AMERICAN ACADEMY of ACTUARIES

June 15, 2012

Albert V. Sekac
Chair – AG 43 / C-3 Phase II Subgroup
National Association of Insurance Commissioners (NAIC)

Re: C-3 Phase II and AG-43 reviews

Dear Mr. Sekac,

On behalf of the American Academy of Actuaries[1], Actuarial Guideline 43 / C-3 Phase II Work Group (Work Group)[2] I appreciate the opportunity to comment on the deliberations of the NAIC's C-3 Phase II/AG43 (E) Subgroup (NAIC Subgroup). The Work Group was formed in May 2012 to provide actuarial information, analysis, and education on issues involving statutory reserve and risk-based capital requirements for variable annuity products. Our analysis is intended to provide a basis for recommending methods and processes to help actuaries and other reviewers better evaluate the overall effectiveness of these requirements and the actuarial practices used in their implementation.

The Work Group's mission is similar to the charge given to the NAIC Subgroup by the Financial Condition (E) Committee. We agree that the approach outlined in the charge – to evaluate the overall effectiveness of the methodologies by conducting an in-depth analysis of the models and then to make any recommendations for changes to the methodologies – is an appropriate way for the NAIC to proceed. Therefore, we have focused our comments on the work we believe is necessary to complete this charge, and provide comments on the processes to be employed and on the necessary resources.

<u>Plan to Address the NAIC Subgroup Charge</u>
The Academy Work Group believes it is critical that the plan developed by the NAIC Subgroup to address its charge be discussed and vetted with all interested parties. As the NAIC Subgroup begins its work, it is important to recognize that a significant amount of useful analysis and supporting data has already been prepared by various parties. For example, there were several reports presented to LATF and the Capital Adequacy Task Force in 2009 and 2010 that outlined observations about Actuarial Guideline 43 (AG 43) and C-3 Phase II. These reports, and the work done to support the observations, would be valuable to this process. By publicly discussing and vetting the plan to address its charge with all parties, the NAIC Subgroup would maximize its ability to obtain and share information with all knowledgeable and affected parties.

---

[1] The American Academy of Actuaries is a 17,000-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.

[2] The Actuarial Guideline 43 / C-3 Phase II Work Group is a work group of the Academy's Life Financial Soundness Risk Management Committee.

Critical Elements

Certain elements are essential for this process and the NAIC Subgroup should consider the following:

1. The basis for measuring and evaluating the overall effectiveness of the methodologies needs to be articulated.

   We recommend that overall effectiveness of C-3 Phase II and AG 43 be evaluated in the context that the basic tenets associated with risk-based capital and statutory reserves, respectively be recognized. That is:

   - The intent of risk-based capital is to identify weakly capitalized companies.
   - Statutory reserves are determined using principles of conservative valuation and are intended as a mechanism to set aside funds that, together with future revenues and expenses, will allow the insurer to provide the benefits promised to policyholders. For example, companies are currently required to obtain an actuarial opinion stating that aggregate company reserves are adequate under moderately adverse conditions, when considered in light of the supporting assets.

   The overall effectiveness of the current requirements should be measured and evaluated from the perspective of both the level of risk-based capital and reserves at the time of the calculation and over time as these levels change along with the economic environment and company experience, thus providing assurance that reserves and capital are appropriate under prevailing conditions.

   We suggest possible questions that could be considered in determining how the effectiveness is measured and evaluated, such as:

