American Academy of Actuaries Life Risk Based Capital Task Force

Proposal Regarding C - 1 Risk for Modified Coinsurance and Funds Withheld

Recommendation:

- The transfer of the default risk in modified coinsurance (mod-co) and other transactions with funds withheld should be recognized by reducing the RBC for the ceding company and increasing it for the assuming company.
- If mortgages are involved, the Mortgage Experience Adjustment factor of the ceding company should be utilized in determining the amount of C-1 risk transferred to the assuming company.
- The bond size factor and the concentration factor of both the ceding and assuming companies should be adjusted to recognize the assets that have been allocated to the modified coinsurance or funds withheld transactions.
- The adjustment for the size and concentration factors should only be made for assets that have been specified as part of the reinsurance transaction for at least six months.

Previous Proposal

The proposal previously sent to the NAIC contained the following:

> **C - 1**:
>
> The current RBC calculation makes no adjustment for mod-co.
>
> **No change is necessary.** Under the new Reinsurance Agreements Model Regulation, any significant asset default risk must be transferred to the assuming company. However, making an adjustment to the RBC to recognize this transfer is not justified. To the extent the ceding company transfers the default risk, it will simply increase its reinsurance recovery risk. Overall, there would be little change because any reduction in the C-1 formula for the mod-co assets would be offset (in whole or in part) by an increase in the 0.5% of ceded reserves that reflects the reinsurance recovery risk. On the other side of the transaction, the assuming company does not hold the assets and does not have easy, or timely, access to the asset information. In the end, making no change for mod-co, leaves a result that is consistent with that for coinsurance with funds withheld and is consistent with the goal of keeping the formulas simple.

Transfer of Default Risk

Recent input from reinsurance experts has indicated that in most, if not all mod-co cases, the ceding company does indeed transfer the default risk to the assuming company, even though the ceding company retains the assets. Since the amount of risk transferred can be sizeable, it seems reasonable to recognize the transfer of the risk by reducing the RBC requirement for the ceding company and increasing it for the assuming company.

Similar adjustments should be made whenever the default risk, but not the assets are being transferred to the assuming company (e.g. coinsurance with funds withheld). Under the current formula, this transfer of the default risk is not being recognized.

The RBC transfer can be accounted for by having the ceding company provide the assuming company with the amount of C-1 RBC for the assets on which the C-1 risk has been transferred (segmented, in a trust, etc.) to the assuming company. If mortgages are involved, the Mortgage Experience Adjustment factor of the ceding company should be utilized in determining the amount of C-1 risk transferred to the assuming company.

Number of Bond Issuers and Asset Concentration

Since the C-1 risk is being transferred to the assuming company, an adjustment should be made to the factors that recognize the number of bond issuers and the concentration of these issuers within each company. This can be accomplished by having the ceding company provide the information to the assuming company. To prevent companies from manipulating these adjustments, it is recommended that they only be made for assets that have been identified as part of the transaction for at least six months.

Reinsurance Recovery

It is not necessary to recognize the 0.5% reinsurance recovery risk for mod-co because assets equal to the required reserves are being held by the ceding company, just as they are for funds withheld. The recovery risk is only present if the assuming company holds the assets.

Materiality

Since quantifying this transaction will be relatively difficult, it may be reasonable to allow companies to avoid the calculation if the risk transfer is immaterial to both companies. Whether there is any precedent for this avoidance and just how it might work is not known at this time. However, if it is deemed worthy of consideration, the Academy Task Force will pursue it further.

Changes to Instructions and Formulas

Changes to the C-2 and C-3 factors to recognize the transfer of risk under mod-co were developed and published by NAIC in May, 1997. The Academy of Actuaries Task Force is willing to help the NAIC develop the appropriate instructions and formula changes to implement this proposed change to C-1.