EXPOSURE DRAFT: A PUBLIC POLICY PRACTICE NOTE

# Credit for Life Reinsurance in U.S. Statutory Financial Statements

*May 2017*

Developed by
the Credit for Reinsurance Subgroup
of the Reinsurance Committee
of the Risk Management and Financial Reporting Council
of the American Academy of Actuaries

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**Exposure Draft of the Practice Note on Credit for Life Reinsurance in U.S. Statutory Financial Statements**

This practice note is not a promulgation of the Actuarial Standards Board, is not an actuarial standard of practice, is not binding on any actuary and is not a definitive statement as to what constitutes generally accepted practice in the area under discussion.

Events occurring subsequent to this publication of the practice note may make the practices described in this practice note irrelevant or obsolete.

This revised practice note was prepared by the Credit for Reinsurance Subgroup of the Reinsurance Committee of the American Academy of Actuaries. The practice note represents a description of some of the practices believed by the current subgroup to be commonly employed by actuaries in the United States in 2016-17. The purpose of the practice note is to provide information to actuaries on current practices in the determination of credit for reinsurance that may be taken on statutory financial statements. However, no representation of completeness is made; other approaches may also be in common use. It should be recognized that the information contained in the practice note discusses current and emerging practice, but is not a definitive statement as to what constitutes generally accepted practice in this area. Further, there are variations in the implementation and interpretation of the National Association of Insurance Commissioners' (NAIC) model laws and regulations that may apply to the determination of credit for reinsurance by jurisdiction. The commentary in this practice note does not cover all such variations.

We welcome comments and questions. Please send comments to RMFRCPolicyAnalyst@actuary.org.

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## Introduction

This practice note is intended to provide actuaries with information on current and emerging practices used to determine the credit for reinsurance that may be taken on statutory financial statements. Primary source materials referenced in this practice note include (abbreviations by which each document is referenced in this document are given in parentheses):

1. Accounting Practices and Procedures Manual, NAIC, 2016. (APPM)
    a. Statement of Statutory Accounting Principles 61R: *Life, Deposit-Type and Accident and Health Reinsurance*, NAIC, 2015. (SSAP 61R)
    b. Appendix A-785
    c. Appendix A-791
2. *Credit for Reinsurance Model Law* (Model #785), NAIC, 2016.
3. *Credit for Reinsurance Model Regulation* (Model #786), NAIC, 2012.
4. *Term and Universal Life Insurance Reserve Financing Model Regulation* (Model #787), NAIC, 2017. (Reserve Financing Model Regulation)
5. *Life and Health Reinsurance Agreements Model Regulation* (Model #791), NAIC, 2002. (Risk Transfer Regulation)
6. *Standard Valuation Law* (Model #820), NAIC, 2010.
7. *Actuarial Opinion and Memorandum Regulation (Model #822)*, NAIC, 2010. (AOMR)
8. *Valuation of Life Insurance Policies Model Regulation* (Model #830), NAIC, 2009. (Regulation XXX)
9. *Valuation Manual*, NAIC, Aug. 29, 2016. (Valuation Manual)
10. *Recognition of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation* (Model #814), NAIC, 2003.
11. Actuarial Guideline XXXVIII: *Application of the Valuation of Life Insurance Policies Model Regulation*, NAIC, 2012. (AG 38)
12. Actuarial Guideline XLVIII: *Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830)*, NAIC, 2014. (original version of AG 48)
13. Actuarial Guideline XLVIII: *Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830)*, NAIC, 2016. (AG 48)
14. Actuarial Standard of Practice No. 11: *Financial Statement Treatment of Reinsurance Transactions Involving Life or Health Insurance*, Actuarial Standards Board, 2011.

 

(ASOP No. 11)
15. Actuarial Standard of Practice No. 40: *Compliance with the NAIC Valuation of Life Insurance Policies Model Regulation with Respect to Deficiency Reserve Mortality*, Actuarial Standards Board, 2011. (ASOP No. 40)
16. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, HR 4173, Public Law 111-203, 12 US Code, Chapter 53, U.S. Congress, 2010. (Dodd-Frank Act)
17. *Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance*, 2017 (Covered Agreement)

This practice note represents a description of some of the practices the subgroup believes to be common among some U.S. actuaries; however, other approaches also may be used in practice. Further, there are variations in the implementation and interpretation of the NAIC model laws and regulations by jurisdiction. The commentary in this practice note is based on the model laws and regulations and does not cover all such variations.

This practice note is intended to encourage discussion on the issues set forth below, providing a framework to foster dialogue among the actuaries involved in the process.

## Background

In 2005, the Life Valuation Subcommittee of the Academy developed the original *Reinsurance Reserve Credit in U.S. Statutory Financial Statements* practice note, which was intended as a description of the practices at the time that were used by actuaries in the United States regarding credit for reinsurance. The members of the subcommittee responsible for the original Practice Note were:

James Dallas, MAAA, FSA (Chairperson)
Frank Clapper, MAAA, FSA
Andrew Creighton, MAAA, FSA
Arnold Dicke, MAAA, FSA
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After the passage of the Dodd-Frank Act in 2010, the Academy determined the practice note should be updated to reflect the subsequent changes to the law and federal and state regulations associated with the legislation.

The updated practice note reflects the Covered Agreement concluded between the European Union and the United States on Jan. 13, 2017, as well as changes to the Credit for Reinsurance Model Law and Regulation, including those regarding certified reinsurers, the adoption and implementation of AG 48 and the new Reserve Financing Model Regulation, changes to SSAP 61R, and aspects of the Valuation Manual that impact reinsurance. In addition, it covers topics discussed in previous versions of this practice note as well as evolving practice among actuaries.

## Section A: General Issues Regarding Credit for Reinsurance

### *Q1. What regulations, laws, actuarial standards of practice (ASOPs), and other guidance regarding credit for reinsurance would the actuary normally take into account?*

To promote uniformity in financial reporting and solvency supervision across the states, the NAIC establishes standards that states and their insurance departments are expected to meet and adopt in law and regulation in order to be certified as "accredited." At this writing, all states have been so certified. Model laws and regulations governing credit for reinsurance are included among the NAIC standards, as is statutory accounting guidance codified in the APPM, which is maintained and updated regularly by the NAIC.

In implementing accreditation standards, the NAIC may choose to permit some degree of variation by state, such that individual state laws and regulations may differ. But, most states have enacted their reinsurance requirements largely as drafted by the NAIC. The APPM is generally adopted as a whole, although some states may prescribe certain accounting deviations through law or regulation.

Among the more relevant NAIC accreditation standards for credit for life reinsurance are:

1. The APPM
    a. SSAP 61R
    b. Appendix A-785
    c. Appendix A-791
2. The Credit for Reinsurance Model Law (Model #785)
3. The Credit for Reinsurance Model Regulation (Model #786)
4. The Life and Health Reinsurance Agreements Model Regulation (Model #791)
5. The Standard Valuation Law (Model #820)
6. Regulation XXX; specifically, the sections addressing yearly renewable term (YRT) reinsurance (see Section B of this practice note for clarifying discussion)

ASOP No. 11 has been developed to provide guidance with respect to the actuary's professional work relating to financial statements that include material reinsurance transactions involving life insurance (including annuities) or health insurance risks. In March 2017, the ASB approved a proposal to revise ASOP No. 11 and to have the ASB Life Committee form an ASOP No. 11 Revision Task Force.

The revision to the Model Standard Valuation Law (SVL) adopted by the NAIC in 2009 introduces the concept of principle-based reserves (PBR), calculated subject to requirements set forth in a Valuation Manual, the requirements for which are specified in the SVL. The Valuation Manual has an operative date of Jan. 1, 2017. Reserves for new business written after this date may be principle-based; reserves for certain business written after Jan. 1, 2020, will be required to be principle-based. See Section F below for more details regarding credit for reinsurance for policies subject to principle-based reserving.

AG 48 became effective Jan. 1, 2015, and sets forth requirements for the reinsurance of level term and universal life with secondary guarantees under certain circumstances (primarily in situations in which the reinsurance is ceded to insurer-owned captive reinsurers). See Section G below for more details regarding credit for reinsurance for policies subject to AG 48. As of the drafting of this practice note, the NAIC had adopted a revision of the Credit for Reinsurance Model Law and a new Reserve Financing Model Regulation that would replace AG 48 upon adoption by a state. AG 48 has also been updated, effective as of Jan. 1, 2017, to make it as substantially identical to the Reserve Financing Model Regulation as possible to ensure uniformity in treatment among states. Section G of this practice note will make note of the differences between AG 48 and the Reserve Financing Model Regulation.

### *Q2. What are the regulatory requirements that must be satisfied for a reinsurance agreement to provide credit for reinsurance?*

A company is not prohibited from entering into a reinsurance agreement that does not satisfy all the requirements of the Risk Transfer Regulation and the APPM; however, if a company wishes to take statutory credit for reinsurance, then (i) the reinsurance agreement must qualify for reinsurance accounting treatment per the APPM, requiring satisfaction of the relevant risk transfer requirements in A-791 and (ii) additional security must be established for reinsurance arrangements with certain types of assuming insurers. Requirements for additional security, including the forms of acceptable security, are specified in the Credit for Reinsurance Model Law (Model #785) and Regulation (Model #786), as described Question 3 below. Both AG 48 and the Reserve Financing Model Regulation set forth additional requirements that will be discussed in Section G.

The APPM incorporates and references credit for reinsurance rules as Appendix A-785 (which includes relevant provisions from the Credit for Reinsurance Model Law) and Appendix A-791 (which includes relevant provisions from the Risk Transfer Regulation). Appendix A-791 also incorporates questions and answers clarifying its scope and application; these clarifications are substantive and the actuary may wish to review them. For example, the Q&A immediately following paragraph 2.a reflects the language of the Risk Transfer Regulation: “The primary purpose of the accounting requirements is to prohibit credit for reinsurance under financial arrangements where the ceding company enters into the agreement for the principal purpose of producing significant surplus aid for the ceding insurer on a temporary basis, while not transferring all of the significant risks inherent in the business being reinsured.”

