted Proposal modified for “funding agreements” as opposed to “spread lending”
- 3-25-18: Capital Adequacy (E) Task Force adopted at the Spring National Meeting.

**** This section must be completed on all forms.** **Revised 11-2013**

Federal Home Loan Bank Pledged Asset RBC Proposal

Executive Summary:

When an insurer obtains an advance from a Federal Home Loan Bank (FHLB), collateral is posted using assets from the insurer's balance sheet. The pledged assets remain on the insurer's balance sheet and generate an RBC amount based on the credit risk of that asset. The advance may be recorded as either borrowing (Liability, Page 3 Line 20) or as a Funding Agreement (Exhibit 7 – Deposit type contracts). It is generally included in the insurer's C-3 modeling to generate an RBC amount for asset – liability mismatch. Additionally, since these assets are classified as 'Non-controlled assets', there is an RBC factor of 1.3% applied to the collateral in addition to any other RBC amounts for those assets and liabilities.

This memo outlines a proposal that this 'Non-controlled assets' charge be revised in light of the risks and the other components of RBC. Specifically, we propose that for FHLB advances subject to C3P1 Cash Flow Testing, there be a factor of zero for the collateral up to the amount of the advance, and a factor for the excess collateral that is equal to the NAIC credit risk charge for FHLBs as counterparty . For advances which are not subject to C3P1 Cash Flow Testing, the NAIC FHLB credit risk based charge will be applied to the entire amount of pledged collateral supporting the advance. Additionally, excess assets held by a FHLB but not associated with a FHLB advance (i.e. assets above the required collateral amount and therefore available to be recalled by the insurer), do not present non-controlled asset risk and should be excluded from the C-0 RBC risk charge.

Collateral supporting certain FHLB funding agreement activities might be subject to a higher non-controlled asset charge. If the FHLB funded advance liabilities, associated with funding agreement activities is greater than 5% of total net admitted assets, collateral supporting FHLB funding agreements in excess of this 5% will receive a higher factor equal to the factor for an NAIC 2 Corporate Bond asset factor.

FHLBs and Insurance Companies

As participants in the mortgage investment industry, many insurance companies have formed a synergistic relationship with the FHLB. The companies can become members of their local FHLB after satisfying underwriting review, demonstrating housing and mortgage market involvement and support, and purchasing membership stock. As members, they have access to FHLB funding and other banking products and receive dividend returns on the stock. The FHLB system's mandate is to provide liquidity and promote stability in the mortgage industry by providing cost effective products to its members. As federally chartered, government-sponsored banking cooperatives, the FHLBs are able to access the capital markets at extremely favorable interest rates and are thus able to offer attractive rates to their members.

FHLB products provide insurers with a diversified low-cost form of funding, with flexible structuring terms to match their investment funding and capital structuring needs. The programs can be an important and stable source of liquidity for many life insurers even during uncertain economic times.

In order to keep funding costs for its members low, the FHLBs mitigate their overall credit risk by lending only on a secured basis. Members are required to pledge assets as collateral to secure their outstanding obligations. Given their specialized expertise in mortgage assets, the FHLBs can even accept as collateral life insurer commercial mortgage loans, which tend to be less liquid and not suitable for other collateral purposes. The collateral is managed, not as specific assets backing any single obligation, but rather as a substitutable collateral pool managed in aggregate. All beneficial interests (investment income, gains/losses on sales, etc) remain with insurers and the assets remain available for the insurers' use as long as the minimum collateral levels are sustained. These characteristics increase the insurer's liquidity by freeing up other assets for general liquidity purposes and diversifying its sources and uses of liquidity. Finally, advances from the FHLB are generally pre-payable.
It is beneficial to insurers' long-term economic strength as well as their short- and long- term liquidity, to be able to prudently utilize FHLB products, without punitive risk capital charges. The risk charges should recognize the relative risks inherent in the funding and the low counterparty risk of the FHLBs, as well as the pooled and unrestricted nature of the collateral pledged.

FHLBs are strong counterparties
The FHLB system was established in 1932 and has been making advances to savings and loans, banks, and insurance companies for over 80 years. Unlike commercial lenders that tend to restrict advances when faced with tight liquidity markets, the FHLBs, as government-sponsored enterprises (GSEs), maintain access to the global capital markets and are able to continue making advances to their members across business cycles. During the global liquidity crisis that peaked in 2008, insurance company members increased advances from $28.7 billion in 2007 to $54.9 billion in 2008.

