Post-NAIC Update Webinar

April 17, 2015
Agenda

- **Introduction**
  - Dave Neve, MAAA, FSA, CERA
    - Chairperson, American Academy of Actuaries Life Reserves Work Group

- **Spring NAIC/PBR Update**
  - Mike Boerner, MAAA, ASA
    - Director, Actuarial Office, Texas Department of Insurance
    - Chair, NAIC Life Actuarial (A) Task Force; PBR Review (EX) Working Group; Emerging Actuarial Issues (E) Working Group

- **NAIC Risk-Based Capital Update**
  - Mark Birdsall, MAAA, FSA, MBA
    - Chief Actuary, Kansas Insurance Department
    - Chair, NAIC Life Risk-Based Capital (E) Working Group

- **C-1 Project Update**
  - Jerry Holman, MAAA, FSA
    - Co-Chairperson, American Academy of Actuaries C1 Work Group
Spring NAIC/PBR Update

Mike Boerner, MAAA, ASA
Texas Department of Insurance
TOPICS

- **PBR Work:**
  - Life Actuarial (A) Task Force (LATF)
  - PBR Review (EX) Working Group
- **PBR Related – AG 48**
- **Other LATF Work**
- **Emerging Actuarial Issues (E) Working Group**
LATF PBR WORK - Mortality

- LATF Spring 2015 Meeting: Mary Bahna-Nolan reported on the work of the American Academy of Actuaries Life Experience Committee & the Society of Actuaries Project Oversight Group.

- 2014 VBT & Relative Risk (RR) Tables
  - VBT Structure: S/NS/Uni-smoke; M/F; ANB/ALB; Select&Ultimate, Ultimate only
  - RR: 10 non-smoker & 4 smoker; M/F; ANB/ALB
  - LATF exposed these tables for a 45 day comment period to begin after they are updated with mortality improvement thru 2015.
LATF PBR WORK - Mortality

- 2017 CSO & Preferred Structure Tables
  - Recommendation provided to LATF to wait for exposure of these tables until impact study on these tables is completed.
  - Study results are expected by the end of May.
  - LATF comment requested for: 1) Structure of loading; 2) Coverage; & 3) Approach to development of preferred structure tables.
PBR Margins (VM-20 Deterministic & Stochastic Reserves) Recommendations Include:

- Use of different credibility factors for the Buhlmann Method and the Limited Fluctuation Method.
- Make Buhlmann more granular for Z factors above 90%.
- Put formula into VM-20 to allow use of the Buhlmann Method without assistance from the Statistical Agent.

Impact study to provide more information on PBR margins.

GI/SI/Preneed. Progress continuing on GI & SI. Preneed slowed due to resource constraints.
LATF PBR WORK - Mortality

2017 CSO/VBT Impact Study (SOA & ACLI):

- Karen Rudolph, Milliman, Inc., is leading the effort.
- Eleven companies involved.
- Testing of 2017 CSO, 2014 VBT, & PBR margins involving statutory reserves, tax reserves, and nonforfeiture values.
- Products include whole life, term, basic universal life, universal life with secondary guarantees, indexed universal life, and variable life with secondary guarantees.
- Preliminary results expected in early May with final report later in May.
LATF will need to update Actuarial Guideline 48 (AG 48) with any revisions to the Net Premium Reserve (NPR) based on the 2017 CSO Table when complete.

It is possible that LATF will also consider changes to the qualified actuarial opinion requirement in AG 48. This consideration may depend in part on other requirements being developed such as those relating to risk-based capital.
LATF PBR WORK

- Commercial Mortgage Default Costs for VM-20.
  - Exposed ACLI APF for comment thru 4/28/15

- Review of VM-31 Documentation Requirements
  - Discussed initial ACLI draft that included elimination of some VM-31 requirements and reduction of data reporting elements.