The Risk Transfer Regulation, Appendix A-791, and SSAP 61R specify risk transfer conditions that must be met to “reduce any liability or establish any asset in the financial statement” on account of reinsurance ceded. The SSAP specifies risk transfer conditions necessary for “reinsurance accounting treatment” as described in the SSAP, including establishing a reinsurance credit or asset, and further specifies that deposit accounting treatment is required if these conditions are not met.

YRT reinsurance and certain non-proportional agreements, such as agreements covering stop loss and catastrophic risks, are specifically addressed in SSAP 61R, Appendix A-791, and the Risk Transfer Regulation. They are defined and exempted from certain risk transfer conditions that would otherwise apply. The APPM also clarifies how and when reserves and credit for reinsurance for certain non-proportional agreements are to be calculated.

Policies subject to principle-based reserving are subject to additional requirements. VM-20, Section A.3, permits reinsurance cash flows and SSAP 61R credits to be taken into account if the reinsurance agreement meets the requirements of the APPM for taking credit for reinsurance, but not otherwise. Furthermore, Section 8.A.4 provides, "If a reinsurance agreement or amendment does not qualify for credit for reinsurance, but treating the reinsurance agreement or amendment as if it did so qualify would result in a reduction to the company's surplus, then the company shall increase the minimum reserve by the absolute value of such reductions in surplus." Section F below provides more details about the impact of principle-based reserving on credit for reinsurance.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

## *Q3. What are the rules that govern the collateral that a reinsurer must provide for the ceding company to take credit for reinsurance?*

Model #785 and Model #786 distinguish seven categories of assuming insurers, determined from the perspective of the ceding company's state of domicile:

1. An assuming insurer licensed to transact insurance or reinsurance in the state of domicile of the ceding company (Model #785 Section 2.A);
2. An assuming insurer accredited by the commissioner as a reinsurer in the state of domicile of the ceding company, together with additional conditions including minimum surplus (Model #785 Section 2.B);
3. An assuming insurer that is domiciled in (or entered through, in the case of a U.S. branch of a non-U.S. assuming insurer) a state that employs substantially similar standards for reinsurance, together with additional conditions including minimum surplus (Model #785 Section 2.C);
4. An assuming insurer that maintains a trust fund in a qualified U.S. financial institution for payment of claims together with additional conditions including minimum surplus (Model #785 Section 2.D);
5. An assuming insurer that is certified by the commissioner of the state of domicile of the ceding company, together with additional conditions, including domicile of the assuming insurer in a qualified jurisdiction, most often non-U.S., financial condition review, and minimum capital and surplus (Model #785 Section 2.E);
6. An assuming reinsurer not falling in categories 1 to 5, but only as to the insurance of risks in jurisdictions where the reinsurance is required by law or regulation (Model #785 Section 2.F); and
7. An assuming insurer not meeting one of the conditions above, deemed an unauthorized reinsurer (Model #785 Section 3).

Under the provisions of Model #785 and Model #786, if the conditions required for reinsurance accounting treatment as described in A-791 are met:

- reinsurance ceded to assuming insurers in categories 1-4 and 6 receives credit without the requirement for the reinsurer to provide additional security;
- reinsurance ceded to a certified reinsurer, category 5, is eligible for full credit if the certified reinsurer provides collateral equal to a percentage of the credit for reinsurance determined by the reinsurer's assignment to one of several security tiers (currently zero percent, 10 percent, 20 percent, 50 percent, 75 percent, or 100 percent); placement may be no more favorable than that determined by the reinsurer's lowest financial strength rating and can be moved to a less favorable, that is, more conservative, tier at the discretion of the commissioner (Section D below provides additional information on this matter); and
- reinsurance ceded to an unauthorized reinsurer, as described in category 7, receives full credit only if the reinsurer provides collateral equal to 100 percent of the reserve credit.

Model #786, Section 10A, specifies that collateral, when required, must be "in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the exclusive benefit of the ceding insurer under a reinsurance contract with such assuming insurer as security for the payment of obligations under the reinsurance contract."

Conditions that must be met by the trust agreement are specified in the law and regulation, as are eligible forms of security:

1. Cash;
2. Securities listed by the SVO and qualifying as admitted assets;
3. Clean, irrevocable, unconditional letters of credit issued or confirmed by a U.S. financial institution that met the standards for qualification as of the date of issue of the letter of credit; or
4. Any other form of security acceptable to the commissioner.

AG 48, as well as the 2016 revision of the Credit for Reinsurance Model Law and the Reserve Financing Model Regulation, referring to the reinsurance of term and universal life with secondary guarantees, has more restrictive requirements for the assets in the trust, as discussed in the response to Question 1 above and in Section G below.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

### *Q4. Is a company required to have a signed reinsurance agreement in place to take statutory credit for reinsurance?*

Section 5A of the Risk Transfer Regulation states, "No agreement or amendment to any agreement may be used to reduce any liability or establish any asset … unless the agreement, amendment, or a binding letter of intent has been duly executed by both parties no later than the 'as of' date of the financial statement" in which the credit for reinsurance is reported. Furthermore, according to Section 5B of the regulation, the reinsurance agreement or amendment must be executed within a reasonable period of time after the signing of the letter of intent, not exceeding 90 days. Should the 90-day period end without a reinsurance agreement being executed, the letter of intent may not be used as the basis for reporting reinsurance credit in any statutory financial statement.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

### *Q5. How is credit for reinsurance determined for non-proportional reinsurance, such as an aggregate cap on benefit payments?*

SSAP 61R includes requirements for determining credit for reinsurance for non-proportional reinsurance. It states that "to reflect reserve credit on a prospective basis, the entity will need to demonstrate that the present value of expected recoveries, using realistic assumptions, to be realized from the reinsurer are in excess of the present value of reinsurance premiums guaranteed to be paid by the ceding entity under the terms of the contract."

Some actuaries believe this can only be measured accurately by modeling the impact of the reinsurance over a broad range of scenarios. The modeling usually directly recognizes the impact of any non-proportional features of the reinsurance program, such as aggregate claim caps and/or deductibles. Other actuaries believe that the existence of non-proportional features, such as a cap on benefit payments, could jeopardize the ability to take even partial credit for a reinsurance agreement.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

### *Q6. What are the accounting requirements for the reinsurance of inforce business?*

The treatment of gains and losses arising from indemnity reinsurance agreements relating to inforce business is addressed in SSAP 61R and in Appendix A-791.

Gains and losses are accounted for differently, and the parties to a treaty may reflect different financial effects in their respective annual statements resulting from the same reinsurance transaction. Gains related to reinsurance of inforce blocks of business that occur in the initial calendar year are to be accounted for in accordance with Appendix A-791, paragraph 3 of the APPM, which states that "any increase in surplus net of federal income tax resulting from reinsurance agreements entered into or amended after the effective date of the Codification which involve the reinsurance of business issued prior to the effective date of the agreements shall be identified separately on the insurer's financial statement as a surplus item and recognition of the surplus increase as income shall be reflected on a net of tax basis as earnings emerge from the business reinsured."

To effect this requirement, some actuaries do not adjust reserves, but book all line items (including federal income tax) in the summary of operations as would be the case without the requirement, except commissions (ceded), which are adjusted by the after-tax impact of the transaction in order to zero out the net gain after tax and move it to line 51.4 within the Capital and Surplus account section of the summary of operations (line reference is based on 2014

Annual Statement blank). Other actuaries may use different line item adjustments that result in the same adjustment to the net gain after tax. Some actuaries believe that the accounting treatment for gains resulting from inforce reinsurance transactions, as set forth in paragraph 3 of Appendix A-791, does not apply to YRT reinsurance.

According to SSAP 61R, if all or a portion of an assumed inforce block of business is "contemporaneously" retroceded, any resulting net gain (net of retrocession) recognized by the reinsurer is accounted for in the same way as a gain resulting from an inforce reinsurance agreement (i.e., "below-the-line"). Any net loss is immediately recognized in the company's earnings (i.e., "above-the-line").

If the reinsurance is recaptured, all income and surplus effects of the reinsurance arrangement are reversed for the reporting period in which recapture is effective.

SSAP 61R requires that interest-related gains or losses (net of federal income tax) associated with the reinsurance of an inforce block of business be credited or charged to the interest maintenance reserve (IMR) in accordance with the IMR instructions included in the NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies and amortized into income in future accounting periods.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

### *Q7. Is it permissible under statutory accounting to reflect credit for reinsurance on a policy that exceeds the reserve that would be set up for the reinsured portion of the policy if there were no reinsurance?*

ASOP No. 11, Section 3.3 states, "The actuary should calculate adjustments for reinsurance ceded financial statement items using assumptions that are consistent with those underlying the calculation of the direct items, except as otherwise indicated by the terms and conditions of the reinsurance agreement, even though the values of the direct financial statement values (before reinsurance) and adjustments for reinsurance ceded are generally determined separately."

Terms and conditions that may vary between direct and ceded business include premium mode, policy fee, and modal loadings. These differences can result in a calculated reserve credit on ceded reinsurance that exceeds the before-reinsurance reserve amount. Practice varies regarding the maximum reserve credit that may be established in the financial statements. Some actuaries believe that it is appropriate to fully reflect these differences in establishing the reserve credit on ceded reinsurance, while other actuaries believe it is not appropriate to establish a reserve credit on ceded reinsurance that exceeds the before-reinsurance reserve amount under any conditions. Finally, some actuaries believe that any excess of the reserve credit over the before-reinsurance reserve on the reinsured portion that is not received by the ceding company upon termination of the reinsurance should not be recognized. These actuaries believe that, otherwise, the reinsurance agreement would be out of compliance with Accounting Requirement 2b of Appendix A-791 of the APPM, as the occurrence of an event such as death, lapse, or surrender would deprive the ceding company of surplus.