FHLBs have implicit US government support, are regulated by the Federal Housing Finance Agency, and are highly rated by the rating agencies. The FHLBs also have a unique structure whereby its borrowers are also its stockholders, leading to a strong alignment of interests. The counterparty risk associated with pledging assets to the FHLBs is minimal.

Insurers' Usage of Federal Home Loan Bank (FHLB) Programs

In general, insurers use FHLB funding to provide funding for funding agreement purposes or to support general business operations. When used for funding agreement purposes, the liabilities are matched by a suitable portfolio of invested assets in order to earn a spread return as an integral part of its insurance business activities. The nature of these two activities is different, as was recognized by the NAIC Emerging Accounting Issues (E) Working Group when it issued INT 08-08[1].

SSAP 52 requires that funding used for funding agreement purposes is in substance similar to other insurance activities and should be treated as a funding agreement and reported in the statutory financial statements as an insurance liability whose activity is subject to risk management practices, such as asset-liability management and cash-flow testing adequacy. This is consistent with how rating agencies view

[1] This INT was subsequently nullified, and the guidance incorporates directly into SSAPs 15, 50, and 52.

FHLB funding agreements; rating agencies treat this form of funding as operating leverage rather than financial leverage. Since the primary risk for this use is the asset liability mismatch, which is being measured by the C-3 component of RBC, the 'non-controlled asset' RBC charge is an excess and redundant charge.

The FHLBs provide flexible structures that allow insurers to tailor the funding products to better match the characteristics of asset portfolios. Common structures range from overnight and short-term advances to term advances with maturities out to 15 years. Interest crediting options include adjustable rates, with periodic call options without prepayment penalty, or fixed rates with option to amortize. Certain FHLBs also allow for partial terminations of contracts. Such optionality is important to investors in mortgage related assets which often exhibit variability in cash flows.

SSAP 15 requires that when FHLB advances are used to support general business operations, it is in substance a form of debt financing and is required to be reported as borrowed money. Because these liabilities are not necessarily matched by a specific pool of assets, the risk of default may not be mitigated by the insurers' typical asset-liability management processes. Rather, repayment of the obligations depends on the residual cash flows of the insurer, like other forms of debt financing.

FHLB Programs can Enhance Financial Strength of Insurers

The prudent usage of FHLB products can enhance the immediate and on-going financial strength of the company, by providing low cost and flexible funding to match insurers' investment management and capital structuring needs. The rating agencies acknowledge this benefit in their reviews of insurer financial strength. See recent rating agency comments in the Appendix below. The annual statement disclosures help regulators and other financial statement users understand how an insurer is using and managing its FHLB business. Even if the insurer enters rehabilitation, the FHLBs have demonstrated in the past a willingness to work with the insurers and rehabilitators, to reach a successful outcome that involved no loss to either the guaranty association or the FHLB in connection with the insurers' obligations.

Multiple-tier Risk Based Capital (RBC) structure

FHLB obligations, and the associated collateral, generate RBC amounts in three different parts of the RBC formula.

Assets that are pledged as collateral remain as part of the insurer's balance sheet and are assessed an RBC charge for C-1 asset risk. The fact that the assets are pledged as collateral does not remove them from this requirement, and the insurer continues to have the risk of a reduction in value of these assets.

Risks associated with specific liability characteristics and asset-liability mismatches flow through the C-3 risk charges and the associated C3P1 scenario analyses usually in the following categories:

- Deposit-Type Contract liabilities based the risk classification of each liability: 77-115 bps (low risk); 154-231 bps (medium risk); 308-462 bps (high risk)

- Debt with GIC-like characteristics: 308-462 bps (high risk)

The assets pledged as collateral are also reported as a non-controlled asset within General Interrogatory 25, and they receive an additional 1.30% RBC charge similar to many other non-controlled asset items.

However most other items reported through Interrogatory 25, such as assets loaned to others under securities lending programs, repurchase and reverse repurchase agreements, are not necessarily subject to the C-3 risk charges or asset-liability risk management practices discussed above, do not allow the insurer to freely substitute the collateral, do not provide options to prepay the liabilities to release the collateral or do not have a GSE quality counterparty.