- Definition of products included in VM-20 Section 3 (NPR)

- Accounting smoothing mechanism to address reserve volatility.
  - Will monitor early years of PBR & address if needed.

- PBR Change in Valuation Basis (Joint Charge to LATF & APPM TF)
  - Initial discussion at Spring meeting.
LATF PBR WORK

- LATF adopted the small company exemption prior to the NAIC Spring meeting. The Life Insurance and Annuities (A) Committee adopted the small company exemption at the NAIC Spring meeting. The small company exemption included:
  - Premium threshold criteria of having less than $300 million in ordinary life premium (direct plus reinsurance assumed) & belonging to an NAIC group with less than $600 million in ordinary life premium.
  - An RBC ratio of at least 450% of the authorized control level.
  - No ULSG policies issued or assumed after the operative date of the Valuation Manual that do not meet the definition of a non-material ULSG product.
PBR Review (EX) Working Group

- **PBR Review (EX) Working Group**
  - The working group completed a draft of the procedures for the Valuation Analysis Working Group (VAWG). These procedures are now going through NAIC legal review. The Working Group targets completion of the VAWG procedures by the summer meeting.

- **PBR Blanks Subgroup (Chair, Kaj Samsom, VT)**
  - The subgroup recommended and the PBR Review (EX) Working Group exposed revised PBR blanks & instructions for a 60 day comment period.

- **PBR Review Procedures (EX) Subgroup (Chair, Pete Weber, OH)**
  - The subgroup has initial development of a number of tools and documents and is working to consolidate in a document to be considered for the Examiners’ Handbook and the Financial Analysis Handbook.
The PBR Outreach Subgroup is chaired by Andy Rarus, CT, and reports to the PBR Implementation (EX) Task Force. The subgroup provides reports to LATF and to the PBR Review (EX) Working Group to keep them informed given related interests. The subgroup’s efforts include:

- **PBR Pilot Project.** The subgroup is working to enlist the efforts of regulators and companies where companies will provide information in response to a list of questions currently being drafted that focus on operational impact. The 12 month project is expected to begin later this summer to help inform implementation / changes to PBR and reporting requirements.

- **PBR durable education modules.** The subgroup is working with the SOA to develop and house on the SOA website these modules, which would be updated as needed.
LATF – Subgroups

- VM-22 Subgroup (Chair, Felix Schirripa, NJ)
- Aggregate Margin Subgroup (Chair, Mark Birdsall, KS)
- C3 Phase II/AG43 (E/A) Subgroup (Chair, Pete Weber, OH)
- Experience Reporting Subgroup (Chair, Fred Andersen, MN)
- Indexed-Linked Variable Annuity (ILVA) Subgroup (Chair, Fred Andersen, MN)
- Contingent Deferred Annuity Subgroup (Chair, Tomasz Serbinowski, UT)
LATF – Other Work

- LATF adopted edits to the Synthetic Guaranteed Investment (GIC) Contracts Model Regulation (Model #695). Tina Kennedy and Richard Mattison (American Academy of Actuaries Deposit Fund Subgroup) developed these edits, which include:
  - The determination of the present value of guaranteed contract liabilities by using a blended spot rate that is a 50-50 blend of the Treasury spot rate and a corporate index spot rate.
  - Edits relating to pooled fund arrangements where multiple unaffiliated plan sponsors come together to invest in a shared trust.

- LATF exposed edits to the definition of a Synthetic GIC and will provide all #695 edits to the parent committee when adopted.
LATF – Other Work

- Index-linked Universal Life (IUL) Illustrations Actuarial Guideline
  - Comments will be provided on this webinar regarding the outcome of the LATF 4/16/15 call on the revised actuarial guideline exposure.

- LATF will consider a recommendation to its parent committee to open the illustration model #582.

