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October 30, 2014

Commissioner Julie Mix McPeak and Superintendent Joseph Torti III
Co-Chairs, NAIC Principle-Based Reserving Implementation (EX) Task Force
National Association of Insurance Commissioners

Dear Commissioner McPeak and Superintendent Torti:

The American Academy of Actuaries¹ is, as you know, the objective, independent voice of the U.S. actuarial profession. On behalf of its Principle-Based Reserves Strategy Subgroup (PBRSS) I appreciate the opportunity to provide comment on the October 7, 2014 *DRAFT Actuarial Guideline XLVIII* (AG48) that was exposed by the Principle-Based Reserving Implementation (EX) Task Force (PBRITF).

As we stated in our June 25, 2014 letter² to the PBRITF on the June 4, 2014 *Report of Rector & Associates, Inc.*, (the Framework paper) and in our September 17 letter³ to the Life Actuarial Task Force (LATF) on their August 7, 2014 exposure draft of Actuarial Guideline XLVIII, we continue to have concerns about the requirement to force a “Qualified Actuarial Opinion” to achieve the goals of the Framework.

Those goals, as we understand it include accomplishing the following:

- Credit for reinsurance is granted to the ceding insurer only if the ceding insurer satisfies the Primary Security Requirement;
- If a ceding insurer does not hold “hard” assets equal to the Primary Security Requirement, then a penalty (or “hammer,” as has been used in many public calls) will be imposed upon the ceding insurer;
- Regulatory provisions must be established to enforce the new requirements for transactions that take place before modifications can be made to the Credit for Reinsurance Model Act.

Introducing a regulatory requirement that specifies what constitutes a “qualified actuarial opinion” is inconsistent with the purpose of the Actuarial Opinion and Memorandum Regulation, Model #822 (AOMR). The purpose of the AOMR is to impose the responsibility on the

¹ The American Academy of Actuaries is an 18,000+ 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.

² http://actuary.org/files/Comments_on_June_4_Rector_Report_6-25-14.pdf

³ http://actuary.org/files/PBRSS_AG48_Letter_091714.pdf

appointed actuary to issue an opinion as to the overall adequacy of reserves. A new regulatory requirement that supersedes this vested responsibility, even when used only as an interim solution, establishes a bad precedent. Codifying circumstances when an appointed actuary must qualify his/her opinion reduces the independence given to the appointed actuary in the AOMR in forming his/her opinion. Qualified actuarial opinions have ramifications on risk-based capital (RBC) requirements, and potentially in other aspects of an insurer's financial statements as well.

While the potential solution of a mandated qualified actuarial opinion has been described as an interim solution (until the Credit for Reinsurance Model Act can be modified and adopted by the states), there are plans in place to modify the AOMR and make this interim solution permanent. These plans are discussed in the Framework paper and included in the proposed 2014 LATF Charges voted on by the "A" Committee on October 28⁴. The PBRSS is even more strongly opposed to a permanent change to the AOMR.

Our specific concerns related to AG48 follow:

- The AOMR is designed to ensure the overall adequacy of an insurer's reserves based on asset adequacy analysis and is not designed or intended to implement new transaction-specific calculation requirements. Section 3 of the AOMR provides:

This regulation shall be applied in a manner that allows the appointed actuary to utilize his or her professional judgment in performing the actuarial analysis and developing the actuarial opinion and supporting memoranda, consistent with relevant actuarial standards of practice. However, *the commissioner shall have the authority to specify specific methods of actuarial analysis and actuarial assumptions* when, in the commissioner's judgment, these specifications are necessary for an *acceptable opinion to be rendered relative to the adequacy of reserves and related items*.

The reference to actuarial methods and assumptions in Section 3 supports our view that the AOMR is focused on reserve adequacy. We believe it would be inappropriate for commissioners to mandate a qualified actuarial opinion via AG48, the AOMR, or otherwise.

- There are still serious, unresolved issues related to the need to adjust the RBC formula to remove the unintended consequences of a qualified actuarial opinion. Under the proposed Framework, one of the charges to the Capital Adequacy (E) Task Force is, "Determine whether the current RBC C-3 treatment of qualified actuarial opinions is adequate for the purposes of the risks of XXX/AXXX reinsurance transactions that receive qualified actuarial opinions."

