



AMERICAN ACADEMY *of* ACTUARIES

May 22, 2006

Mr. Philip Barlow, FSA, MAAA
Chairperson, Life Risk Based Capital Working Group (LRBC)
National Association of Insurance Commissioners (NAIC)
Associate Commissioner, Insurance Bureau
Dept of Insurance Securities & Banking
810 First Street NE Suite 701
Washington, DC 20002

Re: Comments concerning April 7, 2006 exposure of LRBC Instructions (LR024)

Dear Mr. Barlow:

The Life Capital Adequacy Subcommittee of the American Academy of Actuaries¹ is pleased to provide comments concerning the proposed 2006 Life RBC Instructions exposed for comment on April 7, 2006. Many of our comments are “housekeeping” in nature but a few of them are somewhat substantive in nature. The LCAS is committed to providing assistance to the NAIC to clarify and improve the Life Risk Based Capital Instructions relative to risk based capital for variable annuities.

The comments generally follow the following format:

- (1) Identification of location of item in the April 7, 2006 exposure document being commented on, and
- (2) Comment, in the form of a suggested addition (underlined) and/or deletion (location of deleted text identified) of language in April 7, 2006 exposure document

Please note comment 5 and the treatment of the allocation of amounts attributable to the quantification of interest rate risk arising from variable annuities.

¹ The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

Also, please note comment 11. This comment recommends replacing the C-3 Phase I Interest Rate Generator used for the generation of interest rate scenarios and pre-packaged fund scenarios for funds with returns that depend on bond yields. Details concerning its recommended replacement, the Enhanced C-3 Phase I Interest Rate Generator can be found in the following Report “Construction And Use Of Pre-Packaged Scenarios To Support The Determination Of Regulatory Risk Based Capital Requirements For Variable Annuities And Similar Products”, dated January 13, 2006. This report can be found on the American Academy of Actuaries webpage at http://www.actuary.org/pdf/life/c3supp_jan06.pdf.

Lastly, the LCAS would like repeat its position concerning the use of a Standard Scenario in the calculation of C-3 Phase II Market Risk Amounts by including comments from a letter dated March 8, 2005 to Mr. Lou Felice, Chairperson – NAIC Capital Adequacy Task Force where we made the following comments:

“From the inception of the C-3 Phase 2 project, the American Academy of Actuaries’ Life Capital Adequacy Subcommittee has supported the use of a standard scenario for RBC as helpful to reviewing and regulatory actuaries in understanding product structure, business mix, the nature of the risks, and the model. We have opposed using such a scenario as a required minimum because we feel it compromises the basic concept of our proposal and because we fear it will lead to excessive capital requirements under some circumstances.

A number of changes have been made to the specifics of the standard scenario proposal, including some that address specific concerns we have raised in the past. In spite of these changes, however, the standard scenario as a minimum requirement may still lead to excessive capital requirements and continues to compromise the basic concept of C-3 Phase 2. Therefore, we remain opposed to making the standard scenario results a minimum standard for the Total Asset Requirement.”

We are prepared to discuss our comments at the upcoming NAIC Meeting in Washington DC.

Sincerely,

/s/

Nancy E. Bennett
Chairperson – Academy LCAS

/s/

Larry M. Gorski
Vice-chairperson – Academy LCAS

(1) Page 5 --- Additional Component for Callable/Prepayable Assets

Identify the amount of callable/pre-payable assets (including IOs and similar investments) not reported for Reserves on Certain Annuities and Single Premium Life Insurance that were Cash Flow Tested [deleted text] or the Interest Rate Risk Component for products included under the “Recommended Approach for Setting Risk-Based Capital Requirements for Variable Annuities and Similar Products”. This includes callable/pre-payable assets supporting other reserves and capital and surplus. The C-3 requirement after taxes is 50 percent of the excess, if any, of book/adjusted carrying value above current call price. The calculation is done on an asset-by-asset basis and reported in aggregate.

(2) Page 5 --- Cash Flow Testing for C3- RBC

A [deleted text] company may be required or choose to perform cash flow testing to determine its RBC requirement. Because of the widespread use of increasingly well-disciplined scenario testing for actuarial opinions based upon an asset adequacy analysis involving cash flow testing, it was determined that a practical method of measuring the degree of asset/liability mismatch existed. It involves further cash flow testing. See Appendix 1 – Cash Flow Testing for C-3 RBC for details.

(3) Page 5 --- Lines (2) through (16)

These lines deal with Certain Annuities and Single Premium Life Insurance [deleted text] for which reserves were cash flow tested for asset adequacy. The fixed portion of equity-based variable products should not be included [deleted text]. Guaranteed indexed separate accounts following a Class I investment strategy are reported as low-risk Line 2 and those following a Class II investment strategy are excluded. Company source records entered in Column (3) of Lines (13), (15) and (16) should be adjusted to a pre-tax basis.

(4) Page 5 --- Lines (18) through (31)

These lines cover:

- (a) The remaining company business that was not cash flow tested for asset adequacy (see Appendix 1 for details) excluding products included under the “Recommended Approach for Setting Risk-Based Capital Requirements for Variable Annuities and Similar Products” and
- (b) Business in companies that did not cash flow test for asset adequacy.

