AMERICAN ACADEMY *of* ACTUARIES

February 23, 2011

Mr. Matti Peltonen
Chair, Valuation of Securities (E) Task Force
New York Insurance Department
25 Beaver Street
New York, New York 10004

Re: Staff Reports Related to the Rating Agency Working Group Charges

Dear Matti:

The American Academy of Actuaries[1] Invested Assets Work Group (AIAWG) is a work group of the American Academy of Actuaries' Life Capital Adequacy Subcommittee (LCAS). The AIAWG is charged with monitoring and commenting on life insurance industry investment practices with respect to appropriate risk-based capital treatment.

The AIAWG appreciates the opportunity to comment on the SVO Staff Reports Related to the Rating Agency Working Group Charges. The AIAWG understands the need to consider modification of the NAIC's use of credit ratings from Agency Rating Organizations (ARO) in insurance regulation. However, we are concerned with the ramifications these modifications could have on life insurance company risk-based capital (LRBC) and want to stress the importance of considering the impact on LRBC (whether that impact is positive or negative) along with any changes in the use of ARO ratings.

The AIAWG has concerns with the proposals in the Analysis of the Performance of NRSRO Credit Ratings and Implications of Default Statistics Associated with NAIC Designations staff report (from Bob Carcano and Wes Beal, dated October 10, 2010). While a re-grouping of ARO ratings into revised NAIC reporting classifications may assist the regulatory process of monitoring risk, the re-grouping will have a direct impact on the calculation of LRBC, if no corresponding changes are made to the LRBC formula.

Revised NAIC reporting classifications that reflect a new mapping of ARO ratings and corresponding appropriate modifications to the C-1 asset factors in the LRBC formula must be implemented at the same time. These modifications to the C-1 asset factors should be based on an in-depth review of experience and shifts in the capital markets. The LRBC factors for assets are based on broader groupings of ARO ratings that did not consider the rating modifiers; consequently, the LRBC factors will need to be reviewed with experience data that corresponds to the increased level of granularity proposed in the new ARO mappings.

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public on behalf of 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.

C-1 risk represents the potential for default of principal and interest or fluctuation in fair value of assets. Fixed income assets include bonds, collateral loans and mortgage loans, short-term investments, cash, and other long-term invested assets. Equity assets include unaffiliated common and preferred stock, real estate, and certain long-term assets reported in Schedule BA. Factors are applied to the statutory carrying values to determine their risk-based capital charges.

The factors for bonds, commercial mortgage loans (assumed to be in good standing) and unaffiliated common stock were determined through stochastic modeling of projected future cash flows over a range of interest rate scenarios. The factors reflected the probability of default and the expected recovery over a ten-year period for bonds and a seven-year period for commercial mortgages. The modeled time periods represented the average time-to-maturity for life insurers' portfolios.

Bond factors were developed for each of the six NAIC bond rating categories. A bond's Nationally Recognized Statistical Rating Organization (NRSRO) rating directly maps to one of these six categories. Commercial mortgage loans carry a factor independent of the NAIC rating categories which is adjusted for each company depending on its loss experience relative to the industry. Unaffiliated common stock and the lowest class of bonds (i.e., NAIC class 6) have the same factor since both are reported as marked to market in the statutory statements.

Although there are no formal proposals exposed, the AIAWG also has some concerns with the Alternatives and Supplements to the Use of NRSRO Credit Ratings staff report (from Bob Carcano and Wes Beal, dated October 8, 2010) and the Proposed Methodology to Assess the Reliability of NRSRO Credit Ratings staff report (from Bob Carcano and Norman Schindler, dated October 8, 2010). Both of these reports conclude that ARO ratings were inadequate to identify and differentiate insurer's asset risk.

While the AIAWG acknowledges certain limitations in relying solely on ARO ratings for *any* purpose, we believe it is important to fully evaluate the alternatives being considered. Before any conclusions are drawn about the relative value of alternatives to ratings information, we think it is important to judge the effectiveness of the alternative methodology in terms of the predicative aspects and capacity to indicate or predict future performance. Finding an alternative method for monitoring sectors that have exhibited poor experience in the recent past may not be the most effective predictor of future experience. Shifting reliance on the AROs to something else will also have limitations, albeit different limitations than those that exist with sole reliance on ARO ratings.

The AIAWG believes, as outlined in the Alternatives and Supplements to the Use of NRSRO Credit Ratings staff report, that there could be value in supplemental or alternative data sources. However, we think much more research is needed to determine which source(s) add the most relative value for the regulatory purposes of risk and solvency monitoring, including LRBC determination. A selection of ratings supplemental information sources would need to balance their perceived comparative accuracy to an NRSRO rating and the costs of obtaining and managing the information. We offer these brief thoughts on the report but reserve further comment until there is a formal proposal on the use of alternatives or supplements to NRSRO ratings.

Conclusion

The AIAWG understands the challenges faced by the regulatory community in monitoring risks and financial solvency and the need to continually review the effectiveness of regulations, particularly in light of recent and significant economic events. We are not opposed to the use of alternatives or supplements to NRSRO ratings, but if alternatives or supplements are to be used, then we believe that their relative value should be demonstrated.

We also support different groupings of assets, if those new groupings will aid the regulatory process and the impact of the new groupings is consistently implemented throughout the entire regulatory framework, including the LRBC capital factors. Reviewing the LRBC formula is part of the NAIC's Solvency Modernization Initiative (SMI). A work plan for modernizing the formulas has not been finalized, but a review of the factors that capture investment risk may be part of the final work plan. The efforts of the VOSTF should be coordinated with the efforts of the SMI and other committees within the NAIC.

The AIAWG will continue to follow reports and related proposals from the VOSTF and stands ready to aid in the establishment of improved regulatory investment risk monitoring processes.

Sincerely,

David Berger, FSA, MAAA, Co-Chair of the AIAWG
Jerry Holman, FSA, MAAA, Co-Chair of the AIAWG

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