Currently, the RBC instructions state, "The factors are decreased by one-third if the company submits an unqualified actuarial opinion based on asset adequacy testing." If nothing changes in the RBC instructions, the penalty for a qualified opinion under AG48 would be an effective increase of 50% in the C-3 factors **for all business**, not just the life

⁴ LATF Charge #13 - Draft amendments to specify that, in order to comply with Model #822, the opining actuary must issue a qualified opinion as to the ceding insurer's reserves if the ceding insurer or any insurer in its holding company system has engaged in a reserve financing transaction that does not adhere to the NAIC XXX/AXXX Reinsurance Model Regulation and other aspects of the XXX/AXXX Framework, as adopted by the Task Force.

insurance business covered under a captive arrangement. If the RBC instructions were changed to treat an AG48 qualified opinion separately from other qualified opinions, it would establish an inappropriate precedent for instituting multiple qualified opinions for different products/lines of business.

- An individual state may be able to permit a company to “opt out” of an actuarial guideline in the statutory *Notes to Financial Statements*, since permitted practice disclosures are only required for deviations in accounting practices. In contrast, a state cannot permit a company to “opt out” of an RBC requirement. Mandating a reduction to Total Adjusted Capital (TAC) (or an increase to Required Capital of the same amount) if the company does not comply with AG48 can therefore result in greater uniformity across the states than the use of a mandated qualified actuarial opinion.

As an alternative to the imposing the use of the qualified opinion to enforce AG48, the PBRSS believes requiring a direct adjustment to the RBC ratio calculation for the amount of the Primary Security shortfall will create an adequate incentive for companies to comply with AG48. As you know, the RBC Ratio is TAC divided by Required Capital, so changes to either the numerator or the denominator could accomplish the intended effect, as described below:

- It would require the actuary to disclose the Primary Security Shortfall in the Actuarial Opinion if other remedies are not put into place, and would change the RBC instructions to mandate that any such Primary Security shortfall disclosed in the Actuarial Opinion be subtracted from TAC. This is a more straightforward method to ensure companies comply with the requirements of AG48 than a change to C-3 factors emanating from a qualified opinion. The TAC adjustment is more straightforward because any company that does not make the balance sheet adjustments described in AG48 to make up for the Primary Security shortfall would need to subtract that amount from TAC.
- A second option that could be is to increase required capital by the amount of the Primary Security shortfall. Increasing the required capital would reduce the RBC ratio, as long as the addition to required capital is equal to the full amount of the shortfall and not incorporated into the RBC formula in some other way (e.g., if the required capital before adjustment is equal to \$100 million and the shortfall is \$20 million, then the adjusted required capital would be \$120 million).
- Either option could be implemented without having to require a qualified actuarial opinion, thus avoiding the aforementioned unintended consequences. All that would be needed would be a disclosure of the shortfall in the actuarial opinion, along with appropriate calculations in the derivation of the RBC Ratio.
- The PBRSS prefers a reduction in the TAC (the numerator) over an increase in Required Capital (the denominator) because it is the most straightforward and implementation is less complicated.
- Adjustments to the RBC instructions could be defined during the fourth quarter of 2014, allowing the change to be adopted by the appropriate NAIC committees and be effective for the 2015 RBC calculations. These adjustments could then be broadly communicated to companies, along with the adoption of AG48. With the adoption of these adjustments, AG48 could then be modified to eliminate the qualified opinion requirement, since the enforcement would be provided by the mandated TAC/Required Capital change.

The PBRSS supports adjusting either TAC or Required Capital within the RBC calculation, if it allows deletion of the qualified opinion requirement from AG48. The Academy's Life Capital Adequacy Committee is available to work with the appropriate NAIC groups to ensure that any RBC changes consider all questions and concerns.

If, despite our stated concerns, the PBRITF proceeds with the qualified actuarial opinion proposed in AG48, we strongly encourage the PBRITF to reconsider its plans, as set out in the June Framework document and in LATF's 2015 Charges, to amend the actual AOMR to require a qualified actuarial opinion under the circumstances specified in AG48. We believe changes to the Credit for Reinsurance Model Law can provide adequate incentive for companies to comply with the requirements of AG48 without needing to make a permanent amendment to the AOMR to require that the appointed actuary issue a qualified actuarial opinion.

We hope these comments are helpful. Please contact Brian Widuch, the Academy's life policy analyst (widuch@actuary.org; 202-223-8196), if you have any questions.

Sincerely,

Cande Olsen, MAAA, FSA
Chairperson
PBR Strategy Subgroup
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Cc: Mike Boerner, Chair, NAIC Life Actuarial Task Force
Mark Birdsall, Chair, NAIC Life Risk Based Capital Working Group
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