March 21, 2014

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

Dear Commissioner McPeak and Superintendent Torti:


We agree that, given the direction provided by the Task Force as described in the Report, there is a rationale for using the VM-20 framework for the Primary Asset Level definition.

Due to the short exposure period for the Report, our comments here will focus on only the aspects of the Report that relate to the use of VM-20 as a framework. We note however that there are many other aspects that go beyond the VM-20 framework as a basis for the Primary Asset definition that would benefit from more thorough review and comment. The recommendations outlined in the Report are substantive and the timeline for carrying them out is very aggressive. We therefore suggest that the Report be re-exposed for further comments after this initial exposure to allow more time to focus on the extensive comments covered in the Report, and that a less aggressive timeline be considered for implementing any final recommendations.

Our comments below focus on the three changes suggested to VM-20 for the purposes of determining the Primary Asset Level. In general, we do not believe it is in the best interests of implementing PBR to make adjustments for this purpose to the current VM-20 as these changes may or may not actually be made to VM-20 once PBR is implemented.

- **Development of factors to update the applicable industry basic mortality tables prescribed in VM-20 to bring mortality rates closer to the anticipated 2014 Mortality Table.** Consistent with Section 9.C.3.g. of VM-20, a set of improvement factors has already been developed by the SOA/Academy mortality group and published on the SOA website (link) to be applied to the 2008 VBT table to true up that table to

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1 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.
year end-end 2013. This was put in place for those blocks of universal life with secondary guarantees (ULSG) business for which VM-20 Deterministic Reserve-type reserve calculations are required to be performed under Section 8D of Actuarial Guideline (AG) 38. The PBRSS believes that the application of these factors is a proxy for the updated mortality until the new table is developed, and that nothing more is needed at this time.

- **Make interim adjustments to the Interest Rate Generator to move closer to expected changes being considered.** We are not aware of any formal plans to modify the Interest Rate Generator (IRG), such as modifying the mean reversion speed or the mean reversion formula itself. You may recall that the mean reversion parameter is defined by a dynamic formula. The scenarios generated from the VM-20 approach are based on 17 different parameters. Extensive analysis was conducted to establish each of the parameters both in isolation and the combined effect of all 17 parameters. A change to any one of the IRG parameters can have unintended consequences on the resulting scenarios, as the parameters interact with each other. Since adoption, there has been no subsequent analysis of the VM-20 Economic Scenario Generator scenarios to suggest that there is a need to modify the IRG. Therefore, we do not support interim adjustments to the IRG.

- **Consider adjustments to the Net Premium Reserve.** We suggest eliminating the net premium reserve entirely for this purpose, since the purposes for including a formula-based net premium reserve floor in the Valuation Manual do not apply to the aspects of captive arrangements covered in the Report.

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

Sincerely,

Cande Olsen, FSA, MAAA  
Chairperson  
Principle-Based Reserves Strategy Subgroup  
American Academy of Actuaries
March 21, 2014

The Honorable Julie Mix McPeak
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The Honorable Joseph Torti, III
Superintendent
State of Rhode Island Department of Business Regulation
1511 Pontiac Avenue, Building 69-2
Cranston, RI 02920-4407


Dear Commissioner McPeak and Superintendent Torti:

The ACLI1 appreciates the opportunity to provide our thoughts on the Report of Rector & Associates dated 2/17/14 concerning the regulation of companies ceding business to captive reinsurers (“the Report”).

Introduction and Executive Summary

The ACLI continues to support life insurers’ use of captives and their appropriate regulation and is committed to ensuring that captives can meet their reinsurance obligations. We believe that well-regulated captive transactions provide a useful financing mechanism that helps keep the cost of life insurance as low as possible. It is important to keep this in mind as we endeavor to increase the regulatory oversight of these transactions. We appreciate the work that Mr. Rector performed on behalf of the NAIC to review the existing regulation of Regulation XXX/AXXX-type captives (as used in this letter, this term will mean captives reinsuring Level Premium Term Insurance and/or Universal Life Insurance with Secondary Guarantees). We have reviewed the Report and have outlined many of our thoughts and concerns below. We point out that due to the extremely short exposure period of this Report, it was not possible to provide as complete a review as we would have liked. Therefore, we have limited our

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1 The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with approximately 300 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers’ products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums. Learn more at www.acli.com.
ACLI appreciated the opportunity to provide Mr. Rector with some responses to questions he asked us during the drafting of his Report. Unfortunately, our preliminary responses were based on two premises about the Framework that have proven to be incorrect. First, it was our understanding that the regulatory vehicles for implementing the Primary Asset Requirement were to be the state laws and regulations implementing the NAIC Credit for Reinsurance Model Act and Regulations. Rather, the Report suggests a new Model Regulation that is supposed to rely on the authority of the NAIC Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in Hazardous Financial Condition (“Hazardous Financial Condition Model”). Second, it was our understanding that the Primary Asset Requirement was to be a test performed on the assets of the captive reinsurer rather than on the collateral of the captive.

These changes in direction have led to two of the three overarching concerns that ACLI has with the conceptual framework outlined in the Report. Those three concerns are:

1. We believe there are significant legal and practical hurdles with using the Hazardous Financial Condition Model as the legal authority for placing new rules on reserve credit for reinsurance;
2. We believe there are additional legal and practical hurdles for using the “Primary Asset Requirement” to test the collateral involved in a captive reinsurance transaction, primarily that the Credit for Reinsurance Model Act does not require collateral for licensed and accredited reinsurers; and,
3. We believe the scope of applicability of the new requirements to be overly broad.

ACLI believes that the challenges associated with using the Hazardous Financial Condition Model cannot be surmounted. However, we have developed a conceptual framework that uses the Actuarial Opinion and Memorandum Regulation to overcome these legal and practical obstacles, while still meeting the stated objectives of regulators. An outline of our proposed conceptual framework can be seen in Appendix A, and we encourage the Task Force to give it serious consideration.

The ACLI believes that the conceptual framework should be determined before too many decisions are made concerning the technical pieces of the new regulations. As such, we have limited our focus to just our key technical concerns, which are:

1. We believe that if the NAIC decides to use a modified VM-20 as the Actuarial Method for the Primary Asset Requirement, it is imperative that the Net Premium Reserve component of the methodology be removed, at least until PBR is actually implemented, to ensure the proper calibration of that component;
2. In developing new RBC factors for “Other Assets”, it will be very important to properly set those factors;
3. We believe that some of the Effective Dates contained in the Report are not readily achievable based on the amount of work that still needs to be done;
4. We believe that the definition of Primary Assets should include clean, irrevocable, unconditional letters of credit, and that reinsurance being ceded to an assuming reinsurer that is domiciled in the same state not be required to collateralize primary assets in order for the ceding insurer to be allowed a credit for reinsurance, and we do not believe that Primary Assets should be limited to funds withheld or held in trust; and,
5. ACLI agrees with the Report in that any security that is acceptable to the commissioners of both the ceding company and the captive reinsurer should be counted as an “asset” of the captive and allowed to be used towards the collateral requirement for reserve credit (so-called “Other Assets”).

