



AMERICAN ACADEMY *of* ACTUARIES

April 23, 2014

Kris DeFrain
Director, Research and Actuarial
NAIC Central Office

Dear Kris:

During the NAIC PBR Implementation (EX) Task Force (Task Force) call on April 14, Superintendent Torti indicated that numerous parties have requested an interim meeting of the Task Force to discuss PBR and the recommendations of the *Report of Rector and Associates, Inc. to the PBR Implementation (EX) Task Force* (Report). After the call, you asked for issues that could be discussed at such an interim meeting. The American Academy of Actuaries¹ Principle-Based Reserve Strategy Subgroup (PBRSS) of the Life Practice Council offers its input pursuant to your request.

The PBRSS supports holding an interim meeting, primarily due to the extensive number of complex issues embedded in the Report that need further discussion. As numerous parties have commented, the proposed timeline for implementing the Report's recommendations is aggressive. The PBRSS believes that a face-to-face meeting is the most efficient forum to vet and resolve the many outstanding conceptual and technical issues raised by the Report surrounding the use of captives. Whether or not a face-to-face meeting is held, we suggest first reaching tentative agreement on the following major conceptual issues before proceeding with the many technical issues:

- **Basis for the actuarial method: VM-20, modified VM-20, or some other basis**
The basis for the Actuarial Method is fundamental to all other decisions. We strongly encourage the Task Force reach consensus on the basis for the Actuarial Method.
- **Composition of Primary and Other Assets**
The decision as to the extent various assets other than "hard assets" will be permitted to back portions of the liabilities, both within and above the Primary Asset Level, will drive additional considerations. These considerations will depend on the types of assets that may be permitted for either portion but include RBC considerations, modeling procedures, and ongoing compliance.
- **Framework for ensuring ongoing compliance, including the adequacy of assets, required capital, and actuarial/audit opinions**

¹The 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.

The Report contemplates various regulatory safeguards to ensure ongoing compliance and adequacy of assets. Many such safeguards are in place today, such as the requirement for Asset Adequacy Analysis and the Actuarial Opinion. We recommend discussion of current procedures, with the objective of enhancing existing procedures to incorporate any issues unique to captives, before adding new procedures unique to captive arrangements.

In addition, there are technical issues where additional discussion is needed before final resolution can be reached. We suggest that both Mortality Assumptions and the use of the Net Premium Reserve be covered in an interim meeting, as discussed below.

1. Mortality Assumptions

The Report suggests that VM-20 be the Actuarial Method used to determine the Primary Asset Amount with certain modifications made to the mortality assumptions. The PBRSS position is that VM-20 should form the basis for the Actuarial Method, but with no modifications to the current assumptions. PBR is a dynamic valuation method that will be continually evaluated for its effectiveness. Many elements of VM-20 will be evaluated and updated over time, including the mortality assumption. The Actuarial Method should be the current version of VM-20, as modified from time-to-time.

Some parties have opined that the use of the VM-20 mortality assumption (as VM-20 is currently drafted) within the Actuarial Method could generate a Primary Asset Level that is unnecessarily high and conservative, which in turn will not satisfy one of the Task Force's goals—disincenting the use of reserve financing by captives. An updated set of mortality tables to be used in valuation are in development, and completion of the tables is anticipated by year-end 2014. If the new mortality tables are used for the Actuarial Method, the Primary Asset Level will likely be reduced, but conservatism will remain. Some of the conservatism in the final VM-20 mortality assumption is due to a policy decision made by LATF in 2008 that overrides the fundamental mortality experience used for development of the Valuation Basic Table (VBT) (i.e., there will always be a disconnect between the new VBT and company experience due to mortality variations by face amount). In addition, some of the conservatism is due to the process used to grade company experience to an industry table that diminishes the weight given to company experience and some is due to the explicit margins contained in the mortality rates. We believe regulators could benefit from a thorough discussion of this policy decision to add conservatism to mortality rates, and the effect this policy decision could have on the decision to enter into captive transactions.

2. Use of the Net Premium Reserve

Another topic that we recommend be discussed by the Task Force is whether the VM-20 Net Premium Reserve should be used as part of VM-20 calculation if that approach is chosen as the Actuarial Method. As noted in our comment letters of March 21 and April 11, we believe that the Net Premium Reserve should not be included in the VM-20 calculation if it is used to determine the Primary Asset Amount.

Applying the Net Premium Reserve to captive reinsurance transactions, which generally involve more narrowly defined product blocks issued over a limited period of time, could result in a Primary Asset Level that significantly misses the mark in either direction. This could result either in artificially increasing the Primary Asset Level required or causing significant calculation work and the devotion of resources to develop a reserve that is never used.

We believe that, in order to accomplish the purpose envisioned by the Report of backing the Primary Asset Level by hard assets, the Primary Asset Level should be an appropriately determined risk-based reserve without the need for a prescriptive, formulaic floor. To that end, we recommend that, along with elimination of the Net Premium Reserve, the deterministic exclusion test also be eliminated, which will result in the deterministic reserve serving as the floor reserve.

Making a decision on whether or not to include the Net Premium Reserve for this purpose is one of the critical decisions that the Task Force must make as it moves forward.

In summary, the PBRSS stands ready to participate in an interim meeting should you plan to go forward with one. Perhaps a face-to-face meeting will provide a concentrated block of time to address all of the key conceptual issues, and to allow the PBR Implementation Task Force to determine priorities and a critical decision path. We would be happy to answer any questions that you have about the items covered in this letter.

We hope these additional comments are helpful. Please contact John Meetz, the Academy's life policy analyst (meetz@actuary.org; 202-223-8196) if you have any questions.

Sincerely,

Cande Olsen, FSA, MAAA
Chairperson
Principle-Based Reserves Strategy Subgroup
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