AMERICAN ACADEMY *of* ACTUARIES

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September 30, 2015

The Honorable John M. Huff
Chair, Reinsurance Task Force
National Association of Insurance Commissioners

Dear Director Huff:

The American Academy of Actuaries[1] Principle-Based Reserves Strategy Subgroup appreciates the opportunity to comment on the July 28, 2015 exposure draft, "Non-Universal Life and Universal Life With Secondary Guarantees Credit for Reinsurance Model Regulation."

First, we would like to recognize and express our appreciation for the Reinsurance Task Force's work to transpose the standards of Actuarial Guideline 48 (AG 48) into model law and regulation. In our comments[2] as the XXX/AXXX framework was under development, we expressed concern with the use of an Actuarial Guideline to implement the framework. We believe that a regulation is a better method of implementing the framework, and we support the NAIC's effort to draft such a new regulation, sunset AG 48, and consider any appropriate further adjustments, for example, to risk-based capital.

Second, with regard to the exposed draft model regulation, we focus our comments on the draft's elimination of the AG 48 remedy allowing dollar for dollar reduction in reserve-credit,[3] and on the draft's use of the "Option 1: All or nothing" consequence for any shortfall in Primary or Primary+Other Security.

Rather than Option 1 (or Option 4), we recommend a choice of consequence that reflects the incremental risk to the ceding company created by a shortfall and that affords more flexibility in response to extreme market conditions. Therefore, we could support Option 2 (dollar for dollar reduction in credit) or Option 3 (proportional reduction in credit). Our rationale is discussed in further detail below.

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[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.

[2] http://www.actuary.org/files/PBRSS_AG48_Letter_091714.pdf

[3] The remedy eliminated appears in AG 48 sections 6.A.3.(i)(2) and 6.A.3.{ii}(2), for shortfalls in Primary Security and Primary+Other Security, respectively.

It appears that the Drafting Group elected Option 1 to drive captive funding to the targeted level of Primary Security in all cases. Rather than adjusting reserve credit in relation to the amount of a shortfall and the risk to the ceding company so created, Option 1 imposes a stark penalty, total loss of reserve credit, if there is any shortfall at all. In the extreme, under Option 1, a one-dollar shortfall could cause a loss of millions of dollars in reserve credit and reported surplus.

Obviously, the extreme case mentioned above would never occur—an insurance group (insurer) would just put up the dollar, and do so with ease. However, Option 1 could create difficulties in more plausible ways. In a time of macroeconomic stress and volatile markets, the VM-20 calculation could increase significantly and abruptly. To avoid the disproportionate loss of the total reserve credit under Option 1, an insurer could be forced to contribute additional Primary Security assets into the captive or into funds withheld. Acquiring additional Primary Security might require selling non-qualifying invested assets into distressed markets, at a loss, to acquire additional Primary Security, or seeking additional financing under terms that could be quite expensive at a time of financial stress. Although such actions, incented by Option 1, might benefit the holders of policies ceded to the captive, it is not clear that they would be the best actions, at the time, to protect the interests of all of the insurer's policyholders, especially if the need for additional Primary Security is short term and reverses as the markets revert to a more static level.

Like Option 1, Option 4 establishes a sudden, large penalty that is likely to be disproportionate to the amount of any shortfall and the risk that amount of shortfall creates; any shortfall would cause an immediate drop in reserve credit to the level of Primary Security in trust or funds withheld. While less harsh than Option 1, the penalty under Option 4 could still induce the insurer to take actions that it might more wisely avoid if given more flexibility to decide whether to seek additional Primary Security or accept a reduced reserve credit related to the cession.

Option 2 (dollar for dollar reduction in credit) and Option 3 (proportional reduction in credit) both size the reduction in reserve credit in relation to the amount of any shortfall. Option 2 reduces the reserve credit for the ceding company by the exact amount of the shortfall. That consequence mirrors traditional treatment of unauthorized reinsurance, where a shortfall in collateral reduces reserve credit dollar for dollar. Taken by itself, it creates no incentive to fund the shortfall either within the captive or in funds withheld in preference to simply reducing the reserve credit taken. Option 3 is somewhat similar: the reduction to ceding-company reserve credit is related in size to the amount of the shortfall but likely more than dollar for dollar. As such, Option 3 may create incrementally more incentive (than Option 2) to fund the captive at the Required Level of Primary Security. Both Option 2 and Option 3 give the insurer, and its regulator, more flexibility than Option 1 or Option 4 in times of financial stress, since neither Option 2 nor Option 3 establishes a disproportionately severe consequence from the shortfall that may compel the insurer to fund the captive arrangement with additional Primary Security.

Summarizing, we see either Option 2 or Option 3 as supportable choices for the consequence of a shortfall in security under the new regulation. Option 2 reinstates the AG 48 remedy; Option 3 adjusts it, but in a closely related way. Both of those options provide a consequence for the reserve credit that is sized in relation to the amount of the shortfall and the risk that amount of

shortfall may create; both may afford the company and its regulator useful flexibility in periods of financial market stress.

Thank you again for this opportunity to comment. Please contact Scot Davies, the Academy's life policy analyst (davies@actuary.org; 202-223-8196), if you have any questions.

Sincerely,

Cande Olsen, MAAA, FSA, CLU
Chairperson
PBR Strategy Subgroup
American Academy of Actuaries

Cc: Dan Schelp