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AMERICAN ACADEMY *of* ACTUARIES

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June 25, 2014

Commissioner Julie Mix McPeak  
Superintendent Joseph Torti III  
Co-Chairs, National Association of Insurance Commissioners (NAIC)  
Principle-based Reserving Implementation (EX) Task Force

Dear Commissioner McPeak and Superintendent Torti:

On behalf of the American Academy of Actuaries<sup>1</sup> Life Practice Council (LPC) and the PBR Strategy Subgroup (PBRSS), we appreciate the opportunity to comment on the exposed June 4, 2014 *Report of Rector & Associates, Inc. to the Principle-Based Reserving Implementation (EX) Task Force (June Report)*.

Following are some general comments on each of the modified recommendations.

1) Adopting the Framework Approach.

The LPC agrees that adopting a framework approach as the first step, followed by charges to the appropriate NAIC committees and working groups, is the most efficient way to approach this issue given the NAIC's indicated urgency in implementing a new regulatory regime for captive arrangements. However, the LPC has some preliminary concerns with specific elements of the June Report described below and has not had sufficient opportunity to determine fully if other elements of the current framework as proposed in the June Report merit adoption without change or additional specification.

We welcome the opportunity to hear further public comment and discussion on the many implementation details.

Among the items still being examined by the LPC, as noted in our comment letters of [March 21](#), [April 11](#), and [April 23](#), we do not believe that the Net Premium Reserve (NPR) should be included in the VM-20 calculation used to determine the Primary Security Requirement. Please see our further comments on this issue below.

2) Actions to be taken by the (Life Actuarial) Task Force.

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<sup>1</sup> The American Academy of Actuaries is an 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

**Charge 3 of Exhibit 2** - On Charge 3 to the Life Actuarial (A) Task Force (LATF), we agree that this is the right group to study these issues. In addition, as we said in our [April 23 letter](#), we believe the *Actuarial Method*, including the mortality assumption, should be the current version of VM-20, as may be modified from time-to-time.

In Charge 3, it states, “The Actuarial Method should consist of the NAIC Valuation Manual, VM-20, Requirements for Principle-Based Reserves for Life Products, modified to incorporate changes to mortality tables as developed by the American Academy of Actuaries and any other appropriate modifications determined by LATF, and should explicitly keep (in current or modified form) or eliminate the “net premium reserve” component of the current VM-20.” We have the following comments:

- The charge to LATF (#3) refers to the mortality tables developed by the American Academy of Actuaries. To clarify, the mortality tables used in the valuation are the joint work product of the Academy and the Society of Actuaries. The SOA’s role is to gather basic mortality experience, while the Academy’s role is the development of valuation margins. As we stated in our March 21 comment letter, “Consistent with Section 9.C.3.g. of VM-20, a set of improvement factors has already been developed by the SOA and the Academy’s Life Experience Subcommittee and published on the SOA website (<http://www.soa.org/Research/Experience-Study/Ind-Life/Valuation/research-2014-mort-imp-rates.aspx>) to be applied to the 2008 VBT table to true up that table to year end-end 2013.”
- Further, regarding “any other appropriate modifications determined by LATF,” as indicated in our March 21 comment letter, we do not believe it is in the best interests of implementing PBR to make ad hoc adjustments to any of the current requirements for the VM-20 modeled reserves for this purpose. These ad hoc changes to VM-20 identified in the Rector Report may not be made to VM-20.
- Also, as we said in our April 11 comment letter, we do not believe that the NPR should be included in the VM-20 calculation used to determine the Primary Security Level, since the purposes for including a formula-based NPR floor in the Valuation Manual do not apply to the aspects of captive arrangements covered in the June Report. Applying the NPR to captive reinsurance transactions, which generally involve more narrowly defined product blocks issued over a limited period of time, could result in a Primary Security Level that significantly misses the mark in either direction. This could result either in artificially increasing the Primary Security Level or causing significant calculation work and the devotion of resources to develop a reserve that is never used. For these reasons, the NPR component is not suitable and does not add value as a basis for the Primary Security Level.
- Furthermore, while the LPC was not involved in either its development or testing, we understand the NPR to be a formula-based reserve with fixed industry level

assumptions established at policy issue. The NPR was developed with an intention of being consistent with the existing U.S. Internal Revenue Code, (IRC) thereby potentially serving as a basis for the deductible tax reserve. The NPR uses assumptions that have been calibrated to the current Commissioners Standard Ordinary (CSO) mortality table; as such, it is our understanding that the NPR may need to be recalibrated once a new CSO mortality table becomes effective.

**Charge 5 of Exhibit 2** – See our comments on Recommendation #3.

**Charge 8 of Exhibit 2** – See our comments on Recommendation #7.

3) **Actuarial Opinion Memorandum Regulation (AOMR).**

The modified recommendation provides that the AOMR Actuarial Guideline should specify that “the opining actuary for a ceding insurer (1) must follow the methods and assumptions developed as individual components of the framework to determine whether the ceding insurer’s net reserves are appropriate, and (2) must issue a qualified actuarial opinion if the ceding insurer has entered into a reserve financing transaction that does not adhere to the framework.”

There appear to be three proposed additional requirements of the Appointed Actuary as part of the actuarial opinion requirements:

- 1) The requirement of a certification that the Primary Security Level was determined by following the Actuarial Method;
- 2) The requirement of a certification that either (i) the Primary Security Level is at least as great as the Primary Security Requirement, or (ii) a defined remedy was put in place by March 1 of the following year to address any shortfalls of the Primary Security Level related to the Primary Security Requirement.
- 3) The requirement that the Appointed Actuary issue a qualified opinion if any of the company’s affiliated reinsurers do not comply with (2) above.