   - The C-3 Phase II component could be retroactively evaluated for insurers impaired since the effective date of C-3 Phase II – did the C-3 Phase II component meet the goal of identifying weakly capitalized companies?
   - Is the AG 43 component sufficient to cover the amount needed to provide the benefits promised to policyholders under moderately adverse conditions?
   - Could any conclusions be drawn from evaluating insurers that primarily issue variable annuities or that have spun-off a block of variable annuity business?
   - How did total asset requirements (TAR) and/or risk-based capital change relative to economic conditions during the recent recession (2007 on)? Note that this would need to be evaluated taking into consideration the impact of the smoothing allowed by C-3 Phase II. Does the approach used for smoothing produce the desired results?
   - How do the limits (caps/floors) and other prescribed assumptions impact results?
   - Are there ways to measure the aggregate margin in the results to help determine the appropriate level at which the overall level of margin should be set?
   - How do the results on a total statutory balance sheet basis compare to a purely economic analysis? Since some actuaries believe results are currently affected by the mixed reporting requirements for reserves (statutory) and hedges (market value), evaluating results on a purely economic basis may highlight risks that are not fully recognized or risks whose provision is overly conservative or not conservative enough in the statutory requirements for C-3 Phase II and AG 43. It would be a very significant undertaking to determine an approach for this comparison from both a process and a resource perspective.

- How could experience studies (e.g., policyholder behavior studies) be used to evaluate the overall effectiveness of the methodologies?

2. Sufficient subject matter expertise resources relating to the methods and objectives of C-3 Phase II and AG 43 are needed to assure timely, in-depth analysis that yields actionable results.

3. Results and recommendations should be supported by this in-depth analysis. This requires transparency in the process, the data (in a manner that protects the propriety of such data), and the analytical methods used.

4. The timing for completing this project, and whether it is intended to be an ongoing process, should be communicated to all interested parties.

   We recommend public exposure of the review in the following phases, where all parties have the ability to provide comments and recommendations for each phase. As an example:
   - Step 1: The basis for measuring and evaluating the overall effectiveness of the methodologies is developed, documented and reviewed.

   - Step 2: AG 43 and C-3 Phase II are assessed against the basis for measuring and evaluating the overall effectiveness of the methodologies. Proposals for changes to the requirements are developed, reviewed and proposed. Proposals may include the manner in which the changes are to be applied (e.g., changes to AG 43 vs. VM-21, new business only vs. inforce, etc.).

   - Step 3: The impact that any changes in requirements will have on results are analyzed, including an estimate of how the basis for measuring and evaluating the overall effectiveness of the methodologies are affected by the changes.

   - Step 4: Changes to the requirements are adopted and implemented.

In addition, the NAIC Subgroup should continue to solicit input from all interested parties on ways in which an in-depth analysis of AG 43 and C-3 Phase II can be performed. For example, in 2009 and 2010, the Academy's Life Practice Council presented preliminary ideas to the Life and Health Actuarial Task Force concerning components of the AG 43 and C-3 Phase II calculation that could be reviewed as part of a "feedback" loop. The Academy Work Group is in the process of reviewing and updating this material. We will share these ideas with the NAIC Subgroup once this is completed.

<u>Potential Pilot for PBR Review</u>
Properly addressing these elements could be precedent setting, since this project can very likely provide a proper regulatory structure for similar processes that we believe are necessary to optimize the effectiveness of other principle-based reserve (PBR) and risk-based capital calculation methodologies, such as Life PBR in proposed VM-20.

<u>Resource Needs</u>
We also note that this project will draw upon significant resources from stakeholders, including those of the Academy, the insurance industry, and the regulatory community. Given the priority of completing the Valuation Manual, and informal feedback we have received from several parties, we suggest that the NAIC Subgroup consider examining the resource needs for addressing its charge

and soliciting feedback on the availability of interested party and NAIC resources. We encourage the NAIC Subgroup to address any resource shortfalls or to adjust the plan before proceeding with the work.

The Academy Work Group is available to assist the NAIC Subgroup in its efforts to address its charge. While we believe it is important to evaluate the effectiveness of AG 43 and C-3 Phase II, we believe it is also important to ensure the long-term success of these requirements and other principle-based reserve and RBC requirements under consideration by developing a strong framework that will allow for measuring the effectiveness and continual evaluations of all principle-based requirements.

Please feel free to contact John Meetz, the Academy's life policy analyst (meetz@actuary.org; 202/223-8196) if you have any questions.

Sincerely,

Thomas A Campbell

Tom Campbell, Chair
Actuarial Guideline 43/C-3 Phase II Work Group
American Academy of Actuaries