ACLI has spent a great deal of time analyzing the Report’s suggested use of the PBR Valuation Manual (VM-20) as the Actuarial Method for determining the Primary Asset Requirement. We concluded that a
modified asset adequacy analysis methodology would better address regulatory concerns and avoid the
problems implicit with using VM-20 as the actuarial method. We provided Mr. Rector with our proposed
methodology along with a synopsis of our analysis that we performed in response to his questions as he
drafted the Report. We feel compelled to express our disagreement with the Report’s conclusion that
the modified asset adequacy approach would not be viable. We respectfully ask that the Task Force
review the proposed methodology in Appendix B and consider how it would meet regulatory objectives.
We have also attached as Appendix C the entire copy of the letter that we provided to Mr. Rector to aid in
your review of the Report.

Concerns with the Conceptual Framework

The Use of NAIC Model Regulation to Define Standards and Commissioner’s Authority for Companies
Deemed to be in Hazardous Financial Condition

The proposed XXX and AXXX Reinsurance Model Regulation (“proposed Model Regulation”), Sections 7
and 8, raise several important issues.

1. Promulgation of proposed Model Regulation would be legally impermissible. ACLI believes that
   the promulgation of the proposed Model Regulation is not allowed under administrative
   procedures law and, as to nondomestic insurers specifically, the proposed Model Regulation
   would be preempted under Dodd-Frank Act § 531(b)(4) and possibly by Dodd-Frank § 531(a) as
   well.
   i. Administrative Procedures Law. The vehicle for mandating and enforcing the
      proposed standards is a regulation. Under typical state administrative procedures
      law, regulations may implement and interpret the provisions of law but may not be
      inconsistent with the provisions of law. Furthermore, the power of a regulator to
      interpret, clarify and implement legislative policy through regulation does not include
      the authority, in absence of legislative enactment, to promulgate regulations that
      rewrite statute. Certain provisions of the proposed Model Regulation are in direct
      conflict with the Credit for Reinsurance Model Act (“Model Act”) and therefore would
      not be allowed under administrative procedures law. Conflicting provisions include:
      a. Model Act § 2 - Provides that “Credit for reinsurance shall be allowed a
         domestic ceding insurer as either an asset or a reduction from liability on
         account of reinsurance ceded only when the reinsurer meets the
         requirements of Subsections A [licensed assuming insurer], B [accredited
         assuming insurer], C, D, E or F of this section.”

         The proposed Model Regulation would rewrite Model Act § 2 by
effectively imposing new conditions on reinsurance credit for cessions to
licensed and accredited assuming insurers that are not contemplated by
the statute. Under the proposed Model Regulation, ceding companies
would be allowed to take reinsurance credit for cessions to a licensed or
accredited assuming insurer only if the assuming insurer (i) uses
statutory accounting without any permitted practices, (ii) uses RBC
without deviation, and (iii) is not subject to any RBC action level event.

      b. Model Act § 3 - Allows credit for reinsurance ceded to an unauthorized
         assuming insurer so long as permitted collateral is provided.

         The proposed Model Regulation lists a host of additional conditions that
would be imposed on cessions to unauthorized assuming insurers that
are beyond those contemplated by statute. Proposed Model Regulation §
7 sets forth a host of criteria that must be met, regardless if any
regulatory discretion is exercised with regard to permissible collateral.
As a result of these direct conflicts, ACLI believes that, promulgation of the proposed Model Regulation is unlikely to survive a challenge under state administrative procedures law.

ii. **Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).**
   
   a. The proposed Model Regulation § 4.B states that it applies to certain nondomestic ceding insurers. *Dodd-Frank Act* § 531(b)(4) provides that “all laws, regulations, provisions, or other actions of a State that is not the domiciliary State of the ceding insurer, . . ., are preempted to the extent that they – otherwise apply the laws of the State to reinsurance agreements of ceding insurers not domiciled in that State.” Since the proposed Model Regulation would apply “other actions” to reinsurance agreements of certain nondomestic ceding insurers, ACLI believes that it will be preempted to that extent under *Dodd-Frank Act* § 531(b)(4).

   b. *Dodd-Frank Act* § 531(a) preempts nondomestic state reinsurance credit rules if the ceding insurer’s domestic state is NAIC accredited and recognizes the credit. While proposed Model Regulation § 7 is not labeled a reinsurance credit rule, it effectively is one because it directly denies a reinsurance credit to nondomestic ceding insurers. It creates a conclusive presumption of hazardous financial condition, thereby giving a ceding insurer a choice between as of yet unspecified unfavorable regulatory action or conforming the reinsurance ceding arrangement to the § 7 standards. The non-domestic ceding insurer effectively has no choice and must conform to those standards or lose the benefit of its reinsurance. For that reason, ACLI believes that Model Regulation § 7 as applied to nondomestic ceding insurers is preempted under *Dodd-Frank Act* § 531(a).

   iii. **Case law and the Insurer Receivership Model Act (and its predecessor, the Insurer Rehabilitation and Liquidation Model Act).** It is important to look at the Model Law(s) under which the Hazardous Financial Condition Model draws its authority. The Model Regulation provides that it is promulgated under the *Insurer Rehabilitation and Liquidation Model Act*, and the Model Regulation was subsequently amended after the NAIC adoption of the *Insurer Receivership Model Act*. Under both the *Insurer Rehabilitation and Liquidation Model Act* § 16.F and the *Insurer Receivership Model Act* § 207.I, a petition for a rehabilitation or liquidation order may be made by the regulator if a domestic insurer is in such condition that the further transaction of business would be hazardous, financially or otherwise, to its policyholders, creditors or the public. There is no statutory presumption that any activity constitutes “hazardous condition,” in either Model Act; therefore, ACLI believes that no matter the conclusive preemption in proposed Model Regulation § 7, no court will be bound to accept it as a ground for commencement of a rehabilitation proceeding. While the determination of “hazardous condition” is usually fact specific, study of case law shows that state courts have held that “hazardous condition” means

   a. with reference to an insurer’s financial standing, imminent insolvency, a state in which there is a dwindling surplus and a substantial likelihood, based on recent trends within the insurer, that a condition of actual insolvency will be reached in the near future, or

   b. that insurer’s management so conducts its business that there is loss or risk of loss to policyholders.
ACLI questions whether any reinsurance ceding arrangement necessarily constitutes a “hazardous condition” to warrant the proposed Model Regulation § 7 approach. The form of the transaction does not necessarily lead to imminent insolvency or loss or risk of loss to policyholders. Furthermore, even assuming a given reinsurance ceding arrangement could give rise to a “hazardous condition,” ACLI believes that it cannot be the case that all reinsurance ceding arrangements, without regard to materiality and financial statement impact, necessarily constitute a “hazardous condition.” Lastly, ACLI does not believe that a regulator would logically petition a state court for an order of rehabilitation or liquidation (based upon the fact that the insurer has entered into a reinsurance ceding arrangement with a captive) when the very statutory financial statement upon which any hazardous financial condition will be based actually allows financial statement credit for that reinsurance ceding arrangement. Put another way, would any NAIC member approach a state court and explain that the reinsurance ceding arrangement is, by law, a good asset (deduction) on a statutory financial statement but, because of a declaration in proposed Model Regulation § 7, is grounds for rehabilitation and even liquidation?

