



AMERICAN ACADEMY *of* ACTUARIES

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October 16, 2015

The Honorable Nick Gerhart
Chair, Variable Annuities Issues (E) Working Group
National Association of Insurance Commissioners

Dear Commissioner Gerhart:

The American Academy of Actuaries'¹ AG 43/C-3 Phase II Work Group appreciates the opportunity to provide comments on the October 2, 2015, Variable Annuities Framework for Change (Framework) exposed by the NAIC Variable Annuities Issues (E) Working Group (VAIWG).

We have been monitoring the work of the NAIC C-3 Phase II/AG 43 (E/A) Subgroup and providing material and important input since early 2012. We have issued several reports discussing many of the issues covered in the Framework; we ask that the VAIWG review those materials as part of its work. Other Academy work groups have been actively involved in reserve and risk-based capital requirements for variable annuities since 2001; these work groups have been instrumental in the development of Actuarial Guideline XLIII (AG 43) and C-3 Phase II (C3P2). We hope the VAIWG will continue to view the Academy as central to the development and implementation of the Framework.

The Framework, as exposed, has the tone of a completed effort, with the Quantitative Impact Study (QIS) serving only to validate the Framework. While we support enhancements to the reserve and capital requirements for variable annuities, we believe an industry impact study (which we strongly support) of the exposed framework is premature at this time. We believe that more work is needed to determine whether the exposed framework will achieve the objectives stated by the VAIWG.

We also believe the January 1, 2017, effective date is too aggressive. This effective date will make it very difficult to test any proposed changes or conduct a suitable QIS. While a target date is useful, we believe January 1, 2018 is more realistic. Because AG 43 and C3P2 apply to enforce contracts, the potential impact of proposed changes could be in the billions of dollars. Therefore, it is critical that viable alternatives to the ideas in the current Framework are tested in advance. It would be difficult to have vetted solutions in place by January 2017.

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.

We do think it may make sense to consider identifying a phased approach, where a subset of the proposed changes that could be made by January 2017 are identified. These changes would move toward a final solution with a defined timetable for completely implementing the changes. As noted above, any such changes should undergo an impact study before they are implemented.

In addition, we suggest that the ideas being discussed be first tested on simple products. This testing should be performed before a full industry impact study is started. If the testing does not produce the intended results for simple products, the Framework will likely not achieve the desired objectives when applied to more complex real-world products.

We have offered specific comments to the NAIC's C-3 Phase II/AG 43 (E/A) Subgroup suggesting revisions to some of the features in AG 43 and C3P2 that have created unintuitive results. Our December 10, 2012, letter² discusses several of these suggestions. While many of our suggestions have been addressed in the exposed Framework, we believe there should be opportunity to discuss other ideas and refine existing proposals.

We offer specific comments on the exposed Framework in the attached appendix and also offer these suggestions:

1. **Use the same scenarios and assumptions for statutory reserves and risk-based capital (RBC).** The only difference should be tax treatment and confidence level.
2. **Modify the treatment of hedging in the requirements to address counterintuitive results.** Doing so should include eliminating the Clearly Defined Hedging Strategy (CDHS) concept in the reserve and RBC calculations, requiring hedging strategies to be modeled, and supporting the modeling of hedging strategies with a combination of actuarial judgment, disclosure, margins, and guidance that provides checks and balances.
3. **Evaluate the calibration criteria for equity scenarios to determine whether updates are needed.** This evaluation should include consideration of a more dynamic (i.e., state-dependent) approach.
4. **Consider adding calibration criteria for interest rate scenario generators.** This effort should include a review of the interest rate calibration criteria recommended by the Academy's Economic Scenario Work Group (ESG WG) in 2008.³
5. **Align the common requirements included in C3P2 and AG 43.**
6. **Remove the standard scenario from both AG 43 and C3P2 as a required minimum.** We do understand, however, that a standard scenario can be a useful tool to facilitate the regulatory comparison of reserves. As such, certain improvements could be devised to improve how the reserve standard scenario functions.
7. **Evaluate the tax risk surrounding the creation of captives and determining whether accounting adjustments are needed.** While the impact varies by company, the

² http://www.actuary.org/files/Revised_AG43_Work_Plan_12-10-12.pdf

³ http://actuary.org/files/publications/report_lbrc_dec08.pdf

admissibility of the Deferred Tax Asset (DTA) can have a material impact on both the creation and the recapture of variable annuity captive arrangements.