Certain categories of non-controlled assets do receive a lower RBC charge. Securities lending programs that conform to appropriate operational and investment risk guidelines are assessed a 0.2% 'non-controlled asset' risk charge. The guidelines for conforming programs recognize that such programs are designed to match the liabilities with a suitable portfolio of invested assets. The lower charge reflects the reduction in risk to the pledged assets from risk of default on the securities lending transactions. In another example, assets pledged under the federal TALF program receive a zero 'non-controlled asset' risk charge.

Certain rating agencies have recognized the relatively lower risks for assets pledged in support of FHLB advances. S&P's capital model has a non-controlled asset risk charge but assets pledged as collateral to the FHLB are specifically excluded from that charge.

Assessing a high risk charge of 1.3% on FHLB pledged assets makes it more costly for insurers to access this low cost and flexible funding source and constrains their sources of liquidity by forcing them to move away from pledging more illiquid assets with higher haircuts and creating competition for uses of liquid assets.

For <u>FHLB advances that are subject to C-3 Phase 1 Cash Flow Testing, the risk </u>is already assessed for risk through the C-3 risk charges up to the liability amount. Therefore, we propose that the pledged collateral equal to the FHLB advance have a C-0 RBC factor of zero. An argument can be made that any pledged collateral in excess of the FHLB advance does have additional risk based on the credit standing of the FHLB that is holding the collateral. We propose that this overcollateralization amount be assessed a C-0 RBC factor based on the credit standing of the FHLB. For <u>FHLB advances that are not subject to C-3 Phase 1 Cash Flow Testing, the full amount of pledged collateral associated would receive a C-0 RBC factor based on the credit standing of the FHLB.</u> <u>Excess assets held by a FHLB but not associated with a FHLB advance (i.e. assets above the required collateral amount and therefore available to be recalled by the insurer), do not present non-controlled asset risk and should be excluded from the C-0 RBC risk charge</u>.

Collateral supporting certain FHLB funding agreement activities might be subject to a higher non-controlled asset charge. If the <u>FHLB funded advance liabilities, associated with funding agreement activities is greater than 5% of total net admitted assets, collateral supporting FHLB funding agreements</u>

in excess of this 5% will receive a higher factor equal to the factor for an NAIC 2 Corporate Bond asset factor.

Other "Non-controlled Assets"

To understand the context of this proposal, discussion of RBC for non-controlled assets was raised at the NAIC Capital Adequacy Task Force in October of 2012. Based on a regulatory review of insurer balance sheets, concern was expressed about companies having excessive amounts of restricted or non-controlled assets. Industry has worked with regulators and several actions have occurred.

- The NAIC established a working group under SAPWG to design additional disclosures about non-controlled assets. These resulted in the Interrogatory 25 disclosures discussed above.
- Information was provided regarding the non-controlled assets relating to reinsurance, and why such arrangements did not create any additional risk
- Educational material has been developed and presented to regulators about the repurchase and reverse repurchase agreements.
- RBC for collateral on conforming Securities Lending programs was revised to 20 bps
- ACLI identified FHLB collateral as an issue of concern and has worked with its members to develop this proposal

Other NAIC activity

We also recommend that Life RBC consider 3 referrals to create a complete regulatory oversight framework.

1. Provide a referral to the Financial Examiners to consider questions specific to the insurance company's risk management of its FHLB Program in the Examiners Handbook to ensure review during examinations,
2. Provide a referral to LATF to consider clarifying the guidance for the Actuarial Memorandum to address how the Appointed Actuary is comfortable with the risk profile of the FHLB advance Program as a component of the Company's broader funding agreement business, and
3. That the Capital markets Bureau (or other staff) of the NAIC annually produce a report on the overall amount of FHLB Funding agreement activity using information from Annual Statement Notes to Financial Statement, Note 11.B.(4) a.1. row b col. 1.

