

Viewpoint

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New Year, New Challenges: Issues Insurance Companies Should Consider in 2021

By Cindy Beaulieu, Managing Director and Chair of Conning's Investment Policy Committee

Insurance companies have many more questions than answers as they prepare for a new year. The Biden administration is expected to develop a more demanding regulatory environment, but the nature of those changes is still unknown.

While the market turmoil of 2020 was nearly unprecedented, 2021 is expected to pose its own (if less dramatic) challenges. Conning has gathered a list of regulatory and other issues that may be lurking in the year ahead for insurance companies and institutional investors. We also share our thoughts on how we are managing some of these challenges so we can help our insurance clients navigate potential issues.



Environmental, Social and Governance (ESG)

Increasing pressure from regulatory agencies, particularly in the states of California and New York, will drive interest in ESG investing for U.S. insurers. Conning's view is that the integration of ESG risk factors into the investment process serves insurance and pension clients' long-term investment needs. Determining the long-term sustainability of an issuer's business model is paramount, and ESG risk factors contribute to a robust, holistic assessment.

We maintain independent ESG opinions on a large and growing constituent of corporate holdings and incorporate ESG considerations into the traditional credit research process. Conning received an 'A+' score for its overarching approach to ESG Strategy and Governance in its 2020 Assessment Report from the UN Principles for Responsible Investment (PRI). Conning has been a signatory to the UN Principles since 2012.*



NAIC Risk-Based Capital (RBC) Potential Changes

The NAIC has expanded the RBC categories to 20 from six¹ as it attempts to take a more granular approach based on Certified Rating Providers' (CRPs) bond ratings. Insurers that filed their 2020 annual statement electronically have seen the expanded list of categories, but the new charges for each category have not yet been approved. This new method is likely to result in higher RBC charges (a component of R1) for bond portfolios, especially those with lower rated investments.

The size factors (another component of R1 and used to measure diversity) are also changing and will generally create higher RBC charges for less diverse portfolios. The covariance adjustment will soften the impact somewhat and the R2-R5 assessments will still be a large driver of the overall RBC charge. Nonetheless, these changes may create a desire to move portfolio credit quality higher, despite the low-rate environment, and increase the need for portfolio diversity.



Potential for Corporate Tax Reform

The Biden administration has signaled an interest in higher tax rates on corporations. This has added increased consideration of gain/loss management in client portfolios and potentially a change in preference for tax-exempt rather than taxable income. The lower corporate tax rates that were introduced in 2017 had a significant impact on property-casualty (P/C) insurers' interest in municipal bonds because it reduced the tax-equivalent yield by reducing the multiplier to make tax-exempt yields comparable to taxable bond yields.

Conning believes some changes to the 2017 tax bill could include increasing the corporate tax rate to 28%-31%, eliminating or raising the state and local tax (SALT) cap, restoring the alternative minimum tax to 2017 income levels, and reinstating tax-exempt advance refundings.

The increased corporate tax would make tax-exempt municipal bonds more attractive by raising the multiplier. Higher corporate taxes (e.g., from 21% to 28%) would take a regular rate-paying P/C company multiplier from 1.20 to 1.32, provided proration is adjusted to maintain an effective tax rate of 5.25%. That would equate to an additional 10 basis points on the gross up of a 10-year raw exempt yield using today's yield. Tax increases on high income tax brackets are likely during budget reconciliation, which could also increase demand for tax-exempt municipal bonds. Eliminating or increasing the SALT cap may be a positive for some states as it will increase their ability to raise taxes.

[LIBOR Transition](#)

Industry groups and regulators in different segments of the market are discouraging the use of LIBOR (used to determine rates in floating-rate investment such as CLOs) in new issues and are seeking proper transition processes.² Governor Cuomo has proposed legislation as part of his 2021 budget proposal that would use New York law to help smooth the process.³ The Secured Overnight Financing Rate (SOFR) is the index with which regulators would like to replace LIBOR, but market activity in SOFR has been limited to date and a term-rate SOFR has yet to materialize. Regulators are considering allowing three-month and longer LIBOR contracts to continue until mid-2023 to allow for the majority of contracts to expire naturally.⁴

[China Military-Related Issues](#)

The Office of Foreign Assets Control of the U.S. Department of the Treasury has published a list of companies with significant Chinese military involvement. U.S. investors are prohibited from transacting in securities of those companies and must divest existing ownership of such securities by November 11, 2021.⁵ Conning's compliance system now prevents the purchase of such securities by client accounts.

[CECL \(Current Expected Credit Losses\) Implementation](#)

Conning has been identifying securities with large spread movements relative to their benchmark for CECL analysis for more than a year. Many of our clients use our CECL analysis in addition to their traditional OTTI evaluation process to identify issues to review. Through our screening process, items are identified for further review and are submitted to our clients along with a detailed credit analysis. Our clients use this information to determine the need for and amount of reserves for a security.