Furthermore, regarding reinsurance ceded to a company not meeting the requirements of Section 2 of the Credit for Reinsurance Model Law (reinsurers that are not licensed, accredited, or certified in the state), ceding companies are permitted to take credit for reinsurance in the normal fashion but must establish an offsetting liability equal to the excess of the ceded reserve over the amount of satisfactory security.

Section 8.D.1 of the Valuation Manual states that "credit for reinsurance ceded shall be the excess, if any, of the pre-reinsurance-ceded minimum reserve over the post-reinsurance-ceded minimum reserve." This requirement, however, is an aggregate requirement that applies to all policies subject to principle-based valuation and does not apply on a policy-by-policy basis. See Section F below.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

### *Q8. Is it permissible under statutory accounting to reflect credit for reinsurance for just a specific benefit in a policy, such as for the no-lapse guarantee provided in a universal life policy or a guaranteed living or death benefit provided in a variable annuity contract?*

Accounting requirement 2f of Appendix A-791 of the APPM states that all significant risk inherent in the business being reinsured must be transferred as one of the conditions to reflect credit for reinsurance. Some actuaries believe that reinsurance credit is therefore not permitted when a secondary benefit or guarantee is ceded by itself. Some actuaries believe that reinsurance credit should be permitted if reserves can be calculated separately for the secondary benefit. Other actuaries believe that it is not enough for just the reserves to be calculated separately, but that the actuary must be able to identify the premium and the portion of renewal expenses that pertain to the secondary benefit or guarantee. These actuaries believe this is necessary in order to be able to determine that all the accounting requirements are satisfied. Both AG 48 and the Reserve Financing Model Regulation include provisions regarding the allowance of reserve credit if only the secondary guarantee risk is reinsured (see Question 27).

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

## Section B: Credit for Reinsurance Issues Relating to the Valuation of Life Insurance Policies Model Regulation ("Regulation XXX")

### *Q9. What credit for reinsurance issues are there related to YRT reinsurance; e.g., what limitations on credit for reinsurance taken by a ceding company apply when the reinsurer elects the optional exemption for YRT reinsurance under Regulation XXX?*

As noted in the response to Question 1 above, YRT reinsurance is exempted from the Risk Transfer Regulation. Note, however, that Appendix A-791 states that a treaty labeled as YRT will not qualify for this exemption "if the surplus relief in the first year is greater than that provided by a YRT treaty with zero first year reinsurance premium and no additional allowance from the reinsurer."

Generally, a ceding company calculates the statutory credit for YRT reinsurance as the unearned statutory net premium based on the mode of the reinsurance premium.

Two specific issues related to YRT credit for reinsurance arise from the optional exemption for YRT reinsurance in the section 6.E of Regulation XXX. First, if the assuming reinsurer elects the simplified reserve calculation allowed under the optional exemption, then the ceding company's credit for reinsurance is limited to the reserve held by the assuming company for the affected policies (see section 6.E.6 of Regulation XXX). Regulation XXX does not provide further guidance on this issue. While assuming companies often elect the optional exemption, at this time there does not appear to be consistent practice regarding communication between ceding and assuming companies concerning the optional exemption. Second, if the 2001 CSO valuation basis has been elected for policies for which the optional exemption is also elected, the *Recognition of the 2001 CSO [Commissioners Standard Ordinary Task Force] Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation* (Model #814) applies and modifies several provisions of Regulation XXX, including requiring the use of the *ultimate* mortality rates in the 2001 CSO Mortality Table for the calculations specified in section 6.E.

Regulation XXX does not apply to policies valued under Section VM-20 of the Valuation Manual.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

### *Q10. Would the ceding company actuary usually take into account any analysis done in conjunction with setting X factors on a gross basis for Regulation XXX business when establishing credit for reinsurance?*

Some actuaries believe that it is usually preferable for the actuary to take into account any X factor analysis performed. ASOP No. 40, Section 3.4, states that "anticipated mortality should be assessed and X factor classes should be created on a gross basis." It also states that "the anticipated mortality on ceded business should not be materially different from the anticipated mortality of the X factor class from which the business is ceded. If the difference is material, the appointed actuary should consider creating separate X factor classes." Some actuaries, therefore, believe if anticipated mortality is the same for gross and ceded business and the same X factors are used for both, it is normally preferable for any X factor analysis and any resulting changes in X factors to be applied to both gross and ceded business. Alternatively, some actuaries determine that gross and ceded anticipated mortality are significantly different and create separate X factor classes, in which case such actuaries usually apply subsequent X factor analysis and changes to X factors separately to gross and ceded X factor classes.

## Section C: Credit for Reinsurance Issues Related to Asset Adequacy Analysis

Note: The draft *Asset Adequacy Analysis* practice note[1] includes additional information regarding this topic.

### *Q11. How is credit for reinsurance treated in asset adequacy analysis?*

Credit for reinsurance is an accounting matter and, as such, is not specifically mentioned in the Actuarial Opinion and Memorandum Regulation (AOMR), applicable to valuations with a year-ending date prior to Jan. 1, 2017, or Section VM-30**,** *Actuarial Opinion and Memorandum Requirements*, of the Valuation Manual, applicable to valuations with a year-ending date on or after Jan. 1 2017. However, Section 13.a.vi of VM-30 does specify that the appointed actuary must provide a regulatory asset adequacy issues summary that includes a description of "the methods used by the actuary to recognize the impact of reinsurance on the company's cash flows, including both assets and liabilities, under each of the scenarios tested." ASOP No. 11, Section 3.2 states: "When preparing, reviewing, or analyzing financial statement items that reflect reinsurance ceded or reinsurance assumed, the actuary should consider potential cash flows that may, in the actuary's professional judgment, have a material impact under the reinsurance agreement." According to the 2014 draft of the *Asset Adequacy Analysis* practice note, in a 2012 survey of appointed actuaries, 64 percent of the respondents indicated they model reinsurance in a way meant to approximate treaty terms.

Under current practice, either the cash flows are modeled in an integrated fashion (i.e., using a model that aggregates direct and reinsurance cash flows) or, especially if it is not feasible to model the direct business and the reinsurance ceded in the same model, the cash flows may be modeled separately, using consistent assumptions.

Reinsurance cash flows are not affected by the accounting status of the reinsurance agreement (i.e., whether the agreement satisfies risk transfer requirements), so many of the considerations that affect statutory accounting do not affect the asset adequacy analysis. However, according to VM-30 (applicable to valuations with year-ending dates on or after Jan. 1, 2017), Section 3.A.1.e, the appointed actuary's statement of opinion must include an opinion section expressing

[1] *Asset Adequacy Analysis* practice note exposure draft; Asset Adequacy Analysis Committee; American Academy of Actuaries; August 2014.

the appointed actuary's opinion with respect to the adequacy of the supporting assets to mature the liabilities. If the actuary elects to use the prescribed wording, the appointed actuary's opinion must include the statement that the reserves and related actuarial items "Meet the requirements of the insurance laws and regulations of the state of [state of domicile]." Thus, at least if prescribed wording is used, the appointed actuary is opining that the credit for reinsurance taken in the domiciliary state results in reserves that meet that state's requirements. With respect to reinsurance agreements that do not satisfy risk transfer requirements and are thus subject to deposit accounting, some actuaries may question whether the accounting entries reflecting such agreements are "related actuarial items." Others may believe that because including both the asset and liability impacts of such agreements would be equivalent to including the cash flows under the agreement, treating the related accounting entries as "related actuarial items" would seem to be justified and would tend to capture any interest sensitivity inherent in the cash flows. However, some states may not permit the reflection of any cash flows from reinsurance agreements that do not qualify for credit for reinsurance if such cash flows increase surplus.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

### *Q12. A company has a reinsurance agreement in place and it anticipates recapturing the agreement within the next five years. Would it be preferable for the asset adequacy analysis to assume that recapture occurs, or to assume that the agreement remains in place?*

Asset adequacy analysis generally reflects management's actual strategy, but some actuaries believe it is not necessary for asset adequacy analysis to assume that management will exercise a voluntary option. In a stochastic projection, some actuaries believe it is preferable for the treatment of the potential recapture to be consistent across all scenarios. This means that the actuary may set assumptions as to when and how recapture will occur, if at all. The assumptions may vary according to conditions, but normally would not vary arbitrarily between scenarios, based on results.

Some actuaries believe it is preferable for the actuary not to assume that recapture will occur unless the reinsurance agreement specifies that a unilateral right of recapture exists and can be exercised under the conditions present at the time. These actuaries believe it is preferable for an actuary to assume that, if the reinsurance agreement requires the reinsurer's consent to a recapture, it will be withheld if the recapture is advantageous to the ceding company. If the reinsurance agreement specifies that recapture *must* occur under a given set of conditions even though no credit for reinsurance may be allowed under the reinsurance regulations, some actuaries believe it is preferable for asset adequacy analysis to reflect such recapture under scenarios that meet the given set of conditions. If the reinsurance agreement does not *require* recapture, then some actuaries believe it is not *necessary* for an actuary to assume that recapture will occur, even if that is management's intent, because management still has the right to change its mind. Some actuaries perform a sensitivity test to assess the impact of making the assumption opposite to that assumed in the analysis. Some states may not allow the company to reflect recapture in its asset adequacy analysis if exercise of that provision is subject to regulatory approval.

### *Q13. How does the appointed actuary take into account reinsurer counterparty risk?*

ASOP No. 7, Section 3.8 states the following: "The actuary should consider whether reinsurance receivables will be collectible when due, and any terms, conditions, or other aspects that may be reasonably expected to have a material impact on the cash flow analysis."

It is often difficult to quantify the impact of a financially weak reinsurer. Current practice includes performing a sensitivity test that calculates the ceding company's exposure to this reinsurer as the amount of financial loss which is likely to occur if the reinsurer cannot pay *any* claims over an extended period of time. An emerging refinement of this practice is sometimes used: The reinsurer's financial condition is expected to vary according to economic conditions, to determine the scenarios that are expected to be most harmful and what the ceding company's exposure would be in those scenarios. In such situations, some actuaries take account of countermeasures available to mitigate this risk. For example, if suitable replacement reinsurance is readily available, these actuaries may reflect only any increased cost of the replacement coverage plus any losses sustained from uncollectable balances during the interim before replacement coverage becomes effective.