- Status of Actuarial Guideline 33 edits regarding waiver of surrender charge and the elective component of a non-elective incidence.
American Academy of Actuaries’ Nonforfeiture Modernization Work Group (Chairperson, Tom Berry)

- The Work Group provided a status report at the Spring meeting. This report includes discussion of issues relating to cash surrender values, limitations of current laws, treatment of existing products, and consumer access to information.
- LATF will continue discussions on this report and next steps on a future call.

- LATF exposed for comment the CDA Subgroup edits to Model #805 that provides for the commissioner to establish CDA nonforfeiture by rule.
The Working Group exposed for comment an interpretation regarding questions on the AG-38, 8E ratio. This interpretation limits the denominator of the ratio to be no greater than the net single premium. This interpretation also provides options to determine the ratio when consistency of assumptions between the numerator and denominator is difficult to achieve. The interpretation, if adopted, would apply to issues on and after 1/1/16.

ACLI agreed to a request from the Working Group to provide an interpretation that would work with a possible adoption by LATF of an American Academy of Actuaries’ Amendment Proposal Form for VM-20 regarding the Pre-Tax IMR.
NAIC Risk-Based Capital Update

Mark Birdsall, MAAA, FSA, MBA

Kansas Insurance Department
Capital Adequacy Task Force (CADTF)

- Life Risk-Based Capital Working Group (LRBC)
  - Response to charges from PBR Implementation Task Force regarding the NAIC Captive Reinsurance Framework
  - Review of derivatives proposal from the Investments RBC Working Group
  - Stress Testing Subgroup—Response to charge from the PBR Implementation Task Force to develop a stress testing methodology to ensure that the statutory Total Asset Requirement is appropriate
  - Add indexed annuities to either C3P1 or C3P2
  - Referral from Operational Risk Subgroup to develop a recommended approach for an operational risk component to the Life RBC formula
  - C3P2/AG 43 Joint (A/E) Subgroup-Ohio developing a field test RFP to obtain resources to test proposed alternatives
  - Contingent Deferred Annuities—need sample C3P2 calculations
Three separate proposals to be considered for adoption on the April 22\textsuperscript{nd} call of the LRBC WG

1) Remove the impact of a qualified opinion due to Actuarial Guideline 48

2) Primary Security Shortfall—adjust ACL RBC dollar for dollar for the shortfall (exposed for comment to April 20)
   - Intended as a strong motivation for compliance with respect to Primary Securities
   - AG 48 has remedies available until March 1 after year-end
3) RBC shortfall—new exhibit provides a consolidated view of ceding company and captives’ RBC (exposed to April 20)

- Bridge gap between 85th percentile and 95th percentile of the distribution of the present value of future cash flows with admitted assets
- RBC Benchmark equals 300% ACL RBC to avoid issues with the RBC trend test
- Instructions provided for including entities not required to file RBC
- Interrogatories added regarding ceding company RBC with impact of captives backed out

Proposals for consideration in 2016

- CT provided proposal for assigning RBC factors to Other Securities
- Proposal to make public certain TAC and RBC information for the captives
Investment RBC Derivatives Collateral Proposal Reviewed by Life RBC WG

- Addresses RBC implications of centralized clearing and the increased collateral by Dodd-Frank
  - Reduced potential 8.1% charge for cash collateral posted as part of central clearing
  - Technical correction needed to use updated forms will be handled by LRBC
    - Exposed for comment to April 20
- AVR portion of proposal will be addressed in 2016
Stress Testing Subgroup—Next Steps

- Exposure of proposal indicated a strong sentiment to delay 2015 field test of stress testing proposal
- Work with Academy to refine facets of the stress testing proposal
  - Consider ways to stress additional risks identified by company in ORSA
- Coordinate efforts with U.S. proposal for international group capital standards
  - Possible synergies include:
    - Similar approach of calibrated cash flows with a factor-based floor/alternative such as RBC plus
    - Focus on classification as short-term and long-term liabilities (rather than non-life and life)
Other Life RBC Issues