8. Evaluate the need to modify SSAP 86 to allow hedge accounting under certain conditions related to variable annuities.

Finally, we suggest the VAIWG consider a cash flow framework as the basis for reserve and RBC calculations. We recognize that a cash flow framework is a change from current practice, but we believe a cash flow framework will solve many of the concerns with the current Framework (including hedging impact) and stand the test of time. Practically, we recognize that gaining support for a cash flow framework will take time and therefore, recommend pursuing a shift to a cash flow framework for January 2018.

We encourage the VAIWG to consider our suggestions and to expose a revised Framework, along with a plan for testing, evaluating, and modifying the Framework prior to commencing the QIS.

We look forward to working with the VAIWG in the design and testing of these changes to the regulations affecting variable annuities. If you have any questions or would like to discuss further, please contact Scot Davies, life policy analyst (davies@actuary.org; 202-223-8196).
Sincerely,

Thomas A. Campbell, MAAA, FSA, CERA
Chairperson
AG 43/C-3 Phase II Work Group
American Academy of Actuaries

Appendix

Exhibit 1— Variable Annuities: Framework for Change

1. The Framework will result in changes to AG 43 that will be designed to result in a less non-economic reserve requirement for variable annuities. The changes are expected to include the following:
 - a. Development of calibration criteria for the Interest Rate (USD and possibly international) scenario generation with a market-sensitive mean reversion asymptote – this will align the interest scenarios with broader efforts underway at the NAIC level. Potential to integrate the Interest Rate calibration criteria with Equity Return calibration criteria and to add a volatility calibration prescription;

Academy Work Group comments: We suggest providing more guidance to improve the current interest rate projection requirements. The Academy's ESG WG recommended interest rate calibration criteria in 2008,⁴ and this criteria should be considered for variable annuities. The ESG WG's economic scenario generator for interest rates has been modified to include a dynamic mean reversion parameter, and it has been adopted for VM-20 and used for the 2014 C-3 Phase I field test. Any changes to the scenario generation process need to be completed before the impact study starts.

Regarding the equity scenario generator, the Academy's AG 43/C-3 Phase II Work Group reviewed the parameters and calibration criteria for the equity scenarios and the need to update parameters and/or calibration criteria in light of recent market experience in 2013. An additional 12 years of experience was added to the historical dataset and the scenario generator was evaluated. We presented this work⁵ to the NAIC's Life Actuarial Task Force in 2013. We encourage the VAIWG to consider this analysis in laying the foundation for the impact study.

Regarding the suggested refinements to add specific criteria for international funds, we believe the current calibration criteria, which limit the ability to assume funds experience higher average returns than U.S. equities without also displaying higher volatility, appropriately addresses this category of funds.

In addition, it is isn't clear what is meant by integrating interest rate and equity calibration criteria and adding a volatility calibration prescription. We would like to better understand the direction that the VAIWG envisions for these ideas and/or review any specific proposals before commenting.

- b. In the Standard Scenario calculation: Introduce more granular benefit-specific prescriptions of policyholder behavior assumptions. Separately, the prescribed set of assumptions is to be calibrated to adverse yet plausible levels informed by credible industry experience;
- c. Additionally, the Standard Scenario calculation will be conducted on a portfolio as opposed to seriatim basis with the existing seriatim Standard Scenario calculation made available as a disclosure item;

Academy Work Group comments: These ideas will improve the standard scenario (SS) and could be developed for a January 2017 implementation date, but we believe there are fundamental flaws with an SS floor. We recognize the expedience of using an SS in facilitating regulatory comparisons and tax calculations, but do not believe

⁴ http://actuary.org/files/publications/report_lbrc_dec08.pdf

⁵ http://actuary.org/files/VAREQ_Equity_Calibration_Criteria_Analysis_6-4-13.pdf

it is possible to develop one scenario that will capture the risks of a broad array of complex products and company practices. We do not support the use of an SS in either AG 43 or C-3 Phase II as a floor. We support the use of an SS as a disclosure item to facilitate regulatory comparison.

Note that various Academy work groups have commented in the past that a standard scenario cannot possibly address all product designs and features. The standard scenario may produce inappropriate results for certain products (i.e., either too high or too low) and it requires continual updates to address new products and new features; so care is needed to properly balance the work involved in maintaining the standard scenario with the need to have a useful tool.

- d. Hedging reflection in the Adjusted CTE 70 calculation to allow for the reduction of gross market risk positions for hedge instruments prior to expiration of existing hedges rather than a simple hold-to-maturity treatment;

Academy Work Group comments: We support modifications to better reflect hedging activities. If hedging activities are not properly reflected, the entire Framework suffers.