Some actuaries believe that the counterparty risk should be modeled for all reinsurers. For example, these actuaries would assign a probability of default to all reinsurers rated below a certain credit rating. These actuaries reflect the counterparty risk by applying the default probability to the present value of cash flows projected to be received from the counterparty. One method used by some actuaries to determine the probability of default is to refer to the probability of default of a bond with the same rating as the reinsurer. Reinsurers rated above the threshold would either have no additional loss in the scenario being analyzed, or at most a very small one.

## Section D: Credit for Reinsurance Issues Related to Certified Reinsurers

### *Q14. A company has a reinsurance agreement with a reinsurer domiciled outside the United States that is now listed as a certified reinsurer in the company's state of domicile. Before being designated as a certified reinsurer, the reinsurer held an irrevocable letter of credit equal to 100 percent of the credit for reinsurance that the company was taking. What amount of security must the reinsurer now hold for the company to take full reserve credit on this agreement?*

Certified reinsurers are defined in Section 8 of the Credit for Reinsurance Model Regulation. Credit for reinsurance from a certified reinsurer only applies to reinsurance agreements entered into or renewed on or after the effective date of the certification of the reinsurer. Unless the reinsurance treaty is amended prior to the date of the financial statement, the reinsurer will be required to provide 100 percent security in order for an insurer to avoid losing credit for reinsurance. This security may still be provided via an irrevocable letter of credit. Amended reinsurance contracts may use the lower security requirements only for business losses incurred or policies written after the reinsurer is certified. The answer to Question 15 below provides further information relevant to this matter. Note that although the certified reinsurer could qualify for zero percent security on a new or amended reinsurance agreement, an insurer may request in its reinsurance agreement that the reinsurer hold a higher percentage.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

### *Q15. What happens to a company's credit for reinsurance when a certified reinsurer has a change in rating?*

According to Section 8.B(8) of the Credit for Reinsurance Model Regulation, when a certified reinsurer improves its rating, the lower security requirements apply only to agreements entered into subsequent to the change in rating. If a certified reinsurer's rating declines, all existing business is subject to the increased security requirements. If the certified reinsurer does not post additional security, the commissioner may suspend or revoke the reinsurer's certification. Upon revocation, the commissioner may require the reinsurer to post security in order for the ceding company to take credit for the reinsurance ceded to the reinsurer. Notwithstanding a downgrade or revocation of the certification of the reinsurer, the ceding company can claim full credit for reinsurance for a period of three months from the downgrade in rating, unless the reinsurance is found be the commissioner to be at a high risk of uncollectability. After the three-month period, the ceding company is no longer able to take credit for the portion of the reserves that is unsecured.

Individual states may have adopted variations in the model laws and regulations governing credit for reinsurance. Such variations are not covered in this practice note.

## Section E: Credit for Reinsurance Issues Related to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

### *Q16. My state of domicile has recognized credit for reinsurance for certain risks my company has ceded under a reinsurance agreement. Can another state disallow credit for reinsurance for these risks?*

Section 531(a) of the Dodd-Frank Act (15 USC § 8221(a)) states "If the State of domicile of a ceding insurer is an NAIC-accredited State, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance for the insurer's ceded risk, then no other State may deny such credit for reinsurance."

### *Q17. What is a "covered agreement" under the Dodd-Frank Act and what effect could such agreement have on credit for reinsurance?*

The Dodd-Frank Act authorizes the secretary of the Treasury and the U.S. trade representative, jointly, to negotiate and enter into covered agreements on behalf of the United States. The term "covered agreement" is defined in Section 313(r)(2) as "a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that—(A) is entered into between the United States and one or more foreign governments, authorities, or regulatory entities; and (B) relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation." The law requires the secretary and U.S. trade representative to consult with Congress before initiating such negotiations, during the negotiations, and before entering into the agreement, and enumerates issues to be addressed in such consultation. Section 502 of the Dodd-Frank Act provides that the covered agreement must be submitted to certain congressional committees and becomes effective 90 days thereafter.

Section 502 further establishes a Federal Insurance Office (FIO) within the U.S. Treasury Department, led by a director appointed by the secretary. Subject to procedures, conditions, and limitations on discretion specified in Section 502(f) of the Act, the FIO director may make a determination whether state insurance measures are preempted by such a covered agreement. Federal administrative procedures, potentially up to judicial review, will apply to such a determination by the FIO director.

A covered agreement could pre-empt state insurance laws and regulations, including those that impact credit for reinsurance. If a covered agreement is adopted, the amount of credit for reinsurance permitted for reinsurance agreements subject to the covered agreement could be changed.

***Q18. On Jan. 13, 2017, the Treasury announced the successful completion of a covered agreement with the European Union (the "Covered Agreement"). Which provisions of the Covered Agreement would have an impact on U.S.-based reinsurers and cedents?***

The Covered Agreement imposes conditions on each of the parties in the areas of reinsurance and group supervision (i.e., the regulatory supervision of groups of economic entities at least one of which is engage in insurance or reinsurance). The Covered Agreement defines "Home Party" as the party in whose territory the worldwide parent of the insurance or reinsurance group has its head office or is domiciled and the "Host Party" as the party in whose territory the insurance or reinsurance group has operations, but is not the territory where the worldwide parent is domiciled or has its head office.

Under the terms of Article 3 of the Covered Agreement, once the provisions of the Covered Agreement are fully in force, the following restrictions on supervision by any Host Party supervisory authority apply to any Home Party reinsurer that accepts cessions from a Host Party ceding insurer, provided that it meets the conditions listed below:

- A Party may not impose a collateral requirement or reporting equivalent as a condition to allow a Home Party assuming reinsurer to enter into a reinsurance agreement with a Host Party ceding company (Article 3, paragraph 1), nor may the Host Party impose a collateral requirement or reporting equivalent as a condition to allow the Host Party ceding insurer to take credit for the reinsurance associated with the cessions under a reinsurance agreement concluded with a Home Party assuming reinsurer (Article 3, paragraph 2), if such requirement results in less favorable treatment of the Home Party assuming reinsurer than would apply to Host Party assuming reinsurers (e.g., EU reinsurers will not be required to establish collateral requirements for U.S. cedents that are more stringent than collateral requirements applied to U.S. reinsurers, and vice versa).

- Article 3, paragraphs 1 and 2 also provide that there can be no new requirement with substantially the same regulatory impact on the Home Party assuming reinsurer as the banned collateral requirements if such requirement results in less favorable treatment of Home Party assuming reinsurers than on Host Party assuming reinsurers (e.g., state regulations may not require additional risk-based capital be held by a U.S. cedent that reinsures business with an EU-domiciled reinsurer than would be required if the reinsurance were with a U.S.-domiciled reinsurer).
- There can be no requirement for the Home Party assuming reinsurer to have a local presence to enter into a reinsurance agreement with a Host Party ceding reinsurer nor for a Host Party ceding reinsurer to take credit for the reinsurance (Article 3, paragraph 3).

Article 3, paragraph 4 specifies the conditions that must be met by the Home Party assuming reinsurer (slightly different conditions apply to associations) in order for the restrictions in Article 3, paragraphs 1 to 3, to apply:

- Capital and surplus of the reinsurer must be at least 226 million euro for EU-based reinsurers or $250 million for U.S.-based reinsurers (Article 3, paragraph 4, subparagraph (a)).
- EU-based reinsurers must maintain a solvency ratio of at least 100 percent SCR under Solvency II and U.S.-based reinsurers must maintain a solvency ratio of at least 300 percent of the authorized control level (ACL) in the territory in which the assuming reinsurer has its head office or is domiciled (Article 3, paragraph 4, subparagraph (b)).
- The Home Party supervisory authority confirms to the Host Party supervisory authority on an annual basis that the reinsurer complies with the solvency ratio requirement (Article 3, paragraph 4, subparagraph (l)).
- If its capital and surplus or the solvency ratio falls below the specified minimum levels or if regulatory action is taken against it for serious noncompliance with applicable law, the assuming reinsurer must provide the supervisory authority in the territory of the ceding company with prompt notice of this fact (Article 3, paragraph 4, subparagraph (c)).
- Reinsurer must confirm that it consents to the jurisdiction of courts in the territory of the ceding company, but the parties may agree to use other means of dispute resolution (Article 3, paragraph 4, subparagraph (d)).
- Reinsurer must confirm it agrees to the appointment of the Host supervisory authority as its agent for service of process (Article 3, paragraph 4, subparagraph (e)).
- Reinsurer must confirm it will pay all final judgments or provide 100 percent collateral for any final judgments it resists (Article 3, paragraph 4, subparagraphs (f) and (g)).
- If requested, reinsurer must provide audited financial statements and actuarial opinions or solvency and financial condition reports, to Host supervisory authority for the two years prior to the transaction and annually thereafter, as well as information on disputed or overdue reinsurance claims and reinsurance ceded and assumed by assuming and ceding company, respectively, prior to entry into the agreement and no more than semi-annually thereafter (Article 3, paragraph 4, subparagraph (h)).

- Reinsurer must "maintain a practice of prompt payment of claims," as defined in the Article 3, paragraph 4, subparagraph (i).
- Reinsurer cannot be involved in "any solvent scheme of arrangement" (a form of "winding-up" of a block of business) that involves Host Party ceding insurers, and, if it is, it must notify the ceding company and its supervisory authority and post 100 percent collateral for the benefit of the ceding insurer (Article 3, paragraph 4, subparagraph (j)).
- If the reinsurer is in resolution, receivership or in the process of "winding up," the ceding company may obtain an order requiring reinsurer to post collateral for all outstanding ceded liabilities (Article 3, paragraph 4, subparagraph (k)).