(5) Page 6 --- Line 33

Enter in Column (3) the pre-tax interest rate risk results of cash flow testing per the Appendix 1a methodology along with the Interest Rate Component allocated from the “Recommended Approach for Setting Risk-Based Capital Requirements for Variable Annuities and Similar Products”. Line (33) should only be completed if the answer to Line (14) or Line (22) of LR043 Exemption Test: Cash Flow Testing for C-3 RBC is

“Yes” or if the company chooses to do C-3 RBC cash flow testing on a continuing basis or the company has an Interest Rate Component allocated from Line (35). Once a company chooses to use the C-3 RBC cash flow testing method to calculate RBC it must continue to do so unless regulatory approval from the domiciliary jurisdiction is received to go back to the factor-based method.

For companies with a C3 Phase II Interest Rate Component:

Line (33) is being used to capture this amount until the worksheet can be redesigned. If Line (34) is subject to the maximum of 2 times Line (32), an amount should be added to Line (28) such that the entire C3 Phase II Interest Rate Risk Component will be reflected on Line (34). For companies with a C3 Phase II Interest Rate Component whose answers to Line (14) and Line (22) is “No” and the company does not choose to use the C-3 RBC cash flow testing method, the amount in Line (33) should be the sum of Line (16), Line (17) and the Interest Rate Component allocated from Line (35).

(6) Pages 6-7 Line 35 Overview

The amount reported on Line (35) is calculated using a nine-step process.

Delete text describing 5-step process and replace with the following:

Step 1 - Calculate the Total Asset Requirement as described in the report "Recommended Approach for Setting Risk-Based Capital Requirements for Variable Annuities and (Note that this would include the so called "tax adjustment", see page 14 of the report).

Step 2 - Reduce the amount calculated under Step 1 above by the interest rate risk portion of the calculation. (We want the market risk only portion of the CTE 90 amount.)

Step 3 - Calculate the Standard Scenario Amount.

Step 4 - Take the greater of the amounts in Step 2 and Step 3. (We need to compare the Standard Scenario to the market risk only portion of the CTE 90 amount.)

Step 5 - Apply the smoothing and transition rules (if applicable) to the amount in Step 4. (Note that we are still excluding the interest rate risk portion of C3P2.)

Step 6 - Add the interest rate risk portion of C3P2 to the amount in Step 5.

Step 7 - Subtract the reported statutory reserves from the amount calculated in Step 6. Floor this amount at \$0.

Step 8 - Divide the result from Step 7 by .65 to arrive at a pre-tax amount.

Step 9 - Split the result in Step 8 into an interest rate risk portion and a market risk portion. Note that the interest rate portion may not equal the equivalent of the interest rate

portion amounts used in Step 2 and Step 6 above adjusted to a pre-tax basis. The interest rate portion should be included in Line 33 and the market risk portion in Line 35.

(7) Pages 7-8 --- Calculation of the Total Asset Requirement – Paragraph G

G. Certification of the work done to set the RBC level will be required to be submitted with the RBC filing. Refer to Appendices 10 & 11 of the AAA LCAS C-3 Phase II RBC Report (June 2005) for further details of the certification requirements. Essentially, a qualified actuary will certify that the work has been done in a way that meets all appropriate actuarial standards. The certification should specify that the actuary is not opining on the adequacy of the company's surplus or its future financial condition. The actuary should also note any material change in the model or assumptions from those used previously and the impact of such changes (excluding changes due to a change in these NAIC instructions). Changes will require regulatory disclosure and may be subject to regulatory review and approval. Additionally, if hedging is reflected in the stochastic modeling, additional certifications are required from an actuary and financial officer of the company.

The certification(s) should be submitted by hard copy with any state requiring an RBC hard copy.

(8) Page 8 --- Calculation of the Standard Scenario

Under the "Application to Determine RBC" section the second sentence says that you compare the Standard Scenario amount to the TAR before tax adjustment. The "before tax adjustment" should be deleted.

(9) Page 16 --- Smoothing and Transition Rules: Instructions – 2006

Line (4) of section B on page 16 of the revised instructions has a wrong reference, since a new line was added in Section A (new line #6). Thus, Line (4) of Section 8 should now refer to Line (9) in Section A, not Line (8).

(10) Page 17 --- LR024 Line 35 Amount

Change the "LR024 Line (35) Amount" to "Allocation of Results to Line (33) and Line (35)". And then either point back to Step 9 (Overview) under (2) above or add similar wording.

(11) Page 7 --- Calculation of Total Asset Requirement – Paragraph A

Aggregate the results of running stochastic scenarios using prudent best estimate assumptions (the more reliable the underlying data is, the smaller the need for margins for conservatism) and calibrated fund performance distribution functions. The Enhanced C-3 Phase I Interest Rate Generator should be used for generating any interest rate scenarios or regenerating pre-packaged fund scenarios for funds that include the impact

of bond yields. Details concerning the Enhanced C-3 Phase I Interest Rate Generator (“Construction And Use Of Pre-Packaged Scenarios To Support The Determination Of Regulatory Risk Based Capital Requirements For Variable Annuities And Similar Products”, January 13, 2006) can be found on the American Academy of Actuaries webpage at the following address http://www.actuary.org/pdf/life/c3supp_jan06.pdf. The Enhanced C3 Phase 1 Interest Rate Generator with its ability to use the yield curve as of the run date and to regenerate pre-packaged fund returns using interest rates scenarios based on the current yield curve replaces the usage of the March 2005 pre-packaged scenarios.