



AMERICAN ACADEMY *of* ACTUARIES

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January 30, 2015

Mark Birdsall
Chair, NAIC Stress Testing (E) Subgroup
National Association of Insurance Commissioners

Dear Mark:

On behalf of the American Academy of Actuaries¹ Stress Testing Work Group, we wish to offer the following comments on the Stress Testing Proposal as an Outline for Field Testing, which was recently exposed by the National Association of Insurance Commissioners' (NAIC) Stress Testing (E) Subgroup of the Life Risk-Based Capital (E) Working Group (LRBCWG).

The Academy's work group appreciates the Stress Testing Subgroup's efforts in developing the proposal. It is clear that significant thought has been put into this proposal. Our view is that many of the goals specified in the exposure, (e.g., having a process that is easier to audit, taking a more holistic view of risk, and coordinating the level of statutory reserves and the level of required capital for solvency oversight purposes) are laudable. However, we have the following specific suggestions:

- The Stress Testing Subgroup should assure that the list of goals provided in the proposal is complete and should include any additional goals it may have.
- The Stress Testing Subgroup should clarify how the Representative Scenarios Method (RSM) will be more auditable. We understand that the RSM will reduce computational time and firepower required. However, there may be additional development time required to select and validate the appropriate representative scenarios, and we question the extent to which this additional development will be more auditable.

The Work Group's comments on specific issues relating to the proposal follow.

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.

Clarification of the Scope of Field Test

- The product scope should be clarified as it appears that liabilities such as deposit type liabilities, separate account reserves, claim reserves and miscellaneous reserves are not captured in the proposed LR032.
- The manner in which new business is intended to be reflected should be clarified. Specifically, we question whether the proposal requires the reflection of new business in RBC or is new business part of a sensitivity test.
- Any new business aspect should be coordinated with the NAIC Operational Risk Subgroup as it is considering an RBC charge based on growth. The inclusion of new business in this stress testing proposal and the Operational Risk Subgroup's potential RBC charge based on growth could potentially create duplicative capital requirements.
- The relationship between the treatment of new business in this proposal and the treatment of new business in the company's Own Risk and Solvency Assessment (ORSA) should be clarified. Specifically, we seek clarification as to how the inclusion of new business in this proposal would meet the objective of helping to identify weakly capitalized companies and whether new business is an item that should trigger regulatory action. If, on the other hand, the rationale for including new business is to assess the risks associated with an insurer's current business plan and the sufficiency of its capital resources to support these risks, then perhaps ORSA is the better place for this analysis.
- While significant guidance is available for cash flow testing, there is only limited guidance available for the modeling of new business as new business has historically not been covered in regulatory modeling. For example, what types of assumptions would be used to project new business and has due consideration been given to the time it would take to build new business into regulatory software? We believe that these and related questions should be addressed before including new business in this proposal.

Timing of Field Test

- The Stress Testing Subgroup should demonstrate conceptually and through a proof of concept that the proposal under consideration will meet its goals before embarking on a field test. One concern we have is whether the proposal might inadvertently trade one set of issues for another. For example, can it be demonstrated that the methodology under consideration will not miss some aspect of C3 risk that stochastic testing might have caught? Perhaps the field test currently being performed for RSM for non-variable annuity PBR can be used to demonstrate that the goals of this proposal will be met before embarking on an industry-wide field test of the RBC stress test proposal.
- We understand that LRBC is looking to coordinate its activities with the NAIC ComFrame Development and Analysis (G) Working Group (CDAWG). We believe that it is necessary for LRBC to articulate more completely how this proposal for life insurance RBC fits into the overall CDAWG and international capital standard (ICS)

discussions, as well as its relationship to the ORSA requirements. We believe that it is therefore necessary for this initiative to be well coordinated with other activities at the NAIC before proceeding with a field test.

- Incorporation of stress testing into the current approach for RBC is a significant change. We believe that the need for this change and the problems with existing RBC that lead into this need should be well defined before proceeding with the field test. Further, the emergence of PBR will not justify this type of change as PBR is an updated methodology used to compute reserves that helps to bring reserves to the appropriate level. By itself, this would not automatically trigger changes in the RBC methodology.
- In addition, although we understand that concern has been expressed about the adequacy of RBC thresholds, the extent to which RBC formula projects tend to reduce RBC factors, and regulatory lag with respect to emerging risk and product innovation, among others, we question whether there might be other simpler solutions consistent with the existing framework and whether these solutions have been considered. For example, suppose that it can be demonstrated that RBC Action Level thresholds are too low. Could the solution be to raise the Action Level thresholds without revamping RBC? Similarly, if it can be demonstrated that RBC formula projects tend to reduce the RBC factors, can the oversight process for these projects be revisited without revamping RBC?
- We note that NAIC did a review of RBC several years ago and concluded as a matter of policy that it supports the continued use of current RBC. We ask that LRBC better articulate its concerns in light of the prior review. We believe that this work should be performed before moving ahead with a field test.

Vetting of Methodology Prior to Field Test

The Stress Testing Work Group believes that it is not immediately apparent that relevant stakeholders have a sufficient understanding of the RSM methodology.

- We note that ARWG, which is working on a similar methodology for reserves, is writing a concepts paper so that key stakeholders can understand all the issues with and thought behind the RSM. We question whether it may be best to work through the methodology at ARWG for reserves and for the NAIC Stress Testing (E) Subgroup to then distribute a more fully thought out and well developed methodology for minimum capital standards.
- We also question whether the RSM, which assumes a normal distribution of most variables, is appropriate for factors such as defaults where the median value is zero and whether the methodology under consideration is pre-tax or post-tax. If indeed the methodology is post-tax, is VM-20 a good source of guidance?
- We question why the proposal is concerned with the calculation of reserves when computing TAR (e.g., “These RBC instructions describe a principle-based calculation of the Current Estimate Reserve”).

- Canadian regulations call for capital requirements on segregated fund guarantees (similar to guaranteed living and death benefits on variable annuities in the US) to be calculated on the basis of CTE 90, 95, or 98, depending on the remaining term of the guarantee. IAIS is considering use of a 99.5% VAR for a one year time frame. In this context, use of the 99.9% percentile for the stress test appears significantly more conservative than these other measures and the historical degree of conservatism in RBC. We ask LRBC to identify the appropriate level for stress testing and how this calculation would help to better identify weakly capitalized companies.

A field test is generally used to flesh out the details once the concepts have been well developed. As the above suggests that significant concept development remains, we recommend that a field test not be performed at this time.

Thank you for this opportunity to provide our views on the Stress Testing Proposal as an Outline for Field Testing. If you have any questions or would like to discuss this letter in more detail, please contact Brian Widuch, the Academy's life policy analyst (widuch@actuary.org; 202-223-8196).

Sincerely,

Martin Snow, MAAA, FSA
Co-Chairperson
Stress Testing Work Group
American Academy of Actuaries

Dana Hunt, MAAA, FSA
Co-Chairperson
Stress Testing Work Group
American Academy of Actuaries