2. Creation of conclusive presumption of hazardous financial condition is unprecedented. The proposed Model Regulation § 7 would create an unprecedented nondiscretionary one-size-fits-all approach that has no correlation to an insurer’s financial condition and is completely outside the bounds of other discretionary hazardous financial condition standards that take into account the effect on the insurer’s overall financial condition. Section 3 of the Hazardous Financial Condition Model outlines the standards that a regulator may consider in determining whether the continued operation of an insurer might be deemed to be hazardous to policyholders, creditors, or the general public. These are standards that the regulator may permissibly consider. Section 7 of the proposed Model Regulation would create a binding first and only presumptive standard. A conclusive presumption of hazardous financial condition that removes all regulatory discretion, regardless of the reason for failing the standards, is highly problematic from a legal and practical perspective. For example, the hazardous financial condition branding would apply without regard to the materiality of the reinsurance ceding arrangement in relation to the financial condition of the ceding insurer as a whole. The same branding applies if the reinsurance ceding arrangement cedes 0.1% of the ceding insurer’s gross reserves or 50% of the ceding insurer’s gross reserves. The proposed Model Regulation goes even further if the ceding insurer fails to satisfy the Disclosure Requirements, the hazardous financial condition branding will attach, notwithstanding compliance with all the requisite financial standards. It is difficult to imagine that non-compliance with a disclosure standard alone could be considered a hazardous financial condition let alone a conclusively presumed hazardous financial condition.

Regulatory discretion is important since currently a hazardous financial condition finding has serious consequences. At the regulator’s discretion, it can result in an order requiring remedial action under Hazardous Financial Condition Model § 4.B or the filing of a petition for a rehabilitation or liquidation order under Insurer Receivership Model Act § 207.I. It is not clear what regulatory remedial action is contemplated following a conclusive presumption of hazardous financial condition. If, following presumed hazardous financial condition branding, the matter reverts to regulatory discretion on any action to be taken, ACLI believes that the branding has besmirched the reputation of the branded insurer while adding nothing to the regulatory toolbox that is not already available to the regulator under the Hazardous Financial Condition Model and the Insurer Receivership Model Act.

ACLI believes that the application of the conclusive presumption of hazardous financial condition without regard to materiality is completely inconsistent with the Hazardous Financial Condition
Model § 3 which generally measures the impact of an action or condition on the insurer’s financial condition as a whole.

3. Unforeseen consequences of Hazardous Financial Condition presumption. The ACLI recommends that the NAIC carefully consider the possible negative outcomes of presumptive hazardous financial condition branding. Since the existence of a hazardous financial condition is a ground to place an insurer into rehabilitation or liquidation, branding a material life insurer subsidiary of a public company will likely require public disclosure of the event to public company shareholders. This has the potential to shake investor confidence, result in a stock selloff and loss of capital and a rating downgrade of the public company and the life insurer subsidiary. The end result may be loss of confidence by the insurance buying public thereby creating real financial stress at the life insurer subsidiary – all because of the branding. Nonpublic life insurers may fare no better. Unlike an administrative supervision order, nothing in the Hazardous Financial Condition Model protects a determination of hazardous financial condition or resulting remedial action order from public disclosure. Regulatory action does not live in a vacuum; it can have real adverse consequences that should be carefully considered in light of the regulatory result being sought. If branding is just a lever to encourage ceding insurers to comply with the proposed Model Regulation standards but is not (or is not necessarily) a true measure of hazardous financial condition, then this proposal would force life insurers (and their public company parents) to explain that the branding is not really as bad as it sounds, which they may not be able to do and should not have to do. For reinsurance ceding arrangements that do not give rise to true hazardous financial condition, any resulting loss of confidence by insurance buying public and shareholders will likely be far worse than the reinsurance ceding arrangement that gives rise to the branding.

Other consequences of such a branding could include adverse rating agency actions, which in turn could have a domino effect and trigger a host of problems with other, unrelated, financing arrangements and cross default provisions in all manner of agreements.

4. The Proposed Model Regulation is based, in part, on faulty assumptions. Unlike the proposed Model Regulation § 7 standards which a ceding insurer may have control over during negotiations with an affiliated assuming insurer, a ceding insurer has no control over whether an unaffiliated licensed or accredited assuming insurer employs a permitted practice or deviates from the RBC instructions. Nevertheless, cession to such an accredited or licensed reinsurer would result in the hazardous financial condition brand being attached to the ceding insurer and it would be unresolvable without the consent and cooperation of the unaffiliated assuming insurer. ACLI believes that if hazardous financial condition branding of the ceding insurer is to be a consequence of failing to satisfy the standards, compliance with the standards should be solely under the control of the ceding insurer, not the assuming insurer.

5. Other unintended consequences under the proposed Model Regulation. The ACLI believes that the NAIC should carefully consider any unintended consequences of the proposed Model Regulation. Under proposed Model Regulation §§ 8.A and 8.B, reinsurance ceded to a licensed or accredited assuming insurer would lose its exemption status if the assuming insurer employed any permitted practice, even one completely unrelated to the types of permitted practices commonly used in captive transactions. Loss of exemption status would require the assuming insurer to collateralize the ceded reserves under proposed Model Regulation § 7, a very punitive result for an inconsequential action.

6. Alternative to the Hazardous Financial Conditions Regulation. Recognizing the importance of finding a host regulation for the new requirements recommended by the Report, ACLI has endeavored to find such a host that would meet all the regulatory objectives stated in the Report. We wish to make a suggestion, although we note that due to time constraints, ACLI has not been able to analyze the legal implications of this suggestion and there may be legal issues that would need to be considered. We nevertheless thought that making the suggestion may advance an
ultimate solution. Our suggestion is to look to the Model Actuarial Opinion and Memorandum Regulation (AOMR), amending it to add a requirement for the Appointed Actuary to calculate the Primary Asset Requirement of the policies that are assumed by the captive reinsurer, using the prescribed Actuarial Method, and compare the calculated Primary Asset Requirement to the Primary Assets of the captive. This would be done for any Regulation XXX/AXXX-type captive reinsurance transaction formed after the effective date. Under this suggestion, the opining actuary would not be able to give a clean opinion unless those captives have met the Primary Asset Requirement (as described further in the next section). This would also avoid the unintended consequences of using the Hazardous Financial Condition Model that we pointed out above.

The Primary Asset Requirement Test

ACLI believes that, regardless of the Actuarial Method chosen (see our comments below), the method should be used as an asset adequacy test of the Primary Assets of the captive reinsurer rather than as a test of the collateral of the reinsurance arrangement. We see two major impediments to testing the collateral:

1. As stated above, state laws based on the NAIC Credit for Reinsurance Model Law do not require collateral on every captive reinsurance transaction, and we do not believe that it is appropriate to override these state laws with the use of commissioner discretion contained in the Hazardous Financial Condition Model. Therefore, using the Primary Asset Requirement as a test of collateral would not provide the uniformity desired by regulators. ACLI would have extreme concerns if ceding companies get disparate treatment based on the form of the captive reinsurer.

2. If VM-20 is to form the basis of the Primary Asset Requirement, it should be noted that PBR has been developed to work with assets that are valued based on NAIC Asset Valuation rules, which, in most instances, require assets to be valued at amortized cost. Mr. Rector has designed his collateral test using the market value of the assets held for collateral, likely because funds held in trust for collateral are required to be valued at market value (although funds withheld are not). We can be sure that use of assets marked to market with the PBR Methodology will create significantly more volatility than intended. However, without significant testing, it is unclear what other unintended impacts would occur. ACLI would have extreme concerns with the use of PBR methodology with assets marked to market.

To avoid those two rather thorny issues, ACLI believes that the assets of the captive reinsurer should be tested rather than the collateral, and the aforementioned AOMR is an appropriate vehicle to host such a requirement.

