May 18, 2010

Ms. Anne Kelly, Chair
Property Risk-Based Capital Working Group
Capital Adequacy (E) Task Force
National Association of Insurance Commissioners (NAIC)
2301 McGee Street
Suite 800
Kansas City, MO 64108

Re: Follow-Up Comments Regarding the Academy's "Risk-Based Capital Underwriting Factors – 2010 Update"

Dear Ms. Kelly:

As you know, the Reinsurance Association of America (RAA) commented on the Academy's "Risk-Based Capital Underwriting Factors – 2010 Update" ("2010 Update") during the 30-day exposure period set forth by the NAIC. On behalf of the Property and Casualty Risk-Based Capital (RBC) Committee of the American Academy of Actuaries,[1] we wish to provide further comment regarding our 2010 Update in response to the RAA's April 19, 2010 comment letter to the NAIC.

The RAA comment letter discusses valid issues. In response, we have reviewed our analysis and performed additional testing to validate our original report. This additional work supports the indications of our 2010 Update. In summary, if we were to amend the methodology in accordance with the RAA's primary suggestions regarding filtering and pooling, this would affect the uncapped indications, but it would not affect the final capped indications presented in our 2010 Update.

Changes in the Filter Would Not Impact Capped Indications

The filtering procedure significantly reduced the number of companies whose data was utilized for calculating RBC reserve factors for the Non-Proportional Liability Reinsurance line. The experience of this line in the early part of the 2000s was extremely adverse. For example, using the industry composite 2008 Schedule P, with no filtering (all companies included), reserves as of Dec. 31, 2000 ran off adversely by 52 percent of the total reserve. Adverse runoff of these

[1] The American Academy of Actuaries ("Academy") is a 16,000-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.

years continues even in the latest year available to report (2008), indicating that, when runoff is finally finished, the experience could be worse than that underlying the current update.

The disruption caused by this adverse experience pushed a number of companies out of this line of business and was addressed by some of the major companies with retroactive reinsurance programs, which renders their Schedule P data unsuitable for inclusion in the calculation of the risk charges. This helps explain why many companies were filtered out of the utilized data. Similarly, companies entering the market in 2001 or later developed more significant reserve volume only a few years ago. Development on these reserves, whether favorable or adverse, is too young to be compelling at this point for a very-long-tail line, and thus these data points are also filtered out of the utilized data.

This adverse experience in the history influences any calculation, whether the filter is widened, narrowed, or entirely removed. We tested the impact of filtering using the same methodology with a less stringent filter and with no filter. Each time, the indicated underwriting risk factor for reserve runoff was higher than the current indicated capped factors by a significant margin. Therefore, while the filtering process does limit the volume of companies contributing to the indication, the filtering process does not impact the capped indications using the current method.

Changing the Treatment of Pooling Would Not Impact the Capped Indications

The RAA pointed out that, after filtering, the impact of one group of pooled companies is disproportionate; companies in this pool had significant adverse experience. However, like the above conclusion regarding filtering, changing the treatment of these pooled companies would not have changed the capped indications.

Impact of Adopting the Indicated Capped Factors

The RAA states that the average ratio of reserves to premium in the casualty reinsurance line is very high, with reserves at over six times premium. The resulting reserve charge implies that a high level of capital in proportion to premium is needed to write this line. This capital need arises due to past business and the very-long-tail nature of non-proportional liability reinsurance. The RAA's observation regarding the premium-to-surplus ratio for a monoline reinsurer writing all premiums in this line, while hypothetical, is useful. We too believe that, if regulatory capital handicaps the U.S. reinsurance industry or constricts supply, it is a legitimate public policy consideration for the NAIC. That may be balanced against considerations for appropriate solvency regulation.

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To better gauge the impact of the indicated changes, we examined the authorized control level (ACL) capital from 2009 filings for the nearly 60 companies that have over half of their reserve charge coming from the reinsurance lines. While the impact on any particular company depends on that company's characteristics, we calculated the impact of the indicated factors (for all lines) capped at 15 percent, including the impact of the covariance adjustment percent. This results in an increase in the ACL capital overall for these companies of slightly less than 4 percent.

Prior Years

The RAA implies that Asbestos and Environmental (A&E) claims are the main driver of the adverse runoff. However, looking specifically at the December 31, 2008 evaluation of the most adverse period in the history, the adverse runoff of industry reserves for accident years 1999-2001 as of Dec. 31, 2001 is worse than runoff of reserves for accident years prior to 1999 as of Dec. 31, 2001. It seems A&E contributed to the adverse development for the industry but was not a sole driver, and the adverse experience in less-developed accident years is actually worse than the legacy data. This demonstrates that, while A&E reserves are still an issue on legacy company balance sheets, the newer startups with reserves in less-developed accident years are not free of issues evidenced in the data used to calculate the charge.

Investment Income

The RAA correctly notes that the RBC methodology for calculating the investment income offset assumes the payout pattern cuts off at 14.5 years. Based on Schedule P data, 87 percent of claims are paid by the tenth year. The methodology spreads the remaining 13 percent over the next five years, so it does not seem that spreading this small proportion of reserves over more years would significantly change the discount, particularly since a 5 percent interest rate is used for discounting, while prevailing rates are currently lower.

Expense Ratio

The RAA points out that the expense ratio used in the methodology is 27.5 percent and that this is onerous. However, the expense ratio based on the Insurance Expense Exhibit from Highline Data Services for reinsurance lines specifically is 29.4 percent; thus, using expenses specific to the reinsurance line would not lead to lower charges. The expense ratio is used for the net written premium underwriting charge, not the reserve charge, and thus it does not impact the indicated reserve charges referenced in the RAA letter.

Tailoring Methods to the Reinsurance Line

The RAA letter states that, while it may be appropriate to apply a uniform mechanical calculation to other lines of business, the reinsurance line should not use this calculation without application of "common sense and judgment regarding individual company issues and anomalies

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in the data." Based on the fact that filtering, pooling, and legacy issues do not affect the capped indications, the application of subjective judgment does not seem appropriate for the reinsurance line at this time.

Transparency
It is important to note that the change in methodology that the Academy recommended several years ago emphasized a transparent, objective, reproducible methodology. At the time, aside from small adjustments, the underwriting factors had not been updated since the inception of RBC, in part because the approach at that time incorporated subjective judgments and could not be reproduced. The RAA's comment letter provides the best evidence of the transparency of the methodology, since the RAA was able to reproduce the results using our earlier report.

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We thank the NAIC for the chance to follow up on these issues and hope this additional discussion will be helpful. As always, we stand ready to help the NAIC on this and related initiatives.

Sincerely,

Alex Krutov

Alex Krutov, Chair
American Academy of Actuaries' P/C Risk-Based Capital Committee

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