Additional relevant provisions of the Covered Agreement include the following:

- An insurance or reinsurance group is subject to worldwide prudential supervision only by its Home supervisory authority (Article 4, subparagraph (a). (The Covered Agreement provides a good deal of detail regarding this matter—see Article 4, subparagraphs (b) through (i) and the concluding paragraph of that Article.)
- A Host supervisory authority may nevertheless exercise group supervision with respect to a group at the level of the parent entity in its territory (Article 4, subparagraph (b)).
- Nothing in the Covered Agreement prohibits parties to a reinsurance agreement agreeing to require the posting of collateral (Article 3, paragraph 7).
- In each year after the date of entry into force or provisional adoption of the Covered Agreement, the United States must encourage states to reduce the pre-existing collateral requirements by 20 percent of the amount required prior to Jan. 1, 2017 (Article 9, paragraph 3). Provided the Covered Agreement has entered into force, on a date no later than the first day of the month 42 months after the date of signature (Jan. 13, 2017), the United States shall begin the process leading to a pre-emption determination of state laws (with states prioritized by the highest volume of gross ceded reinsurance), which process must be completed by the first day of the month 60 months after the date of signature (Article 9, paragraph 4).
- The Covered Agreement may be terminated with 180 days' written notice under normal circumstances (Article 11, paragraph 1). Accelerated mandatory consultation and termination provisions apply if the financial stability of the EU or the United States is threatened (Article 10, paragraph 2, subparagraph (d)).

The Covered Agreement does not provide for "equivalence to Solvency II" (a specific provision of EU insurance regulation) for the U.S. solvency system, but exempts U.S. companies from the requirements of Solvency II as long as the Covered Agreement remains in force.

The Covered Agreement does not address equivalence of reserve standards.

 

## Section F: Credit for Reinsurance Issues Related to Principle-Based Reserving

Note: The *Life Principle-Based Reserves Under VM-20* practice note[2] includes additional information regarding this topic.

### *Q19. Under what circumstances is a reinsurance agreement or amendment included in the calculation of PBR?*

PBR is required for certain policies under the revised SVL. The methods to be used in calculating all life insurance, annuity, and health reserves are set forth in a Valuation Manual authorized under that law. The Valuation Manual can be revised as deemed necessary by the NAIC, following the procedures set out in the law; any changes in the Valuation Manual go into effect in all jurisdictions that have adopted the revised law simultaneously, unless a jurisdiction takes specific action. The operative date for the Valuation Manual is Jan. 1, 2017. For policies that are subject to AG 38 and AG 48, PBR calculations may be required for policies issued prior to the effective date of the Valuation Manual. Section G below covers credit for reinsurance issues related to AG 48.

Section 8 of VM-20 sets forth the procedures for reflecting reinsurance in principle-based reserves for life insurance products. Section 8.A.3 states that a company shall include the effect of a reinsurance agreement or amendment in calculating the minimum reserve if, under the terms of the APPM, the agreement or amendment qualifies for credit for reinsurance.

### *Q20. If a reinsurance agreement or amendment does not qualify for credit for reinsurance under the terms of the APPM, how is the minimum reserve under VM-20 affected?*

According to section 8.A.4 of VM-20, "If a reinsurance agreement or amendment does not qualify for credit for reinsurance, but treating it as if it did so qualify would result in a reduction to the company's surplus, then the company shall increase the minimum reserve by the absolute value of such reduction in surplus." For agreements and amendments that do not qualify for credit for reinsurance, any reduction in the reserve is to be ignored, but any increase in the reserve must be reflected.

### *Q21. How is credit for reinsurance defined for life insurance policies subject to principle-based reserving?*

Section 8.B of VM-20 defines credit for reinsurance to be the excess, if any, of the pre-reinsurance-ceded minimum reserve over the post-reinsurance-ceded minimum reserve. VM-20 sets forth the process for calculating the "minimum reserve," which is a post-reinsurance reserve. Calculating the minimum reserve for a group of policies requires the calculation of a net premium reserve ("NPR"), as well as, in some circumstances, a deterministic reserve ("DR") and

[2] *Life Principle-Based Reserves Under VM-20* practice note exposure draft; Life Principle-Based Approach Practice Note Work Group; American Academy of Actuaries; February 2014.

a stochastic reserve ("SR ") for that group of policies. The NPR for a group of policies is the sum of the individual policy NPRs (as defined in Section 3 of VM-20), which are net of the SSAP 61R credits for the policies. The DR and SR are modeled reserves defined in Sections 4 and 5 of VM-20, respectively. Section 2 of VM-20 defines minimum reserves for three product groups, further subdivided based on the two exclusion tests, the stochastic exclusion test ("SET") and the deterministic exclusion test ("DET"), defined in Section 6 of VM-20. The resulting seven "Section 2" groups and their minimum reserves are:

1.a. Term policies that passed the SET: minimum reserve equals the greater of the NPR and the DR plus any due and deferred premium asset ("DDPA") for those policies;

1.b. Term policies that did not pass the SET: minimum reserve equals the greatest of the NPR, the DR plus DDPA, and the SR plus DDPA for those policies;

2.a. ULSG policies that passed the SET: minimum reserve equals the greater of the NPR and the DR plus DDPA for those policies;

2.b. ULSG policies that did not pass the SET: minimum reserve equals the greatest of the NPR, the DR plus DDPA, and SR plus DDPA for those policies;

3.a. "Other" policies that passed both the SET and the DET: minimum reserve equals NPR for those policies;

3.b. "Other" policies that passed the SET but did not pass the DET: minimum reserve equals the greater of the NPR and the DR plus DDPA for those policies; and

3.c. "Other" policies that did not pass the SET (or the DET): minimum reserve equals the greatest of the NPR, the DR plus DDPA, and SR plus DDPA for those policies.

The Valuation Manual defines ULSG policies as universal life policies meeting certain specified conditions, such as having a secondary guarantee in excess of five years. Any universal life policy that is not a ULSG policy is part of the "other" product group. On the other hand, variable universal life policies are ULSG policies if the specified conditions are met.

For the post-reinsurance reserve, each of the three reserve components (i.e., the SR, the DR, and the NPR), as well as the DDPA, is calculated on a post-reinsurance basis. Section 8.D of VM-20 requires that the pre-reinsurance minimum reserve be calculated on a pre-reinsurance basis (see Question 22 below) and that the SET and DET be applied for the pre- and post-reinsurance-ceded reserves separately.

Within each of the seven groups, the (post-reinsurance) minimum reserve is allocated to individual policies based on post-reinsurance policy NPRs (i.e., on the net premium reserve for an individual policy less that policy's reserve credit under SSAP 61R). Section 8.D, which describes how the (aggregate) pre-reinsurance-ceded minimum reserve is determined, does not clearly state a method for allocating this reserve to individual policies or to groups of policies. If Section 8.D.2 is read as implying that Section 2.C allocation rules apply to the pre-reinsurance-ceded minimum reserve, the allocation of the pre-reinsurance-ceded minimum reserve would be based on the pre-reinsurance-ceded net premium reserve. (A drafting note in earlier drafts of the Valuation Manual indicated that "the allocation of the reinsurance credit to each reinsurance agreement should be reevaluated," but no change was made in the Valuation Manual as adopted for 2017 valuations.) Some actuaries believe that an allocation based on reinsurance credits calculated on a stand-alone basis for each treaty and for the retained policies, normalized so that the total credit for reinsurance equals the difference between the (aggregate) pre-reinsurance-ceded minimum reserve and the (aggregate) post-reinsurance-ceded minimum reserve, would be an appropriate allocation method and would reduce certain anomalies associated with applying Section 2.C rules to the pre-reinsurance-ceded minimum reserve. Other allocation methods have also been proposed by actuaries familiar with the issue.

Because the minimum reserve for a specific group of policies, such as the product groupings that must be reported on the VM-20 Reserve Supplement, is the sum of the allocated minimum reserves for the policies in the group, it can be seen that allocated pre- and post-reinsurance minimum reserves for such a group may be calculated on very different bases. Because the exclusion tests are applied separately pre- and post-reinsurance-ceded, all or part of a product grouping could end up in different Section 2 groups pre- and post-reinsurance. The pre- and post-reinsurance Section 2 groups could consist of different policies, and which component (stochastic, deterministic, net premium) is largest for each Section 2 group could be different pre- and post-reinsurance. Due to all these considerations, the reserve credit for a group of policies (the difference between the sum of the allocated minimum reserve on a pre- and post-reinsurance basis) may be very different from the reserve credit that would be obtained by doing the VM-20 calculations for the group on a stand-alone basis.

### *Q22. How is the pre-reinsurance-ceded minimum reserve calculated under VM-20?*

Section 8.D.2 of VM-20 states that, if a pre-reinsurance-ceded minimum reserve is required for financial statement purposes, it shall be calculated using methods and assumptions consistent with those used to calculate the post-reinsurance-ceded minimum reserve, ignoring the effect of reinsurance ceded. Thus, the net premium reserve and, if required after performing the exclusion tests on a pre-reinsurance-ceded basis, the deterministic reserve and the stochastic reserve (as well as the DDPA) must be recalculated, ignoring the impact of reinsurance.

The pre-reinsurance net premium reserve for a group of policies is that reserve without deduction of the credit to the NPR to reflect reinsurance (the sum of the SSAP 61R credits for the policies in the group).

To calculate the DR and SR on a pre-reinsurance-ceded basis, Section 8 of the Valuation Manual requires the company to use assumptions that represent company experience in the absence of reinsurance—for example, assuming that the business was managed in a manner consistent with the manner that retained business was managed. (Assumptions may take account of specific differences in the retained and ceded business, such as different policy sizes.) In particular, the company must develop a hypothetical portfolio of starting assets and a corresponding model investment strategy. Section 8.D provides that the collar that applies to starting assets used in calculating the modeled reserves does apply when calculating the pre-reinsurance-ceded reserves. The recently approved exposure draft of an ASOP on principle-based reserving [Note: Exposure drafts are not binding on actuaries. ASOP No. 1, Section 3.1.7] states: "Possible methods for constructing the hypothetical portfolio include the following:

a. basing the portfolio on assets available at the time the cash flows were ceded;

b. assuming the portfolio consists of assets consistent with those backing the portion of the business retained for policies of the same kind; and

c. assuming the portfolio consists of a pro-rata slice of the assets of the reinsurer that back the reserve for the segment of its business that includes the ceded policies."