We envision this hosting to work as follows:

a. Sections 5, 6, and 7 of the AOMR would be amended to add a requirement to calculate the Primary Asset Requirement of the policies that are assumed by the captive reinsurer, using the prescribed Actuarial Method, and compare the calculated Primary Asset Requirement to the Primary Assets of the captive. The Actuarial Method will be specified in a new Actuarial Guideline.

b. In order to render a clean Actuarial Opinion, the Appointed Actuary would have to find that the Primary Assets of the captive reinsurer equals or exceeds the Primary Asset Requirement.

c. The Appointed Actuary must state in the Opinion that the applicable captive transactions have been tested and:
i. The Primary Assets equal or exceed the Primary Asset Requirement, in which case the Actuarial Opinion is “clean”;
or,

ii. If the analysis reveals that the value of the Primary Assets are less than the Primary Asset Requirement, that the ceding company has either reduced the credit for the reinsurance by the amount of the difference, or the captive has had an infusion of assets between the valuation date and the date of filing of the actuarial opinion for the amount of the difference (and provided the appropriate collateral if required by the Credit for Reinsurance Model Law and Regulation), in which case the Actuarial Opinion is “clean”; or

iii. If neither the conditions in (i) or (ii) are met, the Actuarial Opinion is “qualified”.

d. The new Actuarial Guideline will be calibrated to develop a Primary Asset Requirement roughly equivalent to the reserves expected under PBR.

As pointed out above, use of the AOMR would also avoid the unintended consequences of using the Hazardous Financial Condition Model.

Scope of Applicability (Exemptions)

It is very important that the scope of applicability of the Primary Asset Requirement is accurately defined. There are two different decisions that need to be made on scope of applicability: the policies to which the test is applicable and the types of reinsurance entities that subject the ceding company to testing.

Policies to which the Test is Applicable

We understand that Mr. Rector’s intent is to limit the applicability to ceding company transactions with Regulation XXX/AXXX-type captives. ACLI strongly agrees with this intended scope. However, we believe the wording provided in the proposed draft XXX and AXXX Reinsurance Model Regulation pulls in many more reinsurance arrangements. Section 4 of the draft Model Regulation states:

This regulation shall apply to:

A. Any domestic life insurance company; and
B. Any other licensed life insurance company not subject to a substantially similar regulation in its domestic state

that seeks to reduce statutory policy reserves required to be held under the NAIC Valuation of Life Insurance Policies Model Regulation (#830), which is commonly referred to as Regulation XXX, or statutory policy reserves required to be held under the NAIC Actuarial Guideline XXXVIII - The Application of the Valuation of Life Insurance Policies Model Regulation (A.G. 38), commonly referred to as AXXX, through a reinsurance ceding arrangement.

We note two concerns with this wording:

1. The NAIC Valuation of Life Insurance Policies Model Regulation (Regulation XXX) applies to significantly more product designs than Level Premium Term Insurance and Universal Life with Secondary Guarantees. According to § 3 of the Model, it applies to all life insurance policies with the exclusion of certain UL, VL, VUL, and group life insurance policies, as well as certain re-entry policies.

2. In most instances, there is no intention to reduce statutory policy reserves in a captive transaction. Rather, the full statutory reserve continues to be held by the captive, and certain non-traditional assets are allowed to back the “low-risk” portion of the reserve.
We note that this “seeks to reduce statutory policy reserves” wording is used several places within the proposed Model Regulation.

Assuming Entities Which Bring Ceding Companies under the Requirements

In defining the reinsuring entities that would bring a ceding company under the requirements of the regulation, Mr. Rector has used a very broad brush with limited exemptions. The exemptions listed include certified reinsurers, as well as licensed and accredited reinsurers preparing statutory financial statements without any permitted practices. We believe that he based this scope of applicability on two incorrect assumptions; i.e., no U.S. domiciled professional reinsurer has permitted practices unrelated to captive transactions and no foreign professional reinsurer is not certified. Both of these assumptions are incorrect, and hence we see a couple of problems with this scope of applicability:

1. Traditional reinsurance transactions with professional reinsurers are being subject to these proposed rules; and,

2. Reinsurance from a U.S. subsidiary of a foreign parent back to the parent company is being subject to these proposed rules.

ACLI believes that these are unintended consequences of the limited scope exclusions contained in the Report.

Recommended Scope of Applicability

ACLI believes that application of the Primary Asset Requirement should be limited to captive reinsurers reinsuring Level Premium Term Insurance and Universal Life with Secondary Guarantees.

Therefore, to remedy the problems that we have identified with the recommended scope of applicability contained in the Report, we propose the test apply only to the entities described as follows:

Entities to which this test applies are those entities that reinsure life insurance policies subject to Section 6 and/or Section 7 of the Valuation of Life Insurance Policies Model Regulation and:

A. Are both
   (i) Prohibited from directly issuing policies to consumers; and
   (ii) Prohibited from assuming third-party reinsurance;
   Or,
   B. Are chartered under captive insurer law, special purpose insurer law or other similar law separate from those applicable to traditional insurers and/or reinsurers in the state or non-U.S. jurisdiction where domiciled.

ACLI believes that this definition will include all Regulation XXX/AXXX-type (Level Premium Term Insurance and Universal Life with Secondary Guarantees) captive reinsurers and like arrangements. While we do not believe this definition of applicability will scope out arrangements that should be subject to the Primary Asset Requirement, we believe that regulators can and should properly deny any requests for reinsurance arrangements purposely designed to avoid the applicability of the Primary Asset Requirement that they may encounter.

Critical Concerns with Technical Details
Captives and PBR

We have heard from regulators that the implementation of PBR will “solve the problem” of overly conservative reserves for certain Level Premium Term insurance and Universal Life with Secondary Guarantees products. ACLI would point out that while this may happen over time, the modeled reserves prescribed in the current version of VM-20 still maintain a significant amount of conservatism that ACLI believes should be reviewed as experience emerges with PBR. Most significant is the degree to which a company is limited in using its own mortality experience and the prohibition from using any projection of mortality improvement in the reserve calculations (either explicitly or as part of an implicit margin for conservatism). Only by allowing a better reflection of a company’s true expectation regarding mortality will PBR truly “solve the problem”. We would note that the true problem that the industry is aiming to solve is the delivery of desirable life insurance products that the consumer can afford, while not jeopardizing the solvency of life insurance companies. We think that is a goal toward which we should all be striving.

Use of VM-20 as the Actuarial Method

We agree with Mr. Rector that, if VM-20 is used as the Actuarial Method, modifications will be needed for mortality and the scenario generator. We would be remiss if we did not point out that both of those items will need significant input from the American Academy of Actuaries, and hence the timing of the completion of those items will be dependent upon the resources available from that organization. We also agree that there are numerous “clean-up” items due to the fact that VM-20 is a reserve standard rather than an asset standard, which might be best handled through reasonable allowance of actuarial discretion.

ACLI has another significant concern with the Report. ACLI is very concerned about the use of the Net Premium Reserve (NPR) in the calculation of the Primary Asset Requirement. While ACLI appreciates Mr. Rector’s recognition of some of the issues associated with using the NPR, we believe that LATF will struggle with mitigating these issues in a short timeframe. As Mr. Rector noted, unlike the stochastic and deterministic reserve calculations, NPR assumptions are locked in at issue, and do not take into account changes in experience data or economic environment. This can cause NPRs to become significantly different from the modeled reserve calculations over time, and the impact can be exacerbated when used on a closed block of business reinsured by a captive. Furthermore, the NPR was designed to be an aggregate floor used over large open blocks of business. However, in many cases, it does not track the deterministic or stochastic calculations very well by duration, and therefore will tend to break down when used in isolation on closed blocks of business.