While we do not have an objection to the first two requirements, we do not believe that they should be included in the AOMR. The AOMR is designed to ensure the overall adequacy of an insurer’s reserves based on asset adequacy analysis and is not designed or intended to implement reinsurance specific requirements. The Appointed Actuary’s Opinion is based on state insurance laws and regulations, Actuarial Standards of Practice, experience, analysis and professional judgment.

If a state implements requirements surrounding the Primary Security Requirement, not meeting this requirement would necessitate the inclusion of some consideration in the Actuarial Opinion, but may not result in a qualified opinion. Fundamentally, the Appointed Actuary’s Opinion is just that – a professional opinion; we are strongly

opposed to the notion that the Appointed Actuary be required to form a qualified Opinion for a specific circumstance.

If, after consideration of our comments, the Principle-Based Reserving Implementation (EX) Task Force decides to proceed with implementing the Rector recommendations in this regard, we offer the following specific comments on the Exhibit 3 draft Actuarial Guideline pertaining to the AOMR:

- Item III.B. states that the Appointed Actuary issue a qualified opinion if the reinsurance doesn't conform to the requirements of the Rector Framework (i.e., the Actuarial Method.) However, Item II implies, but doesn't specifically state, that the company can avoid issuing a qualified opinion if it complies with one of the required remedies. We recommend that Item III.B. be clarified to state that an unqualified opinion can be issued if one of the specified remedies is put into place.
  - Item III.C. should be limited, at most, to the case where an affiliated reinsurer receives a qualified opinion under the scope of the guideline on business, some portion of which was ceded to it (either directly or through a chain of retrocessions) from the another affiliate. In such a case, one could consider cascading the qualified opinion back down to the original affiliated source, through the chain of retrocession, as reflecting risk to the original or intermediate cedants. However, we do not believe that automatically extending a qualified opinion from one affiliate to another by virtue of mere affiliation in the holding company system is justified.
- 4) Specific Provisions Relative to Reserve Financing Transactions Involving Licensed and Accredited Reinsurers and Reinsurers Domiciled in a State other than that of the Ceding Insurer.

No comment.

- 5) Specific Provisions Relative to Reinsurance Financing Transactions Involving Unauthorized Reinsurers.

No comment.

- 6) Disclosure of Key Aspects of XXX/AXXX Reinsurance Arrangements.

We are generally in favor of additional disclosure and increased transparency, as long as it is not unnecessarily complicated.

- 7) Risk-Based Capital (RBC) Changes.

If, after consideration of our comments, the Principle-Based Reserving Implementation (EX) Task Force decides to require qualified opinions for non-adherence with the Primary Security requirement, we would not support increasing capital requirements as a consequence of such an Opinion. Currently, the additional C-3 RBC charge is associated with excessive interest rate risk. A company whose assets and liabilities exhibit disintermediation risk greater than the disintermediation risk assumed and which has received a qualified actuarial opinion is required to hold additional RBC. Simply put, if a company has excessive disintermediation risk, then additional RBC must be held.

Requiring additional capital because a company is not complying with the regulations associated with captives is not consistent with the intent of the RBC framework. Current RBC requirements are based on an insurer's risk exposures and the minimum capital deemed necessary by regulators to avoid regulatory intervention. If a company is not complying with the regulations related to captive arrangements, then the appropriate remedy should be to bring the captive transaction into compliance, rather than to allow the transaction to remain out of compliance with an arbitrary amount of additional capital. In addition, we note that under current RBC rules, any increase in the C-3 RBC factor due to a qualified opinion would apply to the entire C-3 exposure of the company, including business that is not involved in a captive transaction.

If, after consideration of our comments, the Principle-Based Reserving Implementation (EX) Task Force decides to go ahead with their plans to require additional capital for qualified opinions under the captive framework outlined, we wanted the Task Force to be aware of the following:

- 1) The June Report states "As described in our February Report, we recommend (1) that the RBC instructions be amended to ensure that at least one party to the reserve financing transaction holds an appropriate RBC "cushion",..." The February Report states, "We recommend that full Risk-Based Capital ("RBC") calculations using traditional NAIC methodology be performed by at least one party to the financing transaction." Although the term "RBC cushion" is used extensively in the June Report (Item 3 and definition #6 of Exhibit 1, and Charges 8.a. and 8.b. of Exhibit 2), neither the February Report nor the June Report specifically define the term.
- 2) With regard to the recommendation that the NAIC evaluate whether the current RBC "charge" relative to qualified opinions is appropriate (also discussed in Charge 8.c. of Exhibit 2, although the effective date in recommendation #7 in 12/31/14 and the effective date in Charge 8.a. it is 12/31/15), if the Principle-Based Reserving Implementation (EX) Task Force decides to require qualified opinions for non-compliance with the Primary Security Requirement, we do not approve of imposing an increased C-3 capital charge.

8) Evaluate risk-transfer rules.

No comment.

9) Financial Analysis Handbook.

No comment.

10) Note to Audited Financial Statement.

No comment.

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We hope these comments are helpful. Please contact Bill Rapp, the Academy's Assistant Director of Public Policy (rapp@actuary.org or 202-223-8196) if you have any questions.

Sincerely,

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