In developing a model investment strategy, in view of the Section 8.D requirement that "assumptions used in calculating the pre-reinsurance-ceded reserve represent company experience in the absence of reinsurance, for example assuming that the business was managed in a manner consistent with the manner in which the retained business was managed," some actuaries have indicated that they would use the current investment strategy applied by the company to the retained business, with such modifications as are necessary to reflect any impact of the reinsurance (for example, by reflecting the impact of the reduced total amount of assets available to be invested).

## Section G: Credit for Reinsurance Issues Addressed by AG 48, the 2016 Revision to the Credit for Reinsurance Model Law, and the Reserve Financing Model Regulation?

### *Q23. What reinsurance issues are addressed by AG 48 and the Reserve Financing Model Regulation?*

AG 48 and the Reserve Financing Model Regulation were developed to address the solvency implications of life insurance "reserve financing arrangements"—i.e., arrangements in which the security or assets backing reserves are (1) issued by the ceding insurer or affiliates, (2) are not unconditionally available to satisfy general account obligations of the ceding insurer, and/or (3) create a reimbursement or indemnification obligation on the part of the ceding insurer or affiliates. Reserve financing arrangements include so-called "XXX/AXXX captive arrangements."

**[The following terms are defined in the Reserve Financing Regulation and AG 48. They are capitalized there and in most references in the actuarial literature and will, accordingly, be capitalized in this section: Covered Policies, Grandfathered Policies, and Non-Covered Policies, defined in Question 25; Primary Security and Other Security, defined in Question 26; and Required Level of Primary Security and Actuarial Method, defined in Question 27. The acronyms NPR, DR, SR, SET, and DET were defined in Section F above.]**

### *Q24. When were AG 48 and the Reserve Financing Model Regulation adopted and what are their effective dates?*

The initial version of AG 48 was adopted by the NAIC with an effective date of Jan. 1, 2015. On Jan. 8, 2016, a revision of the Credit for Reinsurance Model Law was adopted, with a provision that permitted the adoption by the states of a regulation that imposes requirements on ceding insurers wishing to claim credit for reinsurance with respect to reserve financing arrangements. On Dec. 13, 2016, the NAIC adopted the Reserve Financing Model Regulation on which the state regulations regarding term and universal life with secondary guarantee reserve financing permitted by the revision to the Credit for Reinsurance Model Law could be based. As is the case with all NAIC model regulations, each state must adopt a regulation based on the Reserve Financing Model Regulation before its provisions become effective for cessions from a ceding company domiciled in that state.

The Reserve Financing Model Regulation is different in certain respects from the original version of AG 48. In order to promote uniformity among states, a new version of AG 48 was adopted on Dec. 13, 2016, with an effective date of Jan. 1, 2017. It supersedes the original version of AG 48 for valuation periods ending on or after Jan. 1, 2017. The original version applies to Covered Policies (see Question 25 below) for valuation periods ending prior to Jan. 1, 2017.

The revised version of AG 48 was conformed in most significant respects to the Reserve Financing Model Regulation and includes a sunset provision whereby the guideline will cease to apply once a regulation substantially similar to the Reserve Financing Model Regulation is adopted by a ceding company's domiciliary state. However, in view of the fact that, in a small number of states, the a regulation based on the Reserve Financing Model Regulation will need to be adopted to apply only on a prospective basis (i.e., only for policies issued on or after the effective date of the adopted regulation), AG 48 will remain as the authority for Covered Policies to which the adopted regulation does not apply. Thus, the revised version of AG 48 is expected to continue to be used for many years to come.

**[In the remainder of this Section G, the unmodified term "AG 48" will refer to the revised guideline; if reference is made to the original version of the guideline, the term "original version of AG 48" will be used.**

### *Q25. To which policies do the Reserve Financing Model Regulation and AG 48 apply?*

The Reserve Financing Model Regulation and AG 48 apply to liabilities associated with Covered Policies, unless one of the enumerated exemptions applies (see Question 30 below). Covered Policies are defined to be policies, other than Grandfathered Policies, with guaranteed non-level gross premiums and/or guaranteed non-level benefits (i.e., term polices) or universal life policies with a secondary guarantee, subject to the enumerated exemptions listed in Question 30 (for differences in the exemptions under the original version of AG 48, see Question 30). Grandfathered Policies are policies of these same types that were (1) issued prior to Jan. 1, 2015, and (2) ceded as of Dec. 1, 2014, under a treaty that would not have met any of the enumerated exemptions (a non-exempt treaty). Non-Covered Policies are policies that do not meet the definition of Covered Policies. Some actuaries point out that a strict application of this definition would imply that Grandfathered Policies would continue to be Non-Covered Policies if the reinsurance structure under which they had been ceded as of Dec. 1, 2014, is unwound and replaced by a new structure. In this connection, as noted in Question 27 below, the Reserve Financing Model Regulation and AG 48 both include requirements related to a treaty that cedes both Covered and Non-Covered Policies.

For companies ceding Covered Policies under a non-exempt reinsurance arrangement, both AG 48 and the Reserve Financing Model Regulation require that a Required Level of Primary Security be determined using the Actuarial Method and an additional level of Other Security be determined as described therein, and state consequences for failing to hold the amounts so determined. The capitalized terms are defined identically in AG 48 and the Model Regulation. The consequences stated in AG 48 and the Model Regulation are somewhat different.

### *Q26. What constitutes Primary Security and Other Security?*

"Primary Security" may consist of cash, securities listed by the NAIC Securities Valuation Office meeting the requirements of Section 3B of the Credit for Reinsurance Model Law (essentially, assets that would be admitted under statutory accounting), but excluding synthetic letters of credit, contingent notes, credit-linked notes, and similar securities, and, if held under a funds withheld or modified coinsurance arrangement, certain commercial loans, policy loans and certain derivatives (see Section 5F of the Model Regulation).

"Other Security" may consist of any security acceptable to the commissioner that does not qualify as Primary Security.

### *Q27. What are the "Required Level of Security" and the "Actuarial Method"?*

The "Required Level of Primary Security" is the amount determined by applying the Actuarial Method to the ceded Covered Policies, but not more than the statutory reserve ceded.

The "Actuarial Method" is the pre-reinsurance-ceded minimum reserve (i.e., the gross reserve) calculated as described in VM-20, applied on a treaty-by-treaty basis, with the following additional requirements:

1. For term policies, the Actuarial Method is the greater of the NPR and the DR; however, if the Covered Policies do not pass the SET, the Actuarial Method is the greatest of the NPR, the DR, and the SR.
2. For universal life with secondary guarantee policies, the Actuarial Method is the greatest of the NPR, the DR, and the SR—unlike for PBR, the SET cannot be utilized.
3. If both types of Covered Policies are included in the same treaty, the company can choose to apply the Actuarial Method to all Covered Policies (i.e., all three reserves are calculated, but note that the restrictions on aggregation imposed by the Valuation Manual still apply—as of the date of this practice note, this means that universal life and term policies cannot be aggregated (see Section 2 of VM-20)).
4. When ceding less than 100 percent of the Covered Policy risk,

 

a. If a quota share is ceded, the Required Level of Primary Security may be reduced in accordance with the percentage of risk ceded;
b. If only secondary guarantee risk is ceded, the Required Level of Primary Security is reduced by an amount determined by applying the Actuarial Method on a gross basis, but excluding the secondary guarantee, except where VM-20 has not been elected, the Required Level of Primary Security is reduced by the retained reserve after factoring in the impact of any YRT reinsurance ceded in an exempt arrangement. (Note that this provision appears to allow a company to cede just the secondary guarantee risk. However, many actuaries would also take into account in this regard the provisions of the Risk Transfer Regulation);
c. If a portion of the Covered Policy risk is ceded to another reinsurer on a YRT basis in an exempt arrangement, the Required Level of Primary Security is reduced by an amount determined by applying the Actuarial Method, including Section 8 (the reinsurance section) of VM-20, except that, for pre-Jan. 1, 2017, issues, the reduction is limited to $c_x$/(2*number of reinsurance premiums per year) using the same mortality as is used for the net premium reserve; and
d. For any other treaty ceding a portion of the risk to a different reinsurer, including stop-loss and other non-proportional reinsurance treaties, there is no reduction in the Required Level of Primary Security;
e. If a combination of reinsurance forms are applicable, each method is applied in a sequence that "accurately reflects the portion of the risk ceded."

5. If a ceding company cedes Covered Policies under more than one treaty, the aggregate Required Level of Primary Security cannot be less than if all the risks were ceded under a single treaty.
6. If a treaty cedes both Covered and Non-Covered Policies, credit for reinsurance for the latter can only be taken if security is held in addition to any security used to meet the Required Level of Primary Security for the Covered Policies.
7. The asset spread tables and asset default cost tables used in conjunction with the Actuarial Method are those tables that were adopted by the NAIC's Life Actuarial Task Force no later than the Dec. 31 on or immediately prior to valuation date.

### *Q28. What is the impact of the Reserve Financing Model Regulation on credit for reinsurance taken relative to reinsurance of XXX/AXXX business?*

Under the Reserve Financing Model Regulation, subject to the enumerated exemptions (listed in Question 30 below), credit for reinsurance is allowed on Covered Policies if and only if the following requirements are met on a treaty-by-treaty basis:

1. The ceding company's reserves for the Covered Policies are established in accordance with the SVL and related regulations and actuarial guidelines and the credit for reinsurance does not exceed the reserves.
2. The ceding company determines the Required Level of Primary Security for each treaty.
3. Funds consisting of Primary Security (see Question 26 above) at least equal to the Required Level of Primary Security are held by or on behalf of the ceding insurer on a funds withheld, trust or modified coinsurance basis.