- Adding indexed annuity products to either C3P1 or C3P2
  - Academy/SOA economic scenario generator doesn’t produce all the information needed for indexed products
  - C3P2 permits use of a proprietary economic scenario generator subject to calibration criteria
    - The proprietary generators could produce the needed information

- Adopted two ACA proposals
  - Identical to proposals adopted by Health RBC Working Group
  - The first proposal adds an information-only version of the experience fluctuation risk schedule with additional line of business detail
  - The second proposal adds a sensitivity test to assess the potential impact of the risk corridor and risk adjustment aspects of ACA
Investment RBC Working Group

- Proposed corporate bond factors being evaluated
  - Analysis based on life company investment portfolios—how should they be applied to P&C and Health RBC formulas?
- Develop criteria for analysis for non-modeled fixed income assets--municipal bonds, sovereigns, etc.
  - Rating agencies contend that the risk associated with the same rating level are the same for corporate bonds and these other fixed income assets—some are skeptical
  - If there is a difference in risk, what simplified analysis would be suitable to establish the degree of difference from corporate bonds?

Operational Risk Subgroup

- Referral to Life; continue work on P&C and Health
- Consider cyber-security risk in light of data breaches
C-1 Project Update

Jerry Holman, MAAA, FSA
Agenda

- Project Scope
- Asset Class Reviews
- Bond Factor Development
  - Ratings Usage Principles
  - Methodology
  - Assumptions
- Preliminary Proposed Factors
  - Observations
- Current Decision Points
- Future Direction
C1 Project Scope

- NAIC Charge to Investment Risk-Based Capital (E) Working Group (IRBC)
  - Evaluate relevant historical data and apply defined statistical safety levels over appropriate time horizons in developing recommendations for revisions to the current asset risk structure and factors in each of the risk-based capital formulas and delivering those recommendations to the Capital Adequacy (E) Task Force.—Essential
  - http://naic.org/committees_e_capad_investment_rbc_wg.htm

- Project covers entire insurance industry
  - AVR Companies – Life insurers (C1o,C1cs)
  - Non AVR Companies – Property & Casualty and Health insurers (R1,R2) and H1 respectively

- Academy Groups
  - Separate Life, P&C and Health Work Groups
  - Principal to date focus on Life
    - Life C1 Co-Chairpersons are advisory members of the IRBC
Comprehensive Ongoing C1 Review

- **Academy Review - Corporate Bonds**
  - C1o Factors in development by Life C1 Work Group
    - August 2014 published preliminary factors, subject to revision
  - P&C and Health Academy Work Groups pursuing R1 and H1 factors

- **IRBC Subgroup Reviews**
  - Common Stock
    - Reviewed recent experience and converted methodology to be consistent with bonds (i.e., stochastic modeling that produces a loss distribution; C1 factor set at the 90% CTE over a 2-year time horizon)
    - Re-adopted existing factors
IRBC Subgroup Reviews

Derivatives
- Adopted changes as per recent earlier work recognizing new requirements of the Dodd-Frank Act
- No changes to the quantitative factors, but RBC instructions clarified

Schedule BA Assets
- Subgroup’s work is in the initial phases. The variety of assets reported on Schedule BA will necessitate some simplification of the factor.

Investment Real Estate
- Revisions under consideration
- Lower factor recognizing depreciated book value nature of risk vs. prior portion of common stock market volatility approach
Commercial Mortgages (ACLI Workgroup)

- Property specific methodology implemented December 31, 2014
Constraints in Developing C1 Bond Factors

- Factors are based on published, auditable data
  - Consequently, the model is based on historical losses. More sophisticated approaches (e.g., structural) were considered, but not pursued due to inability to audit.

- Factors rely on the rating reported for each issue in the NAIC Annual Statement

- Factors pre-fund future loss given default on bonds on an after-tax basis, with two major assumptions:
  - RBC covers risk in the tail
  - Statutory policy reserves funds expected loss given default

- AVR has no bearing on the C1 factors. The existing AVR balance is added back to Total Adjusted Capital (i.e., $TAC = \text{unassigned surplus} + AVR + .5\text{div liab}$)
Conceptual Corporate Bond C1 Methodology

- C1 factors are based on a model of projected bond losses.

