May 24, 2023

INSURANCE INSIGHTS | MACRO STRATEGY

The Challenges of Interest Maintenance Reserve (IMR)

Discussion

Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with Jingsu Pu, Global Head of Insurance Strategy and Solutions at MIM, to discuss the important changes regarding Interest Maintenance Reserve (IMR) that the insurance industry, the National Association of Insurance Commissioners (NAIC) and state regulators are all focusing on. Jingsu will help explain what IMR is and how it can or should be used.

Guy: Maybe I should start by simply asking what is Interest Maintenance Reserve (IMR)?

Jingsu: It's a reserve held according to standard statutory accounting principles to deal with fluctuations in interest rates. As a special investment-related reserve, it is used by insurance companies to protect and manage capital, surplus, statutory earnings and dividend-paying capabilities from interest-rate fluctuations. It is a key statistic and capital management metric for insurance companies.

IMR should be consistent with the goals and objectives of all other solvency regulations. For example, risk-based capital requirements have similar goals and impacts. Regulators, after

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all, are charged with ensuring that insurance companies can fulfill their financial obligation to policyholders.

Guy: ***If the purpose of the reserve funds is to deal with gain and loss, particularly losses occurred as a result of the dramatic rise in interest rates since 2022, then are the reserve funds getting drawn down?***

Jingsu: As a result of rapidly rising interest rates, companies have repositioned their portfolios for higher yields by selling fixed-income assets at a loss, resulting in IMR balances decreasing or even becoming negative. One big issue arising from having negative IMR is that we have not had rapid interest-rate increases in 40 years. Some parts of the insurance regulations are not structured to deal with the sea change in interest rates. Current statutory accounting practices treat a negative IMR as a non-admitted asset. A lower non-admitted asset results in lower surplus, lower capital and a lower risk-based capital (RBC) ratio. Currently, the guidance on allocating negative IMR differs, and an industry-wide working group has been established to offer recommendations to the NAIC and to work closely with state regulators.

Guy: ***Selling an asset at a loss seems straightforward to me. Why all the confusion?***

Jingsu: This where it gets a bit complicated. But simply stated, disallowance of a negative IMR can result in asymmetric financial results versus taking gains and sometimes, double counting of losses. There are discrepancies with its treatment across companies and states, and even within companies if the negative IMR is at the business, legal entity or total company level. Some companies are seeking and being granted permission to admit negative IMR as an asset and do so, as "a principle-based, reasonable and appropriate allocation." Industry is working hard with the NAIC and regulators to eliminate double counting and provide some consistency between states and between life insurers.

Guy: ***If insurance companies are being granted permission to submit negative IMR, then why don't regulators just permanently change the rule to eliminate this extra step?***

Jingsu: I agree and doing so would be consistent with the original intent of the rule. The NAIC hasn't fully resolved the issue yet, and therefore, groups like the American Council of Life Insurers (ACLI) are requesting urgent action on providing better guidance and workable solutions in time for insurers to report their annual financials for 2023. They are also proposing the allowance of a negative IMR balance in statutory accounting as it will become more prevalent in higher interest-rate environments. Disallowance would not only project misleading optics about insurers' financial strength but could lead to actual investment and capital management actions and impacts.

Guy: ***Did you mean to say, "financial strength?" That seems counterintuitive to me.***

Jingsu: Yes, I can see your confusion. When a negative IMR is disallowed as an admitted asset, it will reduce an insurer's capital, surplus and RBC ratio and therefore project misleading optics on an insurer's financial strength. This is because higher rates are favorable to an insurer's financial health and so non-inclusion would provide an inappropriate perception of decreased financial strength. In addition, it would create uneconomic incentives for asset-liability management by discouraging the prudent investment transactions necessary to increase investment yield and profit margin, and avoid mismatches between assets and liability. In other words, certain prudent, economic decisions would not be made just to try to avoid a negative IMR.

Guy: ***I see your point. Insurance regulators are trying to ensure obligations are met, while accounting standards are trying to reflect an accurate picture for assessing financial strength and solvency. Therefore, consistency and accuracy matter. Is the IMR new?***

Jingsu: It became effective around 1992. The way it works is that only the realized fixed-income gain or loss attributable to changes in interest rates is amortized into income over the remaining term to maturity. This amount does not include gains or losses from credit-related changes. IMR was created to prevent the timing of the realization of gains or losses on fixed income investments—related to interest-rate changes— to affect the immediate financial performance of the insurance company.

Guy: ***Can you give an example of what the rule was trying to protect against?***

Jingsu: Let me give an example without IMR. Let's say interest rates fell, and an insurance company sold all its bonds and reinvested in new bonds. The company's surplus would increase through significant realized gains. However, the increased surplus would inappropriately reflect increased financial strength that is illusory. The lower-yielding portfolio would not provide the change in income needed to support the liabilities.

