AMERICAN ACADEMY *of* ACTUARIES

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July 27, 2015

Mr. Joseph Torti, III
Superintendent, Rhode Island Department of Business Regulation, Division of Insurance
Chair, Financial Condition (E) Committee, National Association of Insurance Commissioners
Via email to ddaveline@naic.org

RE: Financial Condition (E) Committee Questionnaire

Dear Superintendent Torti,

On behalf of the American Academy of Actuaries'[1] Casualty, Health, Life, and Risk Management and Financial Reporting Practice Councils, we are pleased to respond to your request for feedback on the Financial Condition (E) Committee Questionnaire, dated June 23, 2015. Our understanding is the questionnaire seeks to examine the reasons for single-state solutions and to help regulators develop a process for the National Association of Insurance Commissioners (NAIC) to develop a uniform framework for state-based regulation.

We have reviewed the questionnaire and we have determined several areas where we believe the Financial Condition (E) Committee can improve its processes for the future. We have provided selective responses (to questions 2, 3, 5, and 6) to the survey offering suggestions from an actuarial perspective on the concerns raised relative to uniform state-based regulation.

2. Please note any concerns that you see with the NAIC committee process, i.e., identify what you consider "problems" that may have been or would be a motivation for establishing a single state solution instead of using the NAIC process. For example, are there concerns with the willingness and/or timeliness of the actuarial task forces to address reserving concerns, or are there issues with the existing statutory accounting Form A and Form B processes that discourages their use?

First, it is important to ascertain how single state solutions arise. There have been observed occurrences, primarily on the life side, arising due to the existence of redundant reserves and capital requirements or uncertain applicability of existing reserving standards to new product designs. Second, when these issues are not addressed in a timely manner, single state solutions fill the vacuum. We believe the review process for the work of the Life Actuarial, Health Actuarial, and the Casualty Actuarial and Statistical Task Forces could be improved if there was

[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

better coordination between the Task Forces, the Life Insurance and Annuities (A), the Health Insurance and Managed Care (B), the Property and Casualty Insurance (C), and the Financial Condition (E) Committees.

Currently, the Financial Condition (E) Committee does not have a formalized opportunity to review the work of the Life Actuarial, Health Actuarial, and the Casualty Actuarial and Statistical Task Forces until the very end of the process. Including the Financial Condition (E) Committee and its subgroups earlier in the development process would improve the quality and consistency of information presented in financial statements. In particular, greater coordination between reserve and capital requirements, along with reporting conventions, would improve the overall presentation of the balance sheet, resulting in a more accurate representation of an insurer's risks and risk management practices.

For example, better coordination between the Life Actuarial (A) Task Force and the Life Risk-Based Capital (E) Working Group could help analyze complex reserve and capital requirements and assess whether the requirements are functioning as intended. We note that NAIC established such a precedent with the formation of the C3 Phase 2/AG43 Results Subgroup several years ago but we believe other coordinating efforts would be helpful.

In addition, within the Financial Condition (E) Committee structure, the Valuation of Securities (VOS) Task Force, Capital Adequacy Task Force, and Statutory Accounting Principles Working Group of the Financial Condition (E) Committee could benefit from further coordination. The VOS Task Force frequently takes actions that are not aligned with U.S. statutory accounting, which must be addressed after the fact.

3. Other than XXX/AXXX formulaic reserve requirements, please identify if there are other areas of the NAIC solvency framework considered overly conservative, too prescriptive, or not reflective of or responsive to the current industry dynamics. Please be as specific as possible when providing answers.

The current reporting requirements do not appropriately reflect good risk management in the form of economic hedging. Many life insurers use a range of hedging practices to mitigate the economic risk associated with movements in market conditions. In some cases, U.S. statutory requirements penalize an insurer for such hedging because of differences in accounting treatment of the assets and the liabilities. One example of this is the interest rate hedges used to mitigate risk associated with life, annuity, and other long duration products such as long-term care insurance. The hedges (e.g., interest rate swaps) are reported at market value, whereas the liabilities use a book-value type approach. Another example is with variable annuities, for which dynamic hedges are reported at market-value and liabilities follow Actuarial Guideline 43, which, due to its treatment of a “Clearly Defined Hedging Strategy,” can sometimes result in higher reserves due to the existence of an economic hedging program. While it might be advisable to maintain a level of conservatism in U.S. statutory accounting to address the risk that a hedging program does not perform as intended, we believe financial reporting for hedges could be improved within U.S. statutory accounting framework.

5. Related to Question 3 above, do you still find value in maintaining a separate body of statutory accounting focusing on the concepts of conservatism, consistency and recognition? Or would it be better for regulators to consider using GAAP and modifying the other existing solvency framework components due to the loss of conservatism in the accounting basis?

There are fundamental differences between the goals of U.S. statutory and U.S. Generally Accepted Accounting Principles (GAAP) accounting that will make it difficult for regulators to use GAAP without adjustments. Significant challenges would remain in using GAAP with adjustments, including reforming the U.S. solvency framework. Because a GAAP with adjustments approach could improve efficiency in public insurer financial reporting, we are in favor of evaluating it as a possibility. Such a discussion could focus on the convergence of reporting so that additional reporting requirements and costs are limited.

6. Please suggest actions the Financial Condition (E) Committee or any other relevant committee of the NAIC can pursue to remedy the above concerns.
a. For example, do you believe that the current framework for establishing standards for loss/claim and/or policy reserves is appropriate/adequate or that LATF and/or CASTF processes or reporting structure should be modified?
b. Regulators have indicated it is sometimes difficult to determine if a particular company request is something that should rise to a multi-state concern and be addressed at a national level through the NAIC process. Would it be beneficial for the Financial Analysis (E) Working Group or similar body to provide an opinion on these company requests?

Please see our response to question 2 above.

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Thank you for the opportunity to provide feedback to the Financial Condition (E) Committee Questionnaire. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202-223-8196 or sarper@actuary.org

Sincerely,

Shawna Ackerman, MAAA, FCAS
Vice President
Casualty Practice Council
American Academy of Actuaries

Catherine Murphy-Barron, MAAA, FSA
Vice President
Health Practice Council
American Academy of Actuaries

Mary Bahna-Nolan, MAAA, FSA, CERA
Vice President
Life Practice Council
American Academy of Actuaries

William Hines, MAAA, FSA
Vice President
Risk Management and Financial Reporting Council
American Academy of Actuaries