 

4. Funds consisting of Other Security (see Question 26) equal to any excess of the statutory reserve over the Primary Security are held by or on behalf of the ceding company.
5. Any trust used must meet state requirements with certain exceptions (e.g., affiliate investments are not limited, except as regards Primary Security—see Section 7A(5) of the Reserve Financing Model Regulation—and the treaty must prohibit withdrawals or substitutions of trust assets that would leave the market value of Primary Security within the trust (when aggregated with Primary Security outside the trust that is held by or on behalf of the ceding insurer) below 102 percent of the level required by 3 above).
6. The reinsurance treaty is approved by the commissioner.

In addition, the ceding company cannot take or consent to actions that would result in a deficiency of either Primary Security or Other Security and must use its best efforts to eliminate any deficiency as expeditiously as possible.

Prior to the due date of each quarterly or annual statement the ceding company must perform a treaty-by-treaty analysis to determine whether the Primary Security and Other Security requirements have been satisfied and must establish a liability equal to the excess of the credit for reinsurance taken over the amount of Primary Security actually held, unless either (1) the requirements were fully satisfied by the valuation date or (2) any deficiency is eliminated before the due date of the quarterly or annual statement to which the valuation date relates.

Individual states may adopt regulations that are substantially similar to the Reserve Financing Model Regulation, but with certain variations. Such variations are beyond the scope of this practice note.

### *Q29. What is the impact of AG 48 on credit for reinsurance taken relative to reinsurance of XXX/AXXX business?*

Unlike the Reserve Financing Model Regulation, AG 48 does not state requirements that must be met for credit for reinsurance to be taken relative to the reinsurance of Covered Policies. Instead, AG 48 requires that the appointed actuary for a ceding insurer that cedes Covered Policies in situations that are not subject to the enumerated exemptions (see Question 30 below) to: (1) determine annually, on a treaty-by-treaty basis, a “Required Level of Primary Security” by using the “Actuarial Method” defined in the guideline and (2) render a qualified opinion for the ceding company if, for any such treaty, (a) the amount of Primary Security held as of the valuation date by or on behalf of the ceding company in a funds withheld, trust or modified coinsurance arrangement is less than the Required Level of Primary Security calculated using the Actuarial Method or (b) the amount of Other Security held by or on behalf of the ceding company on the valuation date is less than the excess of the statutory reserves over the level of Primary Security actually held unless either (i) such situation is remediated by the annual statement due date or (ii) the ceding company has established a liability equal to the excess of the credit for reinsurance taken over the amount Primary Security actually held. If a trust is used, requirement (5) listed in Question 28 applies.

As may be seen, the impact of AG 48 is largely the same as the impact of the Reserve Financing Model Regulation, except that it is enforced by a qualified actuarial opinion rather than a disallowance of reserve credit. However, the means for avoiding either consequence are the same: either eliminating the deficiency by the statement due date or establishing a liability equal to the excess of the credit taken (e.g., the statutory reserve) over the amount of Primary Security actually held. Under AG 48, the verification of the adequacy of Primary Security and Other Security is the responsibility of the appointed actuary instead of the company and need only be carried out annually, instead of quarterly as is the case for the Reserve Financing Model Regulation.

### *Q30. To which situations involving the reinsurance of XXX/AXXX business do the Reserve Financing Model Regulation and AG 48 not apply?*

The Reserve Financing Model Regulation and AG 48 do not apply to the following situations:

1. Reinsurance of
   a. Policies that are eligible for exemption under Section 6.E (i.e., the YRT exemption has been elected) or Sections 6.F or 6G of Regulation XXX (i.e., the direct policy is an attained age YRT or the direct policy is a series of n-year renewable term insurances where the guaranteed premiums are greater than the 1980 CSO and there are no cash surrender values) and the policy is issued before the later of the effective date of the Reserve Financing Model Regulation in the cedent's domiciliary state or the date on which the ceding company begins to apply VM-20 to the ceded policies, but in no event later than Jan. 1, 2020.
   b. Any universal life policy that meets all of the following requirements:
      - Secondary guarantee period, if any, is five years or less;
      - The specified premium for the secondary guarantee period is not less than the net level reserve premium for the secondary guarantee period based on the CSO valuation tables and valuation interest rate applicable to the issue year of the policy; and
      - The initial surrender charge is not less than 100 percent of the first year annualized specified premium for the secondary guarantee period.

      Note that this exempts universal life policies with secondary guarantees that are not "ULSG" policies as defined in VM-20.
   c. Credit life insurance.
   d. Variable life insurance policies for which the amount or duration of coverage is based upon separate account performance.
   e. Group life certificates, except where the certificate provides for guaranteed maximum premiums that continue coverage in force past one year.
2. The assuming reinsurer maintains a trust in a U.S. financial institution for the benefit of U.S. ceding companies meeting the requirements of Section 2.D of the Credit for Reinsurance Model Law.

3. The reinsurer:

    a.

    (i) is licensed in the state in which credit for reinsurance is sought (see Section 2A of the Credit for Reinsurance Model Law); or

    (ii) is admitted (see Section 2B of the Model Law) in a state where credit for reinsurance is sought; or

    (iii) is domiciled in a state that employs standards regarding credit for reinsurance that are substantially similar to those of the state in which credit is sought, and meets the requirements in Section 2C of the Model Law;

    b. prepares financial statements without material departure from the NAIC statutory accounting practices and procedures; and

    c. is not in a Company Action Level Event, a Regulatory Action Level Event, an Authorized Control Level Event, or a Mandatory Control Level Event.

4. The reinsurer is licensed, admitted, or domiciled in the state in which credit for reinsurance is sought and meets the requirements of Sections 2A, 2B, or 2C of the Model Law and (a) is not an affiliate of the ceding company, (b) prepares its annual statement in accordance with statutory principles, (c) is licensed or accredited in at least 10 states, but not as a captive or special purpose vehicle or other similar licensing regime, and (d) is not below 500 percent of Authorized Control Level Risk-Based Capital, calculated without material deviation from NAIC statutory accounting practices and procedures.
5. The reinsurer has been certified in the domiciliary state of the cedent or, if the cedent's state has not adopted the certification process, then the reinsurer is certified in at least five states. Alternatively, the reinsurer has statutory capital and surplus equal to or greater than $250 million (calculated without regard to permitted or prescribed practices) and is licensed in at least 26 states or licensed in 10 states and licensed or accredited in at least 35 states.
6. The commissioner, after consultation with the Financial Analysis (E) Working Group, finds that: (a) the reinsured risks are clearly outside the intent and purpose of the regulation substantially similar that was adopted by the state or AG 48, as the case may be, and (b) the risks are in scope only due to a technicality, and (c) application of the Guideline is not necessary to protect policyholders.

### *Q31. What are the differences between the original version of AG 48 and the Reserve Financing Model Regulation and the revised version of AG 48?*

The original version of AG 48 is effective for valuation periods beginning on or after Jan. 1, 2015, and ending on or before Dec. 31, 2016. The revised version of AG 48 is effective for valuation periods beginning on or after Jan. 1, 2017. The revised version of AG 48 will cease to be effective on a state-by-state basis when a regulation substantially similar to the Reserve Financing Model Regulation is adopted to replace it.

In the original version, as in the revised version, of AG 48 the appointed actuary is required to issue a qualified opinion if the requirements regarding Primary Security and Other Security are not met and if timely remediation action is not taken. (See Question 29. The term "Other Security" is defined differently in the original version of AG 48, so the statement of the remediation options differs from that in the revised version. However, the economic effect of the remediation options is the same for the original and revised versions of AG 48.) The requirement for the issuance of a qualified actuarial opinion instead of a restriction in the credit for reinsurance is the primary difference of both versions of AG 48 from the Reserve Financing Model Regulation. The Reserve Financing Model Regulation and the revised version of AG 48 differ in several additional respects from the original version of AG 48. Some are merely technical. The more important differences include the following:

- Applicability (Scope): The provisions of the Model Regulation apply only to ceding companies domiciled in states in which regulations similar to the Model Regulation have been adopted and only on and after the effective dates of such regulations, whereas both versions of AG 48 apply in all states on and after their effective dates.
- Exemptions: The exemptions from the requirements of the Reserve Financing Model Regulation are different than the exemptions from the original version of AG 48. In the Model Regulation and the revised AG 48:
    - Exemptions for policies satisfying Section 6 E, F, and G in Regulation XXX are limited to those policies issued before the later of the effective date of the Reserve Financing Model Regulation and the date (not later than Jan. 1, 2020) on which the company first applies VM 20 to the policies (in the original version of AG 48, there was no such limitation);
    - Exemptions were added for
        - any universal life policy that meets all of the following requirements:
            - The secondary guarantee period, if any, is five years or less;
            - The specified premium for the secondary guarantee period is not less than the net level reserve premium for the secondary guarantee period based on the CSO valuation tables and valuation interest rate applicable to the issue year of the policy; and
            - The initial surrender charge is not less than 100 percent of the first year annualized specified premium for the secondary guarantee period;
        - Credit life insurance;
        - Variable life insurance policies for which the amount or duration of coverage is based upon separate account performance; and
        - Group life certificates, except where there are guaranteed maximum premiums that are effective past one year;
    - Exemptions were added for reinsurance ceded to a reinsurer that
        - Meets the requirements of Section 5.B.4.b. of the Credit for Reinsurance Model Law (as revised subsequent to the adoption of the original version of AG 48) by having $250 million in statutory capital and surplus, calculated without regard to permitted or prescribed practices and being licensed in at least 26 states or licensed in 10 states and licensed or accredited in a total of at least 35 states;
        - Meets the requirements of Sections 2A, 2B, or 2C of the Credit for

Reinsurance Model Law and
  - Prepares financial statements in compliance with the APPM without material (per SSAP 1) departures pertaining to the admissibility or valuation of assets or liabilities that increase the assuming insurer's surplus, and
  - Is not in a Company Action Level Event, Regulatory Action Level Event, Authorized Control Level Event, or Mandatory Control Level Event;
- ▪ Meets the requirements of Sections 2A, 2B, or 2C of the Credit for Reinsurance Model Law and
  - Is not an affiliate of the ceding insurer or any insurer that directly or indirectly ceded the insurance to the ceding insurer;
  - Is licensed or accredited in at least 10 states, and is not licensed in any state as a captive, special purpose reinsurer or special purpose life reinsurer, limited purpose subsidiary, or other similar licensing regime; and
  - Is not, or would not be, below 500 percent of the Authorized Control Level RBC as calculated based upon then current NAIC calculation methods without deviation and without recognition of any departures from NAIC statutory accounting practices and procedures pertaining to the admission or valuation of assets or liabilities that increase the surplus of the assuming insurer.