We also support the elimination of the CDHS concept because it does not reflect actual hedging practices. An insurer's hedging strategy should be reflected in all calculations and include the judgment of the actuary, margins, and guidance to provide checks and balances. This will assure the hedging strategy has been appropriately reflected.

- e. Increased regulator only disclosure designed to ensure regulators understand the potential impact under different assumptions;

Academy Work Group comments: We support increased disclosure related to variable annuities and offer the following suggestions:

- Consider expanding the required disclosures to include more information about how the experience assumptions in the calculation of the CTE Amount were validated to actual experience data to include an assessment of their credibility.
 - Better align documentation in the AG 43 Actuarial Memorandum with VM-31.
 - Consider aligning risk and risk mitigation disclosures with those contained in a company's own-risk and solvency assessment (ORSA) documentation.
 - Consider mandatory reporting of variable annuity experience data, including for the important types of dynamic policyholder behavior.
- f. The addition of a feedback loop that continuously reviews granular industry data as a means to modify the AG in the future to ensure the framework continues to operate as redesigned. This will require additional granular data to be submitted to the NAIC and analyzed and presented to a group of regulators.

Academy Work Group comments: We support establishing processes that will facilitate a feedback loop. Variable annuities are complex products requiring sophisticated risk management practices. Periodic evaluation of the effectiveness of the regulatory requirements will benefit consumers, regulators, and insurers.

2. The Framework will result in changes to the Life Risk Based Capital formula that includes material expected changes to C3 Phase II. Similar to changes to AG 43, these will be designed to result in less non-economic capital requirements on variable annuities. The changes that are expected include the following:
 - a. Complete elimination of the standard scenario;

Academy Work Group comments: We support the elimination of the SS in the C-3 Phase II calculation, as noted above.

- b. Alignment of the total asset requirement (TAR) and the AG 43 reserve requirements through use of the AG43 stochastic CTE calculation as the basis for a difference calculation for the direct determination of the C3 charge and the indirect determination to Total Assets Required as the sum of reserves plus the newly defined C3 charge. The C3 charge will be the difference between two AG43 CTE calculations at different confidence levels. The individual CTE calculations will apply an effectiveness factor for the reflection of a CDHS that is calibrated to be consistent with the error factors of the C3 Phase 2 framework. The confidence levels will be determined in the calibration phase during a forthcoming Quantitative Impact Study. The resulting difference will be appropriately tax effected and scaled to arrive at the C3 charge. This use of the AG43 calculation will eliminate the need for a separate C3 Phase 2 calculation;

Academy Work Group comments: We note that there are already efforts under way at the NAIC to modify the C-3 calculation and make the Phase I, II, and III (if applicable) consistent. We urge the VAIWG to be cautious about changing C-3 Phase II without proper consideration of the changes already under consideration. Consistency across the C-3 calculation is important as many insurers manage their interest rate risk across all products for the entire company.

- c. The addition of a feedback loop that continuously reviews granular industry data as a means to modify the C3 Phase II in the future to ensure the framework continues to operate as redesigned. This will require additional granular data to be submitted to the NAIC and analyzed and presented to a group of regulators.

Academy Work Group comments: We support establishing processes that will facilitate a feedback loop. Variable annuities are complex products requiring sophisticated risk management practices. Periodic evaluation of the effectiveness of the regulatory requirements will benefit consumers, regulators, and insurers.

3. The Framework will result in changes to SSAP No. 86 that are designed to reduce the accounting mismatch that exists between the value of the hedge and the value of the hedged item (the variable annuity liability) so that as market conditions change, gains or losses that are not consistent with the economic value of the hedges are not created within the financial statements. In addition, requirements for increased public disclosure on variable annuity risks will be added to the SSAPs, and data captured in the notes to the financial statements.
4. The Framework will result in the development of narrowly defined statutory language that states may use in removing the limitations that may exist within their investment statutes that may otherwise limit the extent of hedges an insurer may use in their risk management.

Academy Work Group comments: We support the evaluation of modifications to SSAP 86 to allow for more effective treatment of hedge activity under certain conditions related to variable annuities. However, we believe that in order to get hedge accounting treatment, the insurer needs to show a track record of hedging and a commitment to continue with a hedging strategy. The insurer should be allowed to modify its hedging strategy, but should demonstrate an ongoing commitment to hedge the business.