Appendix: Rating Agency comments on Insurers' FHLB membership

Moody's Investor Service, Sector Comment, June 25, 2015
"Insurers' Access to Federal Home Loan Banks Lending Capacity is Credit Positive"

"» Access to an alternative, low-cost funding source is credit positive. The FHLBs offer eligible insurers access to low-cost, collateralized borrowing capacity for both their ordinary operating needs and emergency liquidity. This availability is credit positive for insurers when traditional bank credit facilities and the capital markets are no longer available, are unfavorable, or are tapped out. The ability to use less-liquid mortgage related assets on the balance sheet as collateral reduces potential pressure on operating liquidity.
» Injudicious or excessive use of FHLB borrowing is credit negative - Poorly duration and/or cash-matched assets against FHLB advances (i.e., for acquisitions or funding agreements) and/or borrowing that materially increases a company's financial leverage or credit risk will increase the insurer's risk profile. In addition, because secured obligations to the FHLB structurally subordinate unsecured policyholders, these borrowings could put downward pressure on a company's ratings if they become too sizable relative to total policyholder liabilities. However, we do not expect this to happen."

Fitch Ratings Special Report, June 12, 2013
"FHLB's Growing Role in the U.S. Life Insurance Industry"

"Membership in the Federal Home Loan Bank (FHLB) system can enhance liquidity and financial flexibility for insurance companies, particularly those insurers with limited access to capital markets, according to a new report by Fitch Ratings. Further, many life insurers can make use of FHLB advances (loans) as a reasonable low cost source of funds to produce spread income, if done in a controlled manner."

A.M. Best's Ratings Methodology, January 12, 2012
"A.M. Best's Perspective on Operating Leverage"

"FHLB programs provide financial flexibility for insurance company members and are an attractive source of capital due to the low rate offered for advances."

S&P Ratings Direct, May 15, 2013
"How Federal Home Loan Bank Funding Figures in Ratings on Insurers"

"All else being equal, a company that prudently manages its capital structure, investments underwriting, and risk management can enhance its financial flexibility from FHLB capital funding"

"We believe the FHLB will be able to meet members' borrowing needs during the next market dislocation, providing relatively inexpensive funding for illiquid assets when members have few funding alternatives… in our view, pledged liquid assets would damage the stressed liquidity ratio, whereas pledged illiquid assets do not harm the stressed ratio."

OFF-BALANCE SHEET AND OTHER ITEMS

			(1)	(2)	(3)		(4)		(5)	(6)
		Annual Statement Source	Statement Value	Less Noncontrolled Assets Funding Guaranteed Separate Accounts, Synthetic GIC's and certain FHLB Liabilities	Subtotal		Factor		RBC Requirement	Yes/No Response
	Noncontrolled Assets									
(1)	Loaned to Others - Conforming Securities Lending Program	General Interrogatories Part 1 Line 24.05				X	0.002	=		
(2)	Loaned to Others - Securities Lending Programs - Other	General Interrogatories Part 1 Line 24.06				X	0.013	=		
(3)	Subject to Repurchase Agreements	General Interrogatories Part 1 Line 25.21				X	0.013	=		
(4)	Subject to Reverse Repurchase Agreements	General Interrogatories Part 1 Line 25.22				X	0.013	=		
(5)	Subject to Dollar Repurchase Agreements	General Interrogatories Part 1 Line 25.23				X	0.013	=		
(6)	Subject to Reverse Dollar Repurchase Agreements	General Interrogatories Part 1 Line 25.24				X	0.013	=		
(7)	Placed Under Option Agreements	General Interrogatories Part 1 Line 25.25				X	0.013	=		
(8)	Letter Stock or Other Securities Restricted as to sale - excluding FHLB Capital Stock	General Interrogatories Part 1 Line 25.26				X	0.013	=		
(9)	FHLB Capital Stock	General Interrogatories Part 1				X	0.013	=		