Both of these issues will work in tandem to develop a poor floor calculation over time for the Primary Asset Requirement, but can be mitigated to some degree with periodic unlocking of the NPR. An issue that is not as easily remedied is in regards to the proper day-one calibration of the NPR to take into account any initial modifications made to VM-20 to make it workable as the Primary Asset Requirement. The initial calibration to ensure that the NPR was a reasonable floor reserve took close to two years to get approximately right and the Towers’ Report commissioned by the NAIC indicates that there is still work to do, especially for term insurance where the NPR dominated the modeled reserves. There has been no reason to continue to work on calibration until all of the changes to VM-20 have been completed. ACLI does not believe that this re-calibration could be done in a short timeframe, as significant amounts of modeling and testing are required. However, the use of the NPR is dependent upon proper calibration or else it will dominate the modeled reserve calculations (and become the de facto reserve, rather than a floor reserve). Lastly, we point out there is not an NPR calculation specified in VM-20 for stand-alone riders, such as a secondary guarantee rider, or for some forms of reinsurance transactions, such as YRT. In the absence of a specified calculation, the Valuation Manual currently states that the NPR defaults to current CRVM calculations. This would result in disparate effects from company to company of applying the NPR, depending upon the exact form of the reinsurance.
Because of all these difficult to resolve issues, ACLI would propose that, should VM-20 be chosen as the Actuarial Method, that the NPR not be added to the method until PBR becomes effective. Presumably, most of the remaining issues will be worked out by then by LATF. In the meantime, we do not believe that the deterministic and stochastic calculations will produce a materially different result than would be provided using a re-calibrated and fully functional NPR floor.

Calculation of RBC

As the Report points out, in order to provide RBC calculations on captive reinsurers, new RBC factors will need to be developed for “assets” that currently have no factors assigned to them, such as letters of credit or parental guarantees. While we are not opposed to the concept of providing these calculations to regulators, we suggest the following:

1. The new “asset” factors should correlate with the credit worthiness of the financing party;

2. The new factors must not be onerous, or the potential benefits of the reserve financing will be eliminated by overly conservative RBC requirements;

3. The criterion for applying the test at the captive level should be clarified to be the required application of the NAIC RBC formula within the captive jurisdiction, rather than absence of permitted accounting practices (as alternative assets are frequently counted within captive structures using permitted practices); and,

4. At the ceding company level, the RBC calculation should be included as part of the current RBC Stress Testing section of the RBC calculation worksheets. This worksheet is available to regulators only. Given that there will not be time to adequately test the new RBC factors that are needed before they become applicable, we do not believe that this RBC calculation should be made available to the public.

Effective Dates

ACLI has concerns over exactly how “voluntary” compliance beginning 7/1/14 would work, since regulators and insurers are only two of the three parties involved in the transactions. The financing party would not want the requirements to be in flux at the time of the financing, as they would be unsure of the ultimate ramifications on their commitment to provide the financing. There cannot be changes to the requirements after the financing arrangements are effective. In addition, this does not encourage one of the main goals stated by regulators of developing uniformity across jurisdictions, as different guesses of the final Actuarial Method will result in different requirements by each regulator. Given these difficulties, we suggest that this part of the effective date be eliminated, and instead wait until all the requirements are known and specified on the effective date of the new rules.

We also consider the proposed timeline for the effective date of the Actuarial Method (1/1/15) to be very aggressive. There is a lot of work for the technical groups to do in the next six months in order to have a method adopted by year-end. We are not opposed to setting that as the goal for effective date, but caution against allowing the stated effective date to encourage unsupported decisions to be made in respect to the new rules.

ACLI also believes that there should be a period of time in which new business can be added to existing captive transactions without being subject to the Actuarial Method and RBC requirements. Many transactions carry financial penalties or excessive costs if the capacity of the financing is not filled. We think it would be shortsighted to force those captive arrangements to be shut down too quickly. We suggest that a company be allowed to reinsure business into an existing arrangement for a period of one year beyond the ordinary effective date of the new rules. Not only will this minimize the financial costs associated with ending an agreement early, it will allow companies time to re-price and file their products based on the new Actuarial Method rather than on the existing financing transactions. We note that
these transactions would have all had recent regulatory approval of the conditions under which additional years of new business would be included.

We also note that it appears that the wording contained in § 12.B of the draft of the XXX and AXXX Reinsurance Model Regulation does not match the stated intent of Mr. Rector during the 3/12/14 conference call of the PBR Implementation Task Force. Section 12B states “The regulation shall apply to all cessions with respect to any life insurance within the scope of Section 4, regardless when written, under any reinsurance arrangement that is entered into or amended on or after...”. However, Mr. Rector has stated that it was not his intent to apply the new regulation to policies issued prior to the effective date of the new requirements. We believe that, to be consistent with Mr. Rector’s intent, the wording should be “The regulation shall apply to all cessions with respect to any life insurance within the scope of Section 4 issued on or after ...”

Primary Assets

Using the Report’s Proposed Framework

As stated above, ACLI has significant concerns with the Report’s Framework (using the Primary Asset Test to test collateral). Most importantly, we do not believe that this proposed Model Regulation can override the requirements of the Credit for Reinsurance Model Law. Our concerns are not related only to the scope of application, but also in changing the requirements for types of collateral that are recognized in captive transactions. Recognizing the slight error in nomenclature (Primary Assets should more properly be called Primary Security in this Framework), there should be no question that, in addition to cash and securities listed by the NAIC SVO as qualifying as admitted assets, clean, irrevocable, unconditional letters of credit issued by a qualified U.S. financial institution should be included in the determination of the Primary Asset Requirement for a captive reinsuring XXX/AXXX business. These types of letters of credit are explicitly included in the Credit for Reinsurance Model Law as acceptable forms of collateral and are every bit as secure as the other explicitly acceptable forms of collateral. These letters of credit are convertible directly to cash if and when needed and fully back the reserve credit. As a matter of fact, the obligations to the ceding company emanating from clean, irrevocable, unconditional letters of credit are very comparable to those from a reserve credit trust (which is owned by the captive). The ACLI acknowledges that a draw on the letter of credit may create an immediate reimbursement obligation for the captive reinsurer, as well as another party accepting reimbursement obligations. However, the ceding company has no such immediate reimbursement obligation. The ceding company does have an obligation to pay interest on the funds if they are not used to pay amounts currently due under the reinsurance agreement, and must eventually return the funds that are not used to pay claims or other amounts due under the reinsurance agreement. This is the same obligation that applies if the ceding company were to draw assets from a reserve credit trust for amounts not currently due under the reinsurance agreement.

The Report requires the captive to designate Primary Assets to be placed into a trust for the ceding company or requires the ceding company to employ a funds withheld arrangement with respect to reinsur:
proper regulation of both parties, with the full knowledge of the transactions of both the captive and the ceding insurer, is already in effect. A collateralization requirement would serve only to increase costs without providing additional safety and security to the reinsurance transaction. We believe so long as the state regulator adheres to new requirements imposed on captives, credit shall continue to be allowed when reinsurance is ceded to an assuming insurer that is licensed to transact reinsurance or is accredited by the commissioner as a reinsurer in the state.

