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July 13, 2018

Mr. Mike Yanacheak
Chair, Variable Annuities Issues (E) Working Group
National Association of Insurance Commissioners
Via Email: Dave Fleming (dfleming@naic.org)

Re: May 31 Exposure of VAIWG Framework

Dear Mr. Yanacheak,

The AG43/C3 Phase II Work Group of the American Academy of Actuaries[1] (Work Group) appreciates the opportunity to provide comments on the May 31, 2018, "VAIWG Framework" (May 31 exposure), exposed by the Variable Annuities Issues (E) Working Group (VAIWG). We welcome the opportunity to help you shape proposed modifications to Actuarial Guideline XLIII (AG43) and C-3 Phase II (C3P2).

For reasons discussed in this letter, we are unable to conclude at this time that the proposed framework in the May 31 exposure can meet the desired goals to mitigate or remove the motivation for insurers to use captive reinsurance and to provide an incentive to recapture exposures into the primary entities.

The comments below are divided into two sections. The first section outlines general comments about the previously proposed revised framework that apply to this exposure. This is a summary of some of the issues raised in our March 2 letter. We direct any reader wishing to see more details concerning these issues to that letter. The second section includes comments regarding the May 31 exposure. These comments are limited to areas where our understanding of the direction the VAIWG is taking on the 27 recommendations in the framework differ from what is contained in the exposure.

General Comments about the Framework (for each of these comments, please refer to our March 2 letter for more details)

1. Since the results from the quantitative impact studies (QIS), even at a summary level, have not been made publicly available, we are unable to determine whether the results of the studies were interpreted correctly and whether the results were applied properly to the recommendations.

[1] The American Academy of Actuaries is a 19,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted 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. The Work Group believes there is a benefit in understanding the size of the impact of the various recommendations, in prioritizing the recommendations, and in testing the impact of the recommendations on the balance sheet moving though time.

3. Consideration should be given to limiting the number of modifications, with a focus on the items outlined in our March 2 letter.

4. There needs to be a differentiation between the goals of having companies hold lower reserves and risk-based capital (RBC), and the goals of companies to avoid noneconomic volatility in reserves and RBC. It is our observation that the desire to hold lower reserves and RBC it is not necessarily a primary reason for forming a captive. Rather, the issue is more likely that, under the current requirements, hedging adds noneconomic volatility to statutory reserves and RBC. The rationale assigned in the framework to some of the recommendations implies that companies will only be motivated to hedge if reserves and RBC are reduced when that hedging is introduced into the reserve and RBC calculation.

5. Proprietary generators should be allowed for both interest rate and equity scenarios, subject to robust calibration criteria and disclosure requirements.

6. The use of the Clearly Defined Hedging Strategy (CDHS) criteria as a condition to including hedges in the stochastic calculations should be replaced with the requirement that hedging strategies be modeled, supported by a combination of actuarial judgment, disclosure, margins, guidance, and company governance that provides checks and balances.

7. The proposed Standard Projection (SP) should be used only as a disclosure item, rather than as a floor reserve. When AG43 was originally developed, the Academy Variable Annuity Reserve Work Group[2] (VARWG) commented that the Standard Scenario (SS) should not be included. The VARWG raised concerns that the approach and the assumptions in the SS would not appropriately capture the risks associated with all variable annuity contracts. These concerns appear to have come to fruition. Although we recognize that some of the issues with the current SS have been addressed in the proposed SP, there is not enough information for us to conclude that the SP will appropriately capture these risks.

   In particular, an approach that relies on industry average assumptions may not be effective in identifying whether a company's assumptions are appropriate and may continue to produce noneconomic results and volatility. The SP may be inappropriately binding for a company that sets assumptions appropriately based on credible experience that differs from the prescribed assumptions in the SP. It may also fail to identify companies that inappropriately use assumptions consistent with prescribed assumptions in the SP when their experience suggests otherwise.

8. While we agree with VAIWG's desire to build a framework of policyholder behavior experience studies and assumption review, it is not clear to us if the prescribed

[2] The predecessor work group to the Academy AG43/C3 Phase II Work Group.

assumptions in the current SP proposal are consistent with the stated desire to use industry experience.

9. We have two concerns with the proposed C3 calculation. First, conditional tail expectation (CTE) 98 can be an inaccurate measure, especially where it is calculated using fewer than 1,000 scenarios. Second, the use of a 25 percent factor is inconsistent with the intended use of RBC.