		Line 25.27								
(10)	**On Deposit with States**	**General Interrogatories Part 1 Line 25.28**					**X**	**0.013**	**=**	
(11)	**On Deposit with Other Regulatory Bodies**	**General Interrogatories Part 1 Line 25.29**					**X**	**0.013**	**=**	
(12.1)	**Pledged as Collateral - excluding Collateral Pledged to an FHLB**	**General Interrogatories Part 1 Line 25.30**								
(12.2)	**Less Derivative Collateral Pledged**	**Schedule DB Part D Section 2 Column 7, Line 0199999**					**X**	**0.004**	**=**	
(12.3)	**Pledged as Collateral - excluding Collateral Pledged to an FHLB Less Derivatives Collateral Pledged**	**Line (12.1) - (12.2)**					**X**	**0.013**	**=**	
(13)	**Pledged as Collateral to FHLB**	**General Interrogatories Part 1 Line 25.31**			†		**X**	**0□**	**=**	
(14)	**Other**	**General Interrogatories Part 1 Line 25.32**					**X**	**0.013**	**=**	
(15)	**Total Noncontrolled Assets**	**Sum of Lines (1) through (11) Plus Lines (12.3) through (14)**								
	<u>Derivative Instruments</u>									
(16)	**Exchange Traded and Centrally Cleared**	**Schedule DB Part D Section 1 Column 12, Line 0999999, in part**					**X**	**0.004**	**=**	
(17)	**Off-Balance Sheet Exposure NAIC 1**	**Schedule DB Part D Section 1 Column 12, Line 0999999, in part**					**X**	**0.004**	**=**	
(18)	**Off-Balance Sheet Exposure NAIC 2**	**Schedule DB Part D Section 1 Column 12, Line 0999999, in part**					**X**	**0.013**	**=**	
(19)	**Off-Balance Sheet Exposure NAIC 3**	**Schedule DB Part D Section 1 Column 12, Line 0999999, in part**					**X**	**0.046**	**=**	
(20)	**Off-Balance Sheet Exposure NAIC 4**	**Schedule DB Part D Section 1 Column 12, Line 0999999, in part**					**X**	**0.100**	**=**	
(21)	**Off-Balance Sheet Exposure NAIC 5**	**Schedule DB Part D Section 1 Column 12, Line 0999999, in part**					**X**	**0.230**	**=**	
(22)	**Off-Balance Sheet Exposure NAIC 6**	**Schedule DB Part D Section 1 Column 12, Line 0999999, in part**					**X**	**0.300**	**=**	
(23)	**Total Derivative Instruments Off-Balance Sheet Exposure**	**Sum of Lines (16) through (22)**								

(24)	Guarantees for Affiliates	Notes to Financial Statements Number 14A3c1			X	0.013	=
(25)	Contingent Liabilities	Notes to Financial Statements Number 14A1			X	0.013	=
(26)	Long Term Leases	Notes to Financial Statements Number 15A2a1			X	0.000	=
(27)	Total Off-Balance Sheet Items (pre-MODCO/Funds Withheld)	Lines (15) + (23) + (24) + (25) + (26)					
(28)	Reduction in RBC for MODCO/Funds Withheld Reinsurance Ceded Agreements	Company Records (enter a pre-tax amount)					
(29)	Increase in RBC for MODCO/Funds Withheld Reinsurance Assumed Agreements	Company Records (enter a pre-tax amount)					
(30)	Total Off-Balance Sheet Items (including MODCO/Funds Withheld.)	Lines (27) - (28) + (29)					
	<u>Other Items</u>						
(31)	Is the entity responsible for filing the U.S. Federal income tax return for the reporting insurer a regulated insurance company?	"Yes", "No" or "N/A" in Column (6)					
(32)	SSAP No. 101 Paragraph 11a Deferred Tax Assets	Notes to Financial Statements Item 9A2(a)			X	‡	=
(33)	SSAP No. 101 Paragraph 11b Deferred Tax Assets	Notes to Financial Statements Item 9A2(b)			X	0.010	=
(34)	Total Off-Balance Sheet and Other Items	Line (30) + Line (32) + Line (33)					

† For Line (13), include assets pledged as collateral other than assets related to the Federal Reserve's Term Asset Loan Facility (TALF). For Column (2) include excess assets held by a FHLB but not associated with a FHLB advance (i.e. assets above the required collateral amount and therefore available to be recalled by the insurer). . For Column (2) also

include an amount equal to the lessor of Statement Value of FHLB liabilities subject to C3P1 Cash Flow Testing or 5% of total net admitted assets.
If Line (31) Column (6) is "Yes", then the factor is 0.005. If Line (31) Column (6) is "No", then the factor is 0.010. If Line (31) Column (6) is "N/A", then the
‡ **factor is 0.000.**
In most instances, apply a factor based on the NAIC ratings category equivalent to an unsecured debt obligation of the FHLB. A higher factor applies if FHLB funded advance liabilities associated with funding agreement activities exceed 5% of total net admitted assets. This higher factor shall equal the factor for an NAIC 2 corporate bond asset factor (Line 14 Column 4). If the higher factor is applicable, the blended factor for column 4 shall be prorated based on the collateral in column 3 subject to the typical factor (i.e. liquidity and funding agreements below the limit) and the higher factor (only funding
agreements above the limit).

