Article Title: Criteria | Insurance | Life: Methodology: Treatment Of U.S. Life Insurance Reserves And Reserve Financing Transactions Data: (EDITOR'S NOTE: —On Jan. 31, 2023, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) 1. This article presents S&P; Global Ratings' methodology for the treatment of U.S. life insurance and annuity obligations, including those ceded to affiliated reinsurers. The methodology addresses how we incorporate affiliated reinsurers into our ratings and how we treat different accounting methods for this business. 2. This paragraph has been deleted. SCOPE OF THE CRITERIA 3. These criteria apply to our ratings on insurance groups writing term life and universal life (UL) insurance business originating in the U.S. regardless of whether it is retained by the operating company or ceded to an affiliated reinsurer. We may apply these criteria to address other U.S. life insurance and annuity blocks of business where we consider the adjustment material to our credit analysis and where the same principles regarding the conservatism of Generally Accepted Accounting Principles (GAAP) and Statutory Accounting Principles (SAP) apply. These criteria specify how affiliated reinsurers will be treated in determining the group credit profile (GCP) of an insurance group within our ratings methodology. The rating of individual members of the group will continue to be governed by "Group Rating Methodology," published July 1, 2019. 4. Variable annuity business is excluded from the scope of the section below titled "Credit For Reserve Redundancies" on determining reserve redundancy because we use a total asset requirement (TAR), which operates independently of reserves. SUMMARY OF THE CRITERIA 5. Our analysis is intended to be indifferent to the method of accounting because we take an economic view. Consistent with this approach, we analyze U.S. life insurance obligations by: Consolidating the financial statements of the various operating companies and affiliated reinsurers to arrive at a consolidated group-wide view of capital; Adjusting the amount of liabilities for some products to the lower of the reserves booked under GAAP or SAP; Giving partial credit for any additional value of in-force (VIF) business to further normalize between U.S. and international analysis; and Treating reserve financing instruments as capital where they meet our requirements for equity content under "Hybrid Capital: Methodology And Assumptions," published July 1, 2019. 6. This paragraph has been deleted. 7. This paragraph has been deleted. METHODOLOGY Consolidated Capital Analysis 8. We assess capital and earnings and financial leverage for U.S. life insurers on a consolidated basis rather than looking at each legal entity in isolation. We generally incorporate all group entities into our consolidated view and seek to do the same for affiliated reinsurers. This approach allows greater focus on the underlying economics, particularly for affiliated reinsurers because of the complicated risk-sharing arrangements typically in place with their parent and sister companies. Additionally, insurers often have the ability to unwind these structures by paying modest termination fees. 9. We recognize that capital is not perfectly fungible within a group and legal entities are distinct even if their performance is correlated. To address this, when determining a GCP, we may consider capital and earnings overstated and adjust the capital and earnings assessment down if a large percentage of a group's capital is locked up in these affiliated reinsurers. (See "Group Rating Methodology," published July 1, 2019, for more details of our definition of a GCP.) 10. In some cases, we may determine that an affiliated reinsurer is sufficiently isolated that we do not consider fully consolidated capital analysis to be appropriate. This will be the case if we determine the group's exposure to the affiliate to be immaterial in a stress scenario commensurate with the group rating. Factors that we consider in making this determination include: The group's reinsurance credit risk on obligations ceded to the affiliated reinsurer based on an analysis of the adequacy of the affiliated reinsurer's capital and the quality of the assets backing the ceded reserve; Any risks retained by the group that would not be covered by treating the affiliated reinsurer as an external reinsurer. These include any recourse rights that the affiliated reinsurer's creditors would have against other members of the group; and The fungibility of the affiliated reinsurer's capital. We assess this by analyzing the affiliated reinsurer's ability to distribute dividends and the group's ability to unwind the reinsurance agreements. 11. When we have determined, according to the previous paragraph, that an affiliated reinsurer is sufficiently isolated, we start our analysis of the group's capital by treating the affiliated reinsurer as if it were unaffiliated. Because we believe the structure to be sufficiently isolated from the group, any capital within the affiliated reinsurer (e.g., arising due to unrealized gains) is excluded from the calculation of the group's total adjusted capital (TAC); its income is not included in the group's earnings; and debt issued for the purposes of funding the ceded reserves is excluded from calculation of the group's financial leverage ratio. We then incorporate back into our view of the group's capital any risks the group retains, including those resulting from reinsurance credit risk. Credit For Reserve Redundancies 12. Within our consolidated analysis, we adjust reserves when we determine that there are material differences between their reported and economic values. Adjustments to reserves directly increase TAC, a core metric in our capital adequacy assessment, and affect our calculation of mortality, asset-liability management (ALM), and operational risk charges. 