**Using ACLI's Proposed Framework**

The item being measured under ACLI’s proposed framework is not collateral, but rather “assets”. However, in this instance, the “assets” are from the perspective of the ceding company. Therefore, clean, irrevocable, unconditional letters of credit issued by a qualified U.S. financial institution payable to the ceding company are as good as cash to the ceding insurer, and should rightfully be included in the analysis of the ability of the captive reinsurer to meet its obligations to the ceding company when the Appointed Actuary opines on the reserves of the ceding company. Furthermore, we believe that any assets that qualify as Primary Assets that are available to the captive reinsurer to meet its reinsurance obligations to the ceding company should be included in the Appointed Actuary’s analysis, not limited to just those “assets” that are funds withheld or held in trust. In a captive arrangement, the assets and liabilities have been “ring-fenced” in the captive reinsurer. The ceding company does not need the assets segregated into a trust for its protection since the assets have been segregated in the captive reinsurer, generally under a licensing order, and the assets cannot leave the captive except under rules prescribed and ordered by the regulator of the captive reinsurer. The captive regulator has effective control over the assets in the captive. Of course, removing this limitation of funds withheld or held in trust being Primary Assets of the captive is imperative if these new requirements are to be applied to captive transactions that do not entail collateral requirements.

**Other Assets**

ACLI agrees with the Report in that any security that is acceptable to the commissioners of both the ceding company and the captive reinsurer should be counted as an “asset” of the captive and allowed to be used towards the collateral requirement for reserve credit.

**Conclusion**

As we stated above, we have limited our comments at this time to those issues that we believe are most critical to resolve in the early stages of development. We will continue to provide comments on other issues as decisions on the conceptual framework are made. We thank you for your consideration of our views and look forward to working with you on this project. If you have any questions or concerns, please feel free to call me at (202) 624-2164.

Sincerely,

[Signature]

Paul S. Graham, III, FSA, MAAA

cc: Members, NAIC PBR Implementation Task Force
    Neil Rector, Rector & Associates
Appendix A
Synopsis of ACLI’s Proposed Framework

I. The Actuarial Opinion and Model Regulation should be amended to require the Appointed Actuary to perform analysis of Regulation XXX/Axxx-type captive transactions that include cessions after the effective date of the requirement. The analysis will be based on an Actuarial Method described in a new Actuarial Guideline.
   a. In order to render a clean Actuarial Opinion, the Appointed Actuary would have to find that the statement value of the Primary Assets of the captive reinsurer equals or exceeds the Primary Asset Requirement.
   b. If the analysis reveals that the statement value of the Primary Assets are less than the Primary Asset Requirement, in order to render a “clean” Actuarial Opinion, the ceding company must either reduce the credit for the reinsurance by the amount of the difference, or the captive must have an infusion of assets between the valuation date and the date of filing of the actuarial opinion for the amount of the difference (and provide the appropriate collateral if required by the Credit for Reinsurance Model Law and Regulation).
   c. If neither of the conditions in a. nor b. is met, the Appointed Actuary must render a “qualified” Actuarial Opinion.
   d. The Actuarial Opinion will contain disclosure-type information on the captives tested in order for the Appointed Actuary to render an opinion.
   e. The new Actuarial Guideline will be calibrated to develop a Primary Asset Requirement roughly equivalent to the reserves expected under PBR.

II. “Captives” should be defined as those entities that reinsure life insurance policies subject to Section 6 and/or Section 7 of the Valuation of Life Insurance Policies Model Regulation and:
   a. Are both
      i. Prohibited from directly issuing policies to consumers; and
      ii. Prohibited from assuming third-party reinsurance; or
   b. Are chartered under captive insurer law, special purpose insurer law or other similar law separate from those applicable to traditional insurers and/or reinsurers in the state or non-U.S. jurisdiction where domiciled.

III. RBC instructions should be added to include a new Stress Test, based on a consolidation of ceding company and captive reinsurer assets and liabilities, to be performed if the captive is not regulated in a jurisdiction that requires NAIC RBC calculations.
   a. The instructions will include new “asset” factors that will be only used for this stress test.
   b. The factors would be based on the credit worthiness of the financing providers.

IV. The effective dates should include the ability for new policies to be included in existing financing agreements for a short period of time (one year) with a grandfathered status to allow insurers to meet their obligations to financing providers.

V. The Primary Asset amount of the captive reinsurer should be based on all the admitted assets normally allowed by the NAIC as well as clean, irrevocable, unconditional letters of credit issued by a qualified U.S. financial institution.

Other Assets should include any security that is acceptable to the commissioners of both the ceding company and the captive reinsurer, though they would not be included towards the Primary Asset Requirement. The captive would account for assets on its balance sheet as permitted by its domestic regulator; the Framework would not be applicable.
Appendix B
An Alternative Actuarial Method Worth Considering

For all the reasons specified in our letter to Neil Rector (Appendix C), ACLI continues to believe that use of VM-20 as the Actuarial Standard presents obstacles that are not easily handled. There are a number of general concerns with the use of VM-20 as the Actuarial Method. VM-20 was built specifically for reserve calculations. Using VM-20 as the Actuarial Method for the Primary Asset Requirement for a captive reinsurance arrangement is a bit like trying to fit a square peg in a round hole. While VM-20 might be modified to make it a better fit for this purpose, the best that can be accomplished is to round off the edges of the square. We might get it to fit, but it will still be quite clunky. The key to captive financing transactions is the determination of the difference between two reserves, the full statutory reserve and a more standardized economic reserve with margin. This difference will set the amount of financing that needs to be in place to make the transaction effective for many years in the future. That financing has substantial costs and methods that either:

i. create greater uncertainty about the amounts needed, or

ii. produce financing amounts that significantly depart from what the market would offer,

which can create significant inefficiencies in the effective execution of transactions. Unfortunately, using VM-20 as a surrogate for the economic reserve with a margin has both of these characteristics.

ACLI believes a more flexible framework based on a modified Asset Adequacy Analysis could be used to eliminate many of the issues associated with using VM-20 while also removing many of the items that LATF would otherwise have to work on to make VM-20 work for this purpose. This would free LATF up to work on completing PBR (which should be the goal of both regulators and industry). We are not sure how long these items will take to complete, but it is not an insignificant amount of work. ACLI believes that LATF’s resources would be much better spent on completing VM-20, and much of this work would not be required if the Actuarial Method was based on existing requirements of Asset Adequacy Analysis with prescribed requirements as determined by regulators.

ACLI is well aware of the criticisms of using Asset Adequacy Analysis as the basis for this test. We have heard that there is not enough uniformity and it cannot be exactly calibrated to PBR. However, both of those issues are relatively easily overcome. For example, the NAIC can prescribe use of portions of Section 9 (Assumption Setting) of VM-20 for those assumptions where uniformity is desired. And while it is true that Asset Adequacy will not develop the exact same numbers as VM-20, it would be easy to sunset this method and replace it with a completed VM-20 when PBR becomes effective. In the meantime, if asset adequacy analysis is calibrated at the same level as VM-20, the results should not be materially different.

We would appreciate the opportunity to flesh this idea out further with the regulators before the choice of the Actuarial Method is made.
February 4, 2014

Neil Rector
Rector & Associates
172 E State Street
Columbus, OH 43215

RE: Questions posed regarding the regulation of Regulation XXX/AXXX-type captive reinsurers

Dear Neil:

The ACLI appreciates the opportunity to provide our thoughts on questions that you posed regarding the regulation of Regulation XXX/AXXX-type captive reinsurers prior to the finalization of your final report.