IMR requires deferrals of those gains from surplus, and the gains are amortized through income over the remaining life of the bonds sold. This is done for two reasons:

1. to ensure accurate representation of how a company reports surplus by eliminating the potential for overstatement of the surplus; and
2. to keep the relationship of anticipated investment yield consistent with that needed to support the liabilities.

Guy: ***Could you relate this back to a net negative IMR currently being disallowed?***

Jingsu: It is the same concept in both directions. Let me state it more simply. Interest-rate-related gains and losses are transitory. Proceeds from the sale of the securities sold (even though sold at a loss) will be reinvested at a much higher interest rate.

Guy: ***Is it fair to say that, if the liability values are based on the assumption that the assets were purchased at about the same time that the liabilities were established, then there would, or should, be no bounds to the reserve that corrects for departures from that assumption? And this includes a minimum such as a negative IMR?***

Jingsu: Exactly. And you point out a very important point, which is that the current treatment of the IMR is asymmetrical. It is obvious that if a company has to set up a large reserve because of trading gains, it is in no worse position than if it had held the original assets. However, as for negative values of IMR, the same rationale should apply, but a negative reserve allowance has currently not been adopted. The whole rationale for adopting IMR was to consider both rising and declining interest rates.

Guy: ***So, it would be fair to say that the sale of a fixed-income investment and reinvestment in a new fixed-income investment that might lead to a negative IMR, should by itself have no material impact on a life insurance company's liquidity, solvency or claims-paying ability?***

Jingsu: That is right. The NAIC adopted IMR for specific reasons and adopted a series of other safeguards for asset adequacy and risk-based capital. IMR is another safeguard. I'll give you an example. From a standpoint of reserve adequacy, the inclusion of a negative IMR balance would reduce the investment income in asset-adequacy testing and may require a reserve strengthening. However, without the inclusion of negative IMR, reserve inadequacies would potentially not be recognized. Therefore, inclusion of negative IMR does what it is supposed to do—act as a safeguard.

Guy: ***Rising interest rates are good for insurance companies. But, if as you say, non-allowance of negative IMR provides an inaccurate view of financial health, then could that impact rating agencies' view of the industry or a company?***

Jingsu: Yes. And just as important and something I'll mention again, it would incentivize companies to avoid prudent investment transactions that are necessary to avoid mismatches between assets and liabilities. There are plenty of other adequate safeguards in place to ensure that a negative IMR allowance does not cause any unrecognized reserve or capital inadequacies, or any overstatement of the ability to pay claims.

***Guy:* You outline a compelling argument for allowing negative IMR. What guidance is the NAIC providing?**

Jingsu: The ACLI – IMR working group is working closely with industry and the NAIC. Various discussions are happening, and both ACLI and NAIC have draft proposals on the table. I am encouraged by the recent NAIC spring meeting and the messages that came out of it. The discussions are ongoing, but I feel all parties are beginning to converge their positions and are working toward resolutions and guardrails. The important question is whether all can reach an acceptable, short-term solution for 2023—with not much time remaining—and continue working on a longer-term fix.

***Guy:* You've emphasized the importance of not disincentivizing prudent portfolio management. Could you elaborate?**

Jingsu: Not allowing negative IMR submission provides the wrong incentives. Portfolio managers manage all kinds of investment exposures, including credit and duration risks. Managers make decisions regarding sales and reinvestment of fixed-income securities and use derivatives and hedging strategies. Hedging strategies are used to offset risks and include products such as interest-rate swaps, caps, floors, swaptions, interest-rate futures, among others. These may also generate IMR gains and losses.

Negative IMR can be generated by hedging strategies utilized for pension-risk transfers (PRT) too. Once the PRT contract is signed, insurers often enter hedging contracts to ensure interest-rate certainty, while awaiting cash and assets in-kind and/or the right investment opportunities to meet the long-term goals for the accounts. As the hedges are unwound, when cash arrives and is invested to meet pricing and investment targets, immediate losses and negative IMR may be generated as interest rates rise, but the losses are ultimately offset over time with higher fixed-income yields.

***Guy:* I would think that insurance companies have significant reinvestment risk?**

Jingsu: Absolutely. Premiums are received for many decades before benefit payments may be made. Companies may use interest-rate derivatives to reduce reinvestment risk by locking in interest rates at which the future premiums will be invested. As we discussed, when interest rates rise, the hedging transactions may come off the books via settlement, rollover or termination, leading to expected IMR losses. However, they are offset by future higher reinvestment yields, as we've been discussing.

***Guy:* The case for allowing negative IMR seems compelling. Do you have any concluding comments?**

Jingsu: As we have been discussing, the current statutory accounting guidance creates two equally objectionable alternatives. Both scenarios encourage short-term, non-economic activity that is not in the best interests of insurers and their policy holders. The rapid rise in interest rates is here and has caused diminishing and negative IMR balance. This issue can be resolved with a clear and appropriate treatment of IMR, specifically allowing for the submission of a negative IMR balance with proper guardrails.

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