13. The most widely used reserving standards--GAAP and SAP--generally contain significant and unquantified conservatism. Both GAAP and SAP use net premium reserving for traditional life insurance products. While this can be useful for equity analysts by making earnings emerge smoothly, future profitability may be loss-absorbing from a credit perspective. GAAP introduces additional conservatism by requiring a provision for adverse deviation (PAD) for these products and requiring stock companies to accrue policyholder dividends even though these dividends are loss absorbing from the perspective of creditors because they may be revised based on future performance. SAP makes conservative assumptions regarding future mortality and lapses. In our view, this is particularly true for term life and UL products affected by NAIC Model Regulation 830 (Regulation XXX) and the associated actuarial guideline (AG 38 or Regulation AXXX). 14. When determining whether to use GAAP or SAP, we select the one that we think best reflects the underlying economics. To the extent that both embed margins for a given product, we would typically expect this to be the lower of the two accounting bases after making adjustments to enhance comparability. One of these adjustments is to give 50% credit for deferred acquisition costs (DAC) when using GAAP to determine TAC. This adjustment is in line with our general practice when using GAAP and reflects the potential volatility under stressed scenarios. We could decrease this credit if we considered the assumptions aggressive or subject to higher-than-average volatility. 15. We may apply further quantitative credit to determine TAC. One example of this is with closed blocks following demutualizations for which we apply our closed block methodology. Additionally, we give credit for products with large amounts of profits expected to emerge over the term of the contract. We may credit up to 50% of VIF beyond that already reflected in our calculation. We would typically expect to see external validation of the assumptions used in this calculation. We also consider data from other accounting systems, such as Canadian International Financial Reporting Standards, where available. 16. When adjusting for the conservatism of reserves within our capital analysis, we consider the impact of taxes. To the extent that statutory reserves are redundant, groups can generally expect higher tax expenses at some point in the future because of the link between taxes and statutory accounting. Ideally, we would reflect the present value of these payments into our calculation of TAC, but such a calculation would be very challenging and inconsistent with GAAP. As such, we calculate the tax impact without adjusting for discounting. When adjusting the reserve redundancy for the impact of taxes, we include an offset for non-admitted deferred tax assets of the group's other U.S. taxpaying entities and any valuation allowance adjustments that reduce a captive's deferred tax assets. The Treatment Of Financing Transactions And Instruments 17. Instruments used to finance redundant reserves receive the same treatment within our analysis as they would if they were issued for other purposes. We treat these instruments as capital to the extent that they meet our requirements for equity content under "Hybrid Capital: Methodology And Assumptions," published July 1, 2019. 18. We expect that unfunded redundant reserve financing solutions would not increase TAC under our definitions. Examples of unfunded solutions include letters of credit, credit-linked notes resulting from a note for note structure, parental guarantees, or excess of loss reinsurance treaties. 19. Unless they meet the characteristics described in paragraph 10, we include net financing fees in our fixed charge ratio. Additionally, we treat any debt or debt-like financing solutions related to reserve financing as financial leverage. REVISIONS AND UPDATES This article was originally published on March 12, 2015. The criteria became effective as of the publishing date. Changes introduced after original publication: Following our periodic review completed on March 1, 2016, we deleted the outdated "Impact On Outstanding Ratings" section, which appeared in paragraph 6. We also deleted the outdated "Effective Date And Transition" section, which appeared in paragraph 7. Following our periodic review completed on March 10, 2017, we updated the contact information. Following our periodic review completed on March 1, 2018, we deleted text related to the initial publication of our criteria, which had previously been moved to the revision history section and was no longer relevant. On July 1, 2019, we republished this criteria article to make nonmaterial changes in connection with the publication of "Insurers Rating Methodology" (IRM) and "Hybrid Capital: Methodology And Assumptions" (Hybrid Capital). Specifically, we i) deleted outdated text from paragraphs 2 and 19 to aid transparency and ii) made minor changes and clarifications to paragraphs 5, 9, and 17 in order to align these criteria with the IRM and Hybrid Capital and aid transparency. We also updated the relevant criteria references. On Feb. 26, 2021, we republished these criteria to make nonmaterial changes. Specifically, we updated the contact information, as well as deleted outdated text in paragraph two, which was related to criteria that have been superseded and was no longer relevant. On Jan. 31, 2023, we republished this criteria article to make nonmaterial changes to the "Related Criteria" section. RELATED CRITERIA AND RESEARCH Related Criteria Hybrid Capital: Methodology And Assumptions, March 2, 2022 Group Rating Methodology, July 1, 2019 Insurers Rating Methodology, July 1, 2019 Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010 Regulation XXX Structured Solutions, Dec. 15, 2004