Introduction

As we have stated in earlier comment letters, the ACLI supports life insurers’ use of captives and their appropriate regulation and ACLI is committed to ensuring the solvency of captive reinsurers. We appreciate the work that you are doing on behalf of the NAIC to review existing regulation of Regulation XXX/AXXX-type captives and propose solutions to regulators’ concerns. We have reviewed your initial report and your follow-up questions, and have detailed our responses and concerns below.

Executive Summary

You have asked us to comment upon the following issues in regards to the development of new requirements for reserve credit for reinsurance of captives established to assume insurance contracts that have reserves based on either Regulation XXX or AG 38 (also called AXXX):

1. The use of VM-20 as the Actuarial Method for determining the Primary Asset Requirement for these captives;
2. Types of assets and forms of security that should be allowed towards meeting the Primary Asset Requirement of these captives;
3. Types of assets and collateral security that should be allowed to meet the collateral requirements of Section 3 of the Credit for Reinsurance Model Law of these captives (so called “Other Assets”) and thereby be allowed as admitted assets of the captive;

2 The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with approximately 300 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers’ products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums. Learn more at www.acli.com.
4. How best to incorporate an RBC calculation into the regulation of these captives;
5. Our thoughts on using a modified version of the New York Supplement for disclosure purposes for these types of captives; and,
6. The scope of applicability of these new requirements.

We will address each item in that order. Please note that our responses are based on our understanding that the Primary Asset Requirement is a requirement applied to the assets and other security of the captive.

1. ACLI continues to believe that the total capital requirement concept is preferable to using VM-20 as the Actuarial Method for determining the Primary Asset Requirement. ACLI strongly supports the adoption of PBR by the states, and the use of VM-20 for the calculation of reserves for new business. However, VM-20 was purpose-built for reserve calculations, and using VM-20 as the Actuarial Method for the Primary Asset Requirement is not a very good fit. We have spent a considerable amount of time analyzing VM-20, and have determined that we believe the disadvantages outweigh the advantages. VM-20 was purposely designed to be highly conservative in the early years, and still has open items. The total capital requirement concept that ACLI has proffered is specifically focused on the key question of whether the captive can meet its obligations, and provides more flexibility than reserve requirements of VM-20, and we would welcome the opportunity to discuss the total capital requirement concept with you and the NAIC in more detail. Furthermore, trying to duplicate the usefulness of a total capital requirement with the use of a RBC requirement in conjunction with VM-20 is fraught with problems that are difficult to overcome in a timely manner.

If, despite these points, it is the decision that VM-20 should be used as the Actuarial Method, there are many issues that must be addressed. We describe these in greater detail later in this letter, but summarize four main issues that would make VM-20 unworkable as the Actuarial Method if not addressed:

A. The Net Premium Reserve (NPR) must be removed from the calculation. Among several issues (itemized below), unlike the stochastic and deterministic reserve calculations, NPR assumptions are locked in at issue, and do not take into account changes in experience data or economic environment. This can cause NPRs to become significantly different from the modeled reserve calculations over time, and the impact can be exacerbated when used on a closed block of business reinsured by a captive;
B. The industry mortality tables must be updated. Since it is unlikely that the 2015 VBT will be completed before the Primary Asset Requirement goes into effect, this would have to be accomplished through a use of mortality ratios applied to the current 2008 VBT until the 2015 VBT is adopted;
C. The interest rate generator causes extreme volatility from year to year, which is unsuitable for the development of a Primary Asset Requirement. This could be fixed by applying faster mean reversion parameters and developing a more stable formula for the mean reversion point; and,
D. There is a laundry-list of “holes” in VM-20 due to the fact that it was not designed for this purpose which would need to be patched. Due to the amount of time it might take to address these issues, we believe these “holes” would be best handled through the use of actuarial discretion at least initially.

2. All “traditional” assets of the captive (not limited to funds withheld and assets within a trust), as well as clean, irrevocable, unconditional letters of credit should be allowed towards meeting the Primary Asset Requirement. All of these assets are available upon demand to meet the obligations of the captive.

3. The “Other Assets” should include all assets or forms of security that can be used as collateral under Section 3 of the Credit for Reinsurance Model Act. This would allow the continuation of
commissioner discretion for determining the forms of security that are acceptable as “Other Assets”.

4. Any attempt to apply an RBC formula to captives or captive transactions will have its difficulties, which are enumerated below in the body of the letter. In absence of developing an Actuarial Method that incorporates a total capital concept, we suggest that the newly adopted Own Risk and Solvency Assessment (ORSA) requirements would be the best place to determine the capital adequacy of the consolidated operations of ceding companies and captive reinsurers.

5. ACLI’s main concern with the use of a modified version of the New York Supplement for disclosure purposes is confidentiality of the information. New York addressed this issue appropriately, and we will work with the NAIC to develop similar confidentiality requirements. We also would recommend eliminating column 23 of the Supplement – “Estimated RBC impact on Cedent at December 31 of current year (Company Action Level)”, for reasons described in the body of the letter, and develop a more specific definition of scope of applicability than is currently outlined in the Supplement.

6. You have suggested that the scope of applicability be defined by listing specific exceptions to applicability;

   A. Exempting “certified” reinsurers from the new requirements; and,
   B. Exempting “licensed” and “accredited” reinsurers from the new requirements if (1) the reinsurer complies with NAIC statutory accounting, including RBC, and (2) the reinsurer has not been granted any permitted practices for their admitted assets.

   Unfortunately, we believe this wording is incomplete. For example, if an accredited reinsurer is based in a foreign jurisdiction, but not certified, that entity should not be subject to these requirements that are to apply to captives. We continue to work on suggested language.

**Detailed Responses to Items**

The remainder of this letter will go into specific details underlying our comments contained in the Executive Summary. By necessity, much of what follows is quite technical, and we welcome any further questions that you may have.

**Actuarial Method for determining Primary Asset Requirement for Regulation XXX/AXXX-type Captives**

As stated in our letter dated November 15, 2013, ACLI believes that the most appropriate actuarial method for determining a Primary Asset Requirement for Regulation XXX/AXXX-type captives is one calibrated to a total capitalization level (reserves plus capital) with the attendant measure set at a confidence level consistent with existing NAIC RBC requirements.

There are two primary reasons for developing an Actuarial Method in this fashion:

1. The method should focus on the captive reinsurer’s ability to meet its obligations. The captive has assets that are backing not only reserves, but capital. Therefore, the Actuarial Method should test the adequacy of all of those assets to meet the obligations of the captive. This process could be quite similar to the way that the ceding company performs asset adequacy analysis, but would be calibrated to a higher confidence level.

2. The method should offer greater flexibility than the current VM-20. Asset adequacy analysis, as required by the Actuarial Opinion and Memorandum Regulation (AOMR), has significantly more flexibility, in both method and assumptions, as compared to the current principle-based reserve (PBR) requirements contained in Chapter 20 of the NAIC Valuation Manual (VM-20). Our specific concerns over VM-20’s lesser flexibility are further explained below.
Having stated our significant preference for an Actuarial Method based on the requirements of the AOMR, we recognize your preference for a modified version of VM-20, similar to the way that Section 8D of AG 38 was developed. Advantages mentioned by regulators of your approach include:

1. The methods contained in VM-20 have been in development for almost a decade; and,
2. Use of a modified VM-20 most likely would naturally phase out the use of Regulation XXX/AXXX-type captives upon the implementation of PBR without further action being needed.