- Definitions:
  - "Other Security" is defined as security acceptable to the commissioner excluding Primary Security (in the original version of AG 48, Other Security was inclusive of Primary Security—this affects the description of the calculations of the restriction on credit for reinsurance if a deficiency exists but the economic result is the same);
  - The definitions of "Covered Policies" and "Grandfathered Policies" do not reference Model Regulations or Actuarial Guidelines.
  - The Required Level of Primary Security cannot exceed the total reserve ceded.

- Actuarial Method:
  - The NPR is used as a calculated and is not reduced by an "applicable percentage" as was the case for the original version of AG 48.
  - For term policies, the SET from Section 6 of VM-20 must be applied and, if not passed, the Actuarial Method reserve is the greatest of the NPR, the DR, and the SR, not just the greater of the NPR and the DR, as was the case under the original version of AG 48.
  - It is clearly stated that, when applying the Actuarial Method, the Valuation Manual's requirements regarding aggregation must be satisfied.
  - Section 6A(4) of the Reserve Financing Model Regulation and Section 5A(4) of the revised version of AG 48 regarding the treatment of reinsurance treaties that cede less than 100 percent of the risks of the Covered Policies differ in certain respects from the comparable Section 5A(4) in the original version of AG 48.
  - Section 6A(7) of the Reserve Financing Model Regulation and Section 5A(7) of the revised version of AG 48 regarding the treatment of reinsurance treaties that

cedes risks on both Covered and Non-Covered Policies were added; both sections describe the determination of the Required Level of Primary Security and prohibit the use of Primary Security that is used for Non-Covered Policies in satisfying the Required Level of Primary Security, but the Reserve Financing Model Regulation also covers the determination of reserve credit in such cases.
  - For the original version of AG 48, only changes to the Valuation Manual adopted no later than the Sept. 30 immediately prior to year-end are incorporated into the Actuarial Method. For the Reserve Financing Model Regulation and the revised version of AG 48, the Valuation Manual "as then in effect" is to be used.

- Required Analysis: The analysis by the qualified actuary that is required by both versions of AG 48 contains requirements that largely mirror requirements in the Reserve Financing Model Regulation for taking credit for reinsurance, with the following exceptions:
  - The Reserve Financing Model Regulation, unlike either version of AG 48, assigns responsibility for the required analysis to the company instead of the appointed actuary and does not require a qualified actuarial opinion in case of deficiencies in Primary Security and Other Security held;
  - The Reserve Financing Model Regulation states explicitly that statutory reserves for Covered Policies must be established in full and credit for reinsurance cannot exceed the proportionate share of ceded reserves;
  - Trust asset substitutions are only allowed if after the substitution the fair market value of the trust assets is equal to or greater than 102 percent of the required Primary Security (this requirement is found in the revised version of AG 48);
  - The reinsurance treaty must be approved by the commissioner, and
  - Under the Reserve Financing Model Regulation, Primary Security and Other Security requirements must be checked before each quarterly statement, not just the annual statement, as under the original version of AG 48. As under either version of AG 48, if the requirements are not met, a liability in the amount of the excess of the for the level of the inadequacy must be established unless the deficiency was a) eliminated by the valuation date or b) eliminated by the filing date of the statement; however the Reserve Financing Model Regulation makes clear that this provision cannot be used to maintain any deficiency of Primary or Other Security for any longer than is reasonably necessary to eliminate it.

- Prohibition Against Avoidance. The Model Regulation explicitly prohibits any company with Covered Policies from taking any action or series of actions, or entering into any transaction or series of transactions with the purpose of avoiding the requirements, or circumventing the purpose or intent, of the Reserve Financing Model Regulation. This language is not in either version of AG 48, but both include a requirement that the appointed actuary for a company ceding Covered Policies issue a qualified opinion if the appointed actuary for any affiliated reinsurer that reinsures any of the Covered Policies issues a qualified opinion due in whole or in part to the analysis required by AG 48.

### *Q32. If a qualified opinion is filed due to AG 48 requirements, does that mean that a C-3 adjustment will need to be made, too?*

Prior to the adoption of the original version of AG 48, the instructions for calculating the C-3 component of RBC (currently found on page LR027) stated that C-3 factors would be reduced if there was an unqualified actuarial opinion. In response to the requirement in both the original and revised versions of AG 48 that a qualified actuarial opinion be issued if required amounts of Primary Security and Other Security are not held as of the filing date of the annual statement, the instructions for C-3 RBC calculation were modified to state that if the sole reason for a qualified opinion is this AG 48 requirement, for C-3 purposes, the actuarial opinion is to be treated as unqualified for RBC purposes. RBC calculations were also modified to require that the RBC be increased to reflect the shortfall in funding Primary and Other Security.

### *Q33. What is meant by the phrase "securities listed by the SVO" used in the definition of Primary Security?*

The phrase "securities listed by the Securities Valuation Office" is used in the Credit for Reinsurance Model Law and Regulation and in the definition of Primary Security in AG 48 and the Reserve Transfer Regulation. Several groups at the NAIC have been working on clarifying the meaning of this phrase. The process was incomplete as of the date of the practice note, and additional developments should be anticipated. The following is a summary of recent activities in this regard.

The Feb. 24, 2016, "Memorandum from the Senior Counsel of the Securities Valuation Office (SVO)"[3] includes appendices representing proposed amendments to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. The purpose of these amendments is to compile a list of "investment securities" (as opposed to "regulatory securities," which are permitted due to special arrangements with certain state insurance departments) from which the Reinsurance (E) Task Force would pick sub-lists that are eligible for use as Primary Security. Thus, this listing by the SVO, itself not adopted, is preliminary to further action by the Reinsurance (E) Task Force.

In the form presented in the Memorandum, the phase "Securities Listed by the SVO" used in Section 3.B of the Credit for Reinsurance Model Law and Section 10.A(2) of the Credit for Reinsurance Model Regulation refers to a list (the "SVO List of Securities") created by aggregating sub-lists that the SVO has compiled, or caused to be compiled, from each of (1) the VOS Process (this process covers securities that are reviewed and assigned an NAIC designation by the SVO), (2) the FE Data Process (this process covers securities referred to as those "deemed exempt from filing" in the Model Law and Model Regulation due to having ratings assigned by credit rating providers), (3) the RMBS/CMBS Modeled Securities Process, (4) the U.S. Treasury Process, and (5) the Exempt U.S. Government Securities Process plus, for purposes of the Model Law (but not the Model Regulation), certain additional securities. The proposed amendment contained the following list of such additional securities, which it noted was for purposes of

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[3] "Re: Proposal to Expand the NAIC Bank List to Include Eligible Non-Bank Financial Institutions"; National Association of Insurance Commissioners and the Center for Insurance Policy and Research; Feb. 24, 2016

illustration only: (1) The money market funds on the Money Market Funds Sub-List and the exchange traded funds on the SVO's ETF Sub List, (2) any letter of credit identified in the SVO's Letter of Credit Sub-List, and (3) all U.S. Treasury securities whether or not actually owned by an insurance company.

### *Q34. Is a reinsurance agreement out of compliance with risk transfer requirements if it requires that all Primary Security be depleted before Other Security can be used to satisfy the obligations of the reinsurer?*

Some actuaries believe the answer is yes for treaties that fall under AG 48 or the Reserve Financing Model Regulation. The rationale is that if the reinsurer does not have sufficient funds to cure a shortfall in Primary Security caused by a change in actuarial assumptions or another reason, the ceding company would suffer a reduction to its surplus due to the need to set up a liability for the excess of the credit for reinsurance over the Primary Security or due to its use of surplus funds to cure the shortfall. These actuaries believe that if the ceding company's surplus can be impacted in the event of a Primary Security shortfall, particularly when the reinsurer recognizes Other Security as an asset, the reinsurance agreement would be out of compliance with the Risk Transfer Regulation (particularly with the accounting requirement regarding the possible deprivation of surplus). These actuaries argue that some amount of Primary Security will always be required until all policy obligations have been satisfied, and therefore, Other Security may never be available to pay claims even if assumptions turn out to be more adverse than assumed in the original determination of the Primary Security requirement. These actuaries point out that the reinsurance agreement does not need to require that Other Security be used to cure a shortfall, but that its use for this purpose cannot be restricted if the shortfall cannot otherwise be cured by the reinsurer.

Some actuaries believe that the order in which assets would be liquidated to pay claims has nothing to do with meeting A-791 risk transfer requirements. The primary reason an order of use provision would be utilized is that assets held as Other Security may be less liquid than assets held as Primary Security and has no implication on the amount of funding required to be established by the reinsurer. If the Primary Security and Other Security were not fully funded, with or without the order of payment provision, then full credit for the reinsurance agreement would not be allowed. Should the reinsurer be unable to remedy the shortfall in a period "reasonably necessary to eliminate it," then risk transfer issues arise, but this occurs under all circumstances of security shortfalls and has nothing to do with order of use of securities.