- This model contains assumptions that are based on historical experience and reflects behavior that does not change over time.
  - Assumptions must be representative of the entire industry and applied to each company, regardless of the company’s investment risks.
  - Assumptions are consistent with a ten-year time horizon and attempt to capture changes over that horizon.
  - Passive strategies are modeled – unrealistic, but modeling active strategies would not be possible.

- In reality, a bond portfolio would be actively managed reflecting sector, duration and other allocations; individual security decisions would vary with company needs and market conditions.
Calculating Base C1 Factors

- The C1 capital charges are derived from a simulation model where the cash flows for a representative bond portfolio are projected assuming varying economic conditions.

- The required capital for a given scenario equals the amount of initial funds needed such that the accumulation of this initial amount and subsequent cash flows will not become negative at any point throughout the modeling period. Requiring capital to pre-fund the greatest loss is more conservative than pre-funding the cumulative losses over ten years.

- Additions and subtractions from this fund are projected over the modeling period:
  - Additions include an annualized risk premium, interest and tax recoveries of default loss
  - Subtractions include the loss given default and taxes on earned interest
Calculating Base C1 Factors (cont’d)

- The required capital for a given scenario equals PV of the net cash flows discounted at a specified interest rate. DR = 5% before tax.

- The C1 factors pre-fund the greatest cumulative shortfall during the ten-year time horizon – not just the cumulative shortfall at the ten-year horizon point.

- Simulations project varying economic conditions where default rates and recoveries vary from a baseline assumption dependent on the probability of the future economic state (expansion, recession).

- Required capital amount for each simulation is divided by beginning assets to get a required capital factor
  - Recommended C1 charges shown represent a 92nd percentile, 10-year time horizon safety level for an individual security.
  - The statistical safety level at the portfolio level will be tested; expected to fall in the 95-96th%
Ratings Principles Applied in Determining C1 Bond Factors

- C1 Corporate bond factor process is ratings driven
  - Rating agency rating serves as sole input to risk differentiation in factor selection
  - Other approaches reviewed but not deemed practical

- Rating agencies adjust baseline issuer rating to reflect increased/decreased issue rating risk
  - Baseline issuer rating is the rating for a senior unsecured issue.
  - C1 development assumes the rating agency risk assessment cannot be improved on with non-credit specific assumptions
  - Rating agencies assign like issue ratings to like risks
    - Moody’s – Expected loss basis
    - S&P – Loss likelihood basis

- Global ratings process implies like risk for like issue ratings across bond sectors; used by Moody’s and S&P
  - Moody’s implemented 2010
  - S&P utilized on an ongoing basis at earlier dates
Key Modeling Assumptions

- Expected recovery rates derived from S&P proprietary study covering 1987-2012.
- Corporate tax rate and timing of loss recognition, updated for current data, reflecting SSAP 43R.
- Representative portfolio constructed to represent the typical portfolio for an insurer
  - Portfolio characteristics capture the key variables that will have the greatest effect on the variability of capital between companies; characteristics include size, and quality ratings.
  - NAIC provided information on every bond position for every life insurance company as of December 31, 2011; data provided did not identify company or asset cusips. Data represented approximately 287,000 positions; 782 companies.
Key Modeling Assumptions (cont’d)

- Modeling assumes expected losses included in statutory policy reserves are quantified as a constant number of basis points, a risk premium (RP).
  - The RP is defined as the expected loss over ten years for each rating class: a level, annualized risk premium.
  - Essentially, the RP represents the amount of spread contained in statutory reserves that is prefunding expected future defaults.
  - RP varies from 1bp (AAA) to 538bp (Caa3).