OFF-BALANCE SHEET AND OTHER ITEMS

LR017

Basis of Factors

The potential for risk exists in off-balance sheet items. For items other than derivative instruments and assets pledged as collateral to the Federal Home Loan Bank, a 1.3 percent factor was chosen on a judgment basis. The 1.3 percent pre-tax factor will differentiate between the companies that have small and large exposures to this risk. Since there is no firm actuarial basis for assigning the 1.3 percent pre-tax factor to these risks, off-balance sheet items are included in the sensitivity analysis using a factor of 3 percent, and leases are added as an additional off-balance sheet item. For securities lending programs, a reduced charge may apply to certain programs that meet the criteria as outlined below.

For assets pledged as collateral on funded Federal Home Loan Bank (FHLB) liabilities included in the C3 Phase 1 Cash Flow Testing, the C3 calculation already provides adequate provision for potential risks up to the Statement Value of the associated FHLB liabilities tested therein. For any excess of assets pledged as collateral above this Statement Value (FHLB liabilities included in C3 Phase 1 Cash Flow Testing) the potential exposure is proportionate to the credit risk assessed for the FHLB counterparty, making the bond factor associated with the NAIC designation assigned to the FHLB an appropriate risk provision. For FHLB advances that are not subject to the C3 Phase 1 Cash Flow Testing, the full amount of pledged collateral supporting those advances shall receive a C-0 RBC factor based on the credit standing of the FHLB. Excess assets held by a FHLB but not associated with a FHLB advance (i.e. assets above the required collateral amount and therefore available to be recalled by the insurer), do not present non-controlled asset risk and should be excluded.

Collateral supporting certain FHLB funding agreement activities might be subject to a higher non-controlled asset charge. If the amount of FHLB funded liabilities associated with funding agreement activities is greater than 5% of the company's total net admitted assets, the full amount of pledged collateral supporting FHLB funding agreements in excess of this 5% will receive a higher factor equal to the factor for an NAIC 2 Corporate Bond asset factor.

For derivative instruments, the book/adjusted carrying value exposure net of collateral (the balance sheet exposure) is included under miscellaneous C-1o risks. Because collars, swaps, forwards and futures can have book/adjusted carrying values that are positive, zero or negative, the potential exposure to default by the counterparty or exchange for these instruments cannot be measured by the book/adjusted carrying values. Schedule DB, therefore, includes a calculation of the potential exposure that is based on the March 1987 research paper "Potential Credit Exposure on Interest Rate and Foreign Exchange Rate Related Instruments," supporting the 1988 Bank of International Settlements framework for banks. The off-balance sheet exposure (Schedule DB, Part D, Section 1, Column 12) will measure this potential exposure for risk-based capital purposes. The factors applied to the derivatives off-balance sheet exposure are the same as those applied to bonds.

Specific Instructions for Application of the Formula

<u>Column (2)</u>
Assets directly funding guaranteed separate accounts or synthetic GIC contracts should be excluded from the noncontrolled assets computation.

Line (1)

Securities lending programs that have all of the following elements are eligible for a lower off-balance sheet charge:

1. A written plan adopted by the Board of Directors that outlines the extent to which the insurer can engage in securities lending activities and how cash collateral received will be invested.
2. Written operational procedures to monitor and control the risks associated with securities lending. Safeguards to be addressed should, at a minimum, provide assurance of the following:
   a. Documented investment guidelines, including, where applicable, those between lender and investment manager with established procedure for review of compliance.
   b. Investment guidelines for cash collateral that clearly delineate liquidity, diversification, credit quality, and average life/duration requirements.
   c. Approved borrower lists and loan limits to allow for adequate diversification.
   d. Holding excess collateral with margin percentages in line with industry standards, which are currently 102% (or 105% for cross currency loans).
   e. Daily mark-to-market of lent securities and obtaining additional collateral needed to ensure that collateral at all times exceeds the value of the loans to maintain margin of 102% of market.
   f. Not subject to any automatic stay in bankruptcy and may be closed out and terminated immediately upon the bankruptcy of any party.
3. A binding securities lending agreement (standard "Master Lending Agreement" from Securities Industry and Financial Markets Association) is in writing between the insurer, or its agent on behalf of the insurer, and the borrowers.
4. Acceptable collateral is defined as cash, cash equivalents, direct obligations of, or securities that are fully guaranteed as to principal and interest by, the government of the United States or any agency of the United States, or by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation and NAIC 1-designated securities. Affiliate-issued collateral would not be deemed acceptable. In all cases the collateral held must be permitted investments in the state of domicile for the respective insurer.

