AMERICAN ACADEMY *of* ACTUARIES

February 12, 2013

Mr. Stewart Guerin
Chair, Valuation of Securities (E) Task Force
National Association of Insurance Commissioners

Re: SVO Recalibration Project - Definitions for NAIC Designations Proposal

Dear Stewart:

The American Academy of Actuaries[1] C1 Work Group (C1WG) appreciates the opportunity to comment on the SVO Staff Recalibration Project - Definitions for NAIC Designations Proposal (November 9, 2012). The C1WG provides support to the NAIC in reviewing and revising the investment risk component of the Life Risk-Based Capital formula (i.e. the C1 component).

The C1WG understands the need to maintain consistency of the descriptions of NAIC Designations in insurance regulations with the associated credit ratings from Credit Rating Providers (CRPs). However, we believe that the proposed recalibration of ratings and their modifiers into a new set of designations is premature given the ongoing efforts of the Academy's C1WG and the NAIC's C1 Factor Review Subgroup.

The primary focus of our comments is directed to the timing rather than the technical merits of the SVO proposal. While the recommendations of the C1 Factor Review Subgroup might be similar to the SVO's proposal, the revised classification scheme should be derived from the extensive risk analysis that forms the basis for revised C1 bond factors. In addition, the implementation of the revised classification effort should coincide with the changes to the C1 factors.

The C1WG is currently conducting an extensive review of the C1 RBC component and its individual factors; the current emphasis is on life insurance company bond capital. We believe that it is vital for this review to be completed before any recalibrated classification scheme is adopted. The C1WG's work will provide a solid analytical foundation for a revised set of bond classes. Our work has or will involve the following steps:

- Define the investment risks to be included in C1
- Evaluate the merits of different types of credit models for RBC purposes
- Develop a C1 bond model to project the cash flows of a representative bond portfolio over a range of economic scenarios
- Review the methodology and assumptions used in setting the 1991 C1 bond factors
- Replicate the 1991 C1 bond factors

[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.

- Review the default and recovery studies from Moody's and S&P, including discussions with representatives of both organizations to determine how best to translate the CRP loss experience into assumptions for the updated C1 bond model
- Evaluate the merits of reflecting issuer and subordination directly in the development of C1 bond factors (as opposed to issue and an average recovery assumption)
- Determine the characteristics of a representative bond portfolio to serve as input for the C1 bond model
- Define other assumptions for the bond model that affect the projection of cash flows for the bond portfolio (e.g., time horizon, taxes)
- Determine the appropriate interaction between RBC, Asset Valuation Reserve (AVR) and statutory reserves
- Evaluate the impact of different risk metrics and confidence levels (e.g., CTE90, 92nd percentile)

Our approach in the assumption setting and model building portion of our work is to analyze and make recommendations at a granular level to ensure that the adopted set of RBC factors for bonds and AVR, and the revised classifications, are consistently developed, thereby ensuring the statistical integrity and risk coherence of RBC, AVR, and statutory reporting. In developing the loss assumptions and the corresponding bond classifications, we will consider the statistical credibility of the data as well as the manner in which the data is being used.

It is essential not to lose sight of the fundamental purpose of the bond classifications contained in statutory reporting: to facilitate the calculation of RBC and AVR. The existing classifications were implemented in the early nineties to facilitate the transition from the Mandatory Securities Valuation Reserve (MSVR) to a modernized solvency framework that included the Asset Valuation Reserve, Interest Maintenance Reserve (IMR) and RBC formulas. RBC and AVR are calculated directly from the existing six bond classes. Any revisions to the bond classifications should be made in concert with changes to RBC and AVR. We do not know of any other regulatory purpose for the NAIC ratings designations other than to calculate RBC and AVR.

Conclusion

The C1WG understands the merits of a more granular classification scheme, provided the new classes enhance the regulators' understanding of an insurer's investment risks, and the impact of the new classes is consistently implemented throughout the entire regulatory framework, including the RBC and AVR factors. Because we believe that the determination of capital should define the rating classifications used in statutory reporting, we strongly urge the VOSTF to defer the adoption of any recalibrated designations until the work of the Academy's C1WG and the NAIC's C1 Factor Review Subgroup has been completed. The implementation of any changes to the classification scheme should coincide with changes to the C1 factors.

Sincerely,

Nancy Bennett, FSA, MAAA, Co-Chairperson of the C1WG
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