- The RP method is more consistent with current methods for statutory reserve requirements.
  - Current formulaic statutory reserving requirements discount future cash flows at a prescribed discount rate; these formulaic requirements are further tested for adequacy using cash flow testing models with current, company-specific assumptions. Many companies quantify future defaults as a level bp charge, where the level might vary by the portfolio.
## C1 Pre-Tax Bond Factor Comparison

<table>
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<th>Rating</th>
<th>Industry Weight</th>
<th>Aug 2014</th>
<th>Compressed Aug 2014</th>
<th>Updated NAIC 5</th>
<th>NAIC 5</th>
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<tr>
<td>Aaa</td>
<td>4.04%</td>
<td>0.33%</td>
<td>0.38%</td>
<td>0.94%</td>
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<td>0.38%</td>
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<td>Aa2</td>
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<td>0.61%</td>
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<td>A1</td>
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Industry Weights and Aug 2014 C1 Factors are preliminary and subject to update.
Observations on Results

- Discount rate decreased: 3.5% AT vs. 6% AT
- Recovery impact varies by rating
  - Relative to 1992 generally higher LGD for investment grade (IG) and lower LGD for below investment grade (BIG)
  - 2014 based on broader base of experience supplied by S&P

<table>
<thead>
<tr>
<th></th>
<th>1992</th>
<th>2014</th>
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</thead>
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<td>LGD Distribution</td>
<td>Normal</td>
<td>Skewed left</td>
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<tr>
<td>Mean LGD</td>
<td>Vary by rating</td>
<td>Constant by rating</td>
</tr>
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</table>

- 2014 factors have been derived from senior unsecured data. The issue ratings are assumed to capture different LGD expectations for other instrument types.
- Relative to 1992 assumptions, average LGD higher for IG and lower for below BIG.
- More severe tails in the current distribution contribute to higher LGDs under the current model.
- Generally, default rates for investment grade (IG) are unchanged; below investment grade (BIG) default rates are higher.

- Shift of asset distribution
  - Current factors assume Aaa, Aa, A of 25%, 25%, 50% in the Aaa-A range. Actual now is 8%, 23%, 69%
Current Decision Points

■ Degree of granularity
  ■ Academy C1 Work Group recommending 14 compressed buckets including default to replace the current 6 buckets
    ■ Advantages
      – Reduces risk of future portfolio ratings shifts
      – Reduces factor cliffs; better match of capital to risk
    ■ Disadvantages
      – Time/expense for insurers and regulators to implement

■ C1 charges for non-modeled fixed income securities
  ■ Privates/144a, Municipals, Sovereigns, Hybrids, Preferred Stock, Mezz Debt
  ■ Academy work group recommending use of corporate bond factors
    ■ Factors are appropriate based on global rating process
    ■ Interested parties expressing concern about use of corporate bond factors for other bond asset classes, e.g., Municipals and Sovereigns
      – IRBC has requested any alternative proposals be data based and provided by the August 2015 NAIC meeting
Major C1WG Items

- Q2-Q3
  - Economic state and default rate tweaks
  - Complete documentation
  - Recommend revised set of factors
  - Explain and quantify major difference between 2014 and current factors
  - Respond to regulator and interested party questions
  - Produce AVR factors consistent with C1 factors

- Q4
  - Determine portfolio factor adjustments
  - Start review of consistency of corporate bond factors with other modeled asset classes
    - Structured securities modeled by BlackRock/PIMCO
    - Commercial Mortgages
IRBC 2015 Calendar

- For further information, NAIC IRBC webpage:
  http://naic.org/committees_e_capad_investment_rbc wg.htm

- Expected Implementation date
  - Earliest implementation is YE 2016
  - Issues affecting implementation:
    - Granularity decision (state law implications)
    - Desired consistency with Health and P&C
    - Desire to implement all asset classes at the same time
For more information, please contact:
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(202) 223 - 8196