   Collateral included in General Interrogatories, Part 1, Line 24.05 of the annual statement should be included on Line (1).

Line (2)

Collateral from all other securities lending programs should be reported General Interrogatories, Part 1, Line 24.06 and included in Line (2).

Lines (3) through (14)

Noncontrolled assets are the amount of all assets not exclusively under the control of the company, or assets that have been sold or transferred subject to a put option contract currently in force. For Line (12.1) and (13) include assets pledged as collateral reported in the General Interrogatories Part 1 Line 25.30 and 25.31 other than assets related to the Federal Reserve's Term Asset Loan Facility (TALF). For Line (12.2), include all collateral pledged, both cash and securities, to derivative counterparties and/or central clearinghouses for initial margin and variation margin. In addition, include securities collateral pledged as initial margin for futures. Line (12.2) should agree to Schedule DB Part D Section 2 Column 7, Line 0199999. Line (12.3) should equal Line (12.1) minus Line (12.2). For Line (13) column 2 include excess assets held by a FHLB but not associated with a FHLB advance (i.e. assets above the required collateral amount and therefore available to be recalled by the insurer). For Line (13) column 2 also include an amount equal to the lessor of Statement Value of FHLB liabilities subject to C3P1 Cash Flow Testing or 5% of total net admitted assets. For Line (13) column (4), the Factor will be manually input. In most instances, the Factor will be based on the NAIC ratings category equivalent to an unsecured debt obligation of the FHLB. A higher factor applies if FHLB funded advance liabilities associated with funding agreement activities exceed 5% of total net admitted assets. If the higher factor is applicable, the Factor for column 4 is calculated as a blended factor prorated such that collateral in column 3 supporting FHLB funding agreement liabilities in excess of the limit is subject to the factor for an NAIC 2 corporate bond (Line 14 Column 4). All other collateral in column 3 is subject to the factor based on the NAIC ratings category equivalent to an unsecured debt obligation of the FHLB.

Lines (16) through (23)

The off-balance sheet exposure for derivative instruments reported on Schedule DB, Part D, Section 1, Column 12, Lines 0199999 through 0899999. Off-balance sheet exposure is reported for aggregate exchange traded derivatives, OTC – bilateral derivatives aggregated by counterparty brought into each individual NAIC designation 1-6, and aggregated centrally cleared derivatives. For 2015, derivative balances subject to central clearing are to be included in Line (16) regardless of the category they are included in for Schedule DB, Part D, Section 1.

Line (24)

Guarantees for affiliates include guarantees for the benefit of an affiliate that result in a material[†] contingent exposure of the company's assets to liability.

Line (26)

The exposure amount for long-term leases is the annual rental amount of all leases that could have a material[†] financial effect. If the rent expense is shared with affiliates, it should be allocated by company.

Line (31)

"Yes" means the entity which files the US Federal income tax return which includes the reporting entity is a regulated insurance company (including where the reporting entity is the direct filer of the tax return). "No" means the entity which files the US Federal income tax return which includes the reporting entity is not a regulated insurance company (e.g. a non-insurance entity or holding company makes the filing). "N/A" means the entity is exempt from filing a US federal income tax return; lines (32) and (33) should be zero in this case.

Lines (32) and (33)

Apply a one-percent (1%) charge in the RBC formula, placed outside of the covariance adjustment, to admitted adjusted gross deferred tax assets (DTAs) as described in SSAP No. 101, paragraphs 11a and 11b (lesser of paragraph 11b(i) and 11b(ii)). For the period for which the paragraph 11a component is determined, the charge is reduced to one-half percent (0.5%) when the insurance company either filed its own separate Federal income tax return or it was included in a consolidated Federal income tax of which the common parent is an insurance company. The source for the DTA amounts to use in the calculation is found in the Annual Statement, Notes to Financial Statements, Note 9, Part A, Section 2, Admission Calculation Components for SSAP No. 101. Paragraph 11a is found in Section 2, subpart (a), Paragraph 11b is found in Section 2, subpart (b).

[†] The definition of "material" exposure or financial effect is the same as for annual statement disclosure requirements.