<u>Comments on Specific Recommendations in the May 31 Exposure</u>
The following observations are provided with the goal of achieving an accurate reflection of discussions during the VAIWG's in-person meetings in Milwaukee and Kansas City:

Recommendation #3—Allow companies to use proprietary economic scenario generators fully if—and only if—they do not materially reduce Total Asset Requirement (slide 10)

It was noted during the in-person VAIWG meetings that the ad-hoc National Association of Insurance Commissioners (NAIC) group should consider the use of proprietary economic scenario generator and provide feedback to the NAIC Life Actuarial Task Force (LATF) and the NAIC Life Risk-Based Capital Working Group. The recommendation should be updated to reflect this.

Recommendation #6—Discount deficiencies at the Net Asset Earned Rate on Additional Assets (slide 13)

The recommendation defines the Net Asset Earned Rate on Additional Assets as the "earned rate on a 'closed portfolio' of general account assets available on the valuation date that do not constitute a part of Starting Assets." Based on the discussion at the in-person VAIWG meetings, we believe the intent of this recommendation is to reflect reinvestment in general. The recommendation should clarify that the net asset earned rate may include assets that are not a part of the general account assets on the valuation date, and that are assumed to be reinvested within the projection in accordance with the company's written investment policy.

The recommendation notes that both approaches (A and B) to determining the Starting Asset amount have been observed and should be allowed as part of the VAIWG recommendation. During the discussion, we suggested that modifications to AG43/VM-21 should explicitly state that both of these approaches are allowed. The recommendation should be updated to indicate the need to modify AG43/VM-21 to state this.

Recommendation #7—Follow VM-20 guidance on general account asset projections (slide 14)

Our understanding from attending the in-person meetings is that the VAIWG referred the 50/50 AA/A reinvestment limitation provision to LATF for future consideration. The recommendation should be updated to reflect this.

Recommendation #11—Align AG43 Standard Scenario calculations with CTE ("adjusted") (slide 20)

It is also the Work Group's understanding that the provision to use "seriatim in force/no cell grouping" was updated to allow grouping during the in-person VAIWG meeting in May. This is consistent with the update to recommendation #17 that allows grouping. The recommendation should be updated to reflect this.

Recommendation #13—Project Standard Scenario on an aggregated basis, but with disclosure of aggregation benefit observed (slide 22)

As noted on slide 45, this recommendation should note that the approach used to do this calculation could still be up for discussion.

Recommendation #14—Refresh prescribed policyholder behavior assumptions to align with industry experience (slide 23)

Based on our understanding of what was collected and studied, we think it would be more accurate to state that only full surrender and withdrawal experience were included in QIS II.

Recommendation #16—Calculate Standard Scenario Amount based on company-specific market paths (selected from a panel of standardized market paths) (slide 25)

The recommendation implies that the company will create and run a new market scenario, based on interpolating the closest scenarios from the 40-scenario set. Our understanding was that the VAIWG was considering an approach where the company would interpolate the results from the "nearest" scenarios out of the 40, rather than create and run a new (41st) market path.

Recommendation #17—Allow the Standard Scenario Amount to be calculated as a CTE Amount with prescribed assumptions (slide 26)

Since the proposed disclosure relates to the approach described in recommendation #13, this recommendation should be updated to note that the approach used to do the calculation, and therefore the disclosure, could be further modified.

Recommendation #22—Disclose historical Greek coverage over past 12 to 36 months for implicit CDHS reflection (slide 35)

Although this was not specifically discussed during the in-person VAIWG meeting, we note that the recommendation mentions only delta and rho. Since some companies may use additional Greeks in their hedging program, this disclosure should include provision for those other Greeks. (Note that the December 2017 proposed redline version of AG43 mentions delta, rho, and vega, but we think that is still incomplete.)

Recommendation #25—Increase admissibility limit for designated VA hedges (slide 40)

The description of this recommendation captures the intended direction of the proposed criteria for hedges that qualify for the higher threshold. However, the slide notes that the VAIWG is awaiting a separate proposal. It is not clear to us that this is the case.

Other Framework Issues

The exposed framework should reflect the discussion and conclusion reached concerning early adoption of the new framework by companies, and the optional grade-in of the change in reserves and RBC resulting from modifications to AG43 and C3P2.

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The Work Group looks forward to discussing these comments further and working with the VAIWG on developing proposed modifications to AG43 and C3P2. If you have any questions, please contact Ian Trepanier, life policy analyst at the American Academy of Actuaries (Trepanier@actuary.org).

Sincerely,

Tom Campbell, MAAA, FSA, CERA
Chairperson, AG43/C3 Phase II Work Group
American Academy of Actuaries