[Multiple New Fiduciary Standards](#)

In Conning's opinion, insurers, especially annuity insurers, will face a stricter distribution environment because of federal and state fiduciary and suitability rules in 2021. We believe insurers will need to make sure their sales practices and compensation systems now meet the DOL's new fiduciary rule, the SEC's Regulation Best Interest, more commonly known as "Reg BI," and the NAIC's revised annuity suitability model law. It is also our opinion that these new rules may accelerate the shift in traditional distribution from a transaction-based approach to a consultative-based approach and insurers may need to adapt compensation to match a changing distribution landscape.

[Statutory Accounting Guidance for Tender Offers](#)

Effective January 1, 2021, the NAIC's new statutory accounting guidance for tender transactions, found in SSAP No. 26R, is to treat them the same as call transactions.⁶ The adopted calculation is:

Realized Gain / Loss = Difference between Par and Book Adjusted Carry Value

Investment Income = Consideration Received Less Par Value



Exchange Traded Funds (ETFs)

Exchange Traded Funds (ETFs) that consist of a combination of bonds and preferred stocks can receive preferred stock treatment; they can be reported on Schedule D Part 2 Section 1 and reserved at the designation assigned by the NAIC's Security Valuation Office (SVO) instead of being reported and reserved for as common stock (Schedule D Part 2 Section 2).⁷

Conning continues to look for opportunities and ideas to enhance risk-adjusted returns for insurers' portfolios. If there is any aspect of any of the above issues that we can help you work through, we are more than happy to connect you with our experts.



Cindy Beaulieu, is a Managing Director and Portfolio Manager, responsible for insurance and institutional pension assets. She is chair of the firm's Investment Policy and Investment Risk Committees. She has held positions of increasing responsibility during her tenure, from trading all sectors of the fixed income market to analyzing foreign investment opportunities. Prior to joining Conning in 2011, Ms. Beaulieu was a managing director and senior portfolio manager with Goodwin Capital Advisers. Ms. Beaulieu earned a degree in finance from LaSalle University.

RELATED CONTENT

Conning & PRI's Commitment to ESG Investing for Insurers - Matt Daly, Head of & Corporate and Municipal Teams, and Principles for Responsible Investing (PRI) outline the ESG investing issues facing U.S. insurers and how Conning and PRI are addressing their needs.

Conning ConnText Podcast: Quarterly Investment Outlook - In the *Conning ConnText* podcast, Rich Sega, Global Chief Investment Strategist, offers his views on investment and capital markets as we start 2021 and the potential impact of a new political landscape. He is joined by Cindy Beaulieu, chair of Conning's Investment Policy Committee, who discusses the impact for managing client portfolios.

ABOUT CONNING

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including insurers and pension plans, with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

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FOOTNOTES

¹ National Association of Insurance Commissioners © 2020, Credit Rating Providers – Generic Rating Symbol Mapping (*),

<https://content.naic.org/sites/default/files/inline-files/Master%20NAIC%20Designation%20and%20Category%20grid%20-%202020.pdf>

² The Board of Governors of the Federal Reserve System, "Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Statement on LIBOR Transition," <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf>, (November 30, 2020).

³ New York State Division of the Budget "FY 2022 New York State Executive Budget; Transportation, Economic Development and Environmental Conservation/ Article VII Legislation," page 233; <https://www.budget.ny.gov/pubs/archive/fy22/ex/artvii/ted-bill.pdf>

⁴ Intercontinental Exchange (ICE), Inc., "ICE Benchmark Administration to Consult on Its Intention to Cease the Publication of One Week and Two Month USD LIBOR Settings at End-December 2021, and the Remaining USD LIBOR Settings at End-June 2023" press release, November 30, 2020; <https://ir.theice.com/press/news-details/2020/ICE-Benchmark-Administration-to-Consult-on-Its-Intention-to-Cease-the-Publication-of-One-Week-and-Two-Month-USD-LIBOR-Settings-at-End-December-2021-and-the-Remaining-USD-LIBOR-Settings-at-End-June-2023/default.aspx>

⁵ U.S. Securities and Exchange Commission (2012). <https://www.sec.gov/files/risk-alert-securities-investments-finance-communist-chinese-military-companies.pdf>

⁶ National Association of Insurance Commissioners, *Accounting Practice and Procedural Manual*, reference # 2020-02, adopted effective January 1, 2021

⁷ National Association of Insurance Commissioners, Investment Analysis Office, *Purposes and Procedures Manual*, Valuation of Securities [E] Task Force amendment adopted September 29, 2020

* <https://www.unpri.org/transparency-reports-2019/4506.article>