However, we believe the disadvantages outweigh the perceived advantages, which are outlined in the following four categories:

1. The are a number of general concerns with the use of VM-20 as the Actuarial Method, including:
   
   A. VM-20 was built specifically for reserve calculations. Using VM-20 as the Actuarial Method for the Primary Asset Requirement is a bit like trying to fit a square peg in a round hole. While VM-20 might be modified to make it a better fit for this purpose, the best that can be accomplished is to round off the edges of the square. We might get it to fit, but it will still be quite clunky. The key to captive financing transactions is the determination of the difference between two reserves, the full statutory reserve and a more standardized economic reserve with margin. This difference will set the amount of financing that needs to be in place to make the transaction effective for many years in the future. That financing has a substantial cost, and methods that either:
      i. create greater uncertainty about the amounts needed, or
      ii. produce financing amounts that significantly depart from what the market would offer,
    can create significant inefficiencies in the effective execution of transactions. Unfortunately, as can be seen from some of the items below, using VM-20 as a surrogate for the economic reserve with a margin has both of these characteristics.
   
   B. As VM-20 was being designed, regulators purposely made every decision with the intention of leaning towards conservatism. Taken together, the initial VM-20 is extremely conservative in its totality. Regulators took this approach with the idea that VM-20 could be easily modified by the NAIC as experience emerges and more business is subject to VM-20. Given that PBR will only apply to new business, and new business reserves are small and immaterial to an entire company’s reserves, industry was comfortable with this approach, knowing that future changes in methodology would retroactively apply to business written during the early years of PBR. This concept of trusting that the future standards will have more appropriate levels of conservatism as the methodology matures can work as a reserve standard for new business. However, the concept breaks down when used to measure the adequacy of primary assets to back a reserve financing transaction, where the financing provider needs solid projections of reserves and financing need at all future later policy durations in order to price the deal.
   
   C. VM-20 is a reserve standard, and the wording throughout it refers to terms such as “minimum reserve”, “stochastic reserve”, “deterministic reserve”, “gross reserve”, “net reserve”, “scenario reserve”, etc. We do not believe that a simple substitution of the word “amount” for the word “reserve” will suffice in all instances, and a detailed review and non-trivial edit of VM-20 would need to occur for it to operate as a Primary Asset Requirement.
   
   D. VM-20 contains a calculation of a Net Premium Reserve (NPR) as a floor reserve. There are several problems with using a NPR calculation in the calculation of a Primary Asset Requirement. Perhaps most importantly, unlike the stochastic and deterministic reserve calculations, NPR assumptions are locked in at issue, and do not take into account changes in experience data or economic environment. This can cause NRPs to become significantly different from the modeled reserve calculations over time, and the impact can be exacerbated when used on a closed block of business reinsured by a captive. Additionally,
the NPR is a seriatim, formulaic reserve calculation that was calibrated to work specifically with the current VM-20 modeled reserves as a floor reserve. Modifications needed to make VM-20 workable as the Primary Asset Requirement (itemized in the Executive Summary) would require a complete re-calibration of the NPR. The initial calibration took close to two years to get right, and it is not clear that re-calibration could be done in a timely manner. Furthermore, the NPR was designed to be an aggregate floor used over large open blocks of business. However, in many cases, it does not track the deterministic or stochastic calculations very well by duration, and therefore will tend to break down when used in isolation on closed blocks of business. The NPR also has a significantly lower number of mortality classes than the modeled reserves, which could cause large deviations when used on a closed block.

E. Because VM-20 is very different from current reserve calculations, most companies will have to develop new systems or purchase vendor-developed software to perform VM-20 calculations. It is highly unlikely that vendors will be done with programming in the near term, which will cause operational problems for companies that do not have the in-house capability of programming VM-20. For those companies, this problem is not easily overcome.

2. VM-20 is not in the form that it will be when PBR goes into effect, as several items are expected to be corrected or updated by that time.

   A. The current industry mortality tables included in VM-20 are either outdated (2001 CSO) or have known problems (2008 VBT) and are being updated by the SOA/AAA.
   B. The current interest rate generator causes extreme volatility based on economic environment on the valuation date. LATF’s agenda includes a project on how to handle this volatility.
   C. There are known issues in the VM-20 requirements for modeling reinsurance ceded that still need to be addressed. Those issues include:
      i. The modeling of nonguaranteed YRT premiums (how are they impacted by the required conservatism built into the mortality requirements?);
      ii. The Stochastic Exclusion Test tends to create a “false failure” when there is significant amount of YRT on the block being tested, regardless of whether the direct block would fail the test. Reinsurance should reduce a ceding company’s risk, not increase it; and,
      iii. The modeling of reinsurance of some, but not all, of the risks of a product.

3. Because VM-20 is designed for policy reserves, there are items that are currently missing from or improperly described in VM-20 for use as the Primary Asset Requirement. We believe that these items need to be handled if VM-20 is used as the Primary Asset Requirement, and that actuarial discretion will need to be used if regulatory guidance is not given.

   A. There are no rules for modeling letters of credit. LATF has received an amendment proposal form from the American Academy of Actuaries on this, but no action has occurred to date.
   B. VM-20 has not been designed to handle the assumption of split benefits (e.g., a rider consisting only of secondary guarantees is assumed). VM-00 explicitly states that such a rider must be valued in conjunction with the base policy, but that would clearly not work here.
   C. The rules in VM-20 for selecting the Starting Assets for the modeling may not work well for this purpose. It is not clear that the wording will allow the use of all the Primary Assets in the modeling. For instance, funds withheld by the ceding insurer are not explicitly listed, nor are funds held in trust for the benefit of the ceding insurer. This would need further review and possible revision.
4. We believe that VM-20 is currently too conservative for use as the Actuarial Method. In addition to some of the items in #2 above that are already under review by LATF, other items in VM-20 that would create large excesses over normal economic reserves with a solvency margin are:

A. There is no mortality improvement included in VM-20 after the valuation date. Current practice is to include mortality improvement in the calculation of an economic reserve. Lack of mortality improvement creates an implicit, and significant, margin in VM-20.

B. The level of prescription in VM-20 is high, which can cause big differences between a company’s own experience and the prescribed element (especially mortality assumptions and margins).

C. There is a high sensitivity of interest rate generator to recent economic conditions, and extremely slow “mean reversion” can create significant conservatism in certain economic environments (primarily low interest rates).

As you can see, there are quite a few disadvantages to using VM-20 as the Actuarial Method. Of course, many could be overcome given enough time and energy, but it would likely be a time-consuming effort that would take months or even years. We have placed a prioritized listing of these issues in the Executive Summary, along with some recommended solutions.

**ACLI Suggests A Better Solution**

ACLI believes that it would be more straightforward to use Asset Adequacy Analysis as the basis for the Primary Asset Requirement, with perhaps a few additional restrictions to make it more “PBR-like”. For example, there could be a requirement that large portions of Section 9 of VM-20 be used to develop the assumptions used in the modeling. This would keep the advantage of flexibility needed to handle items that VM-20 was not designed for, while placing some level of uniformity on the calculations of the Primary Asset Requirement. If calibrated as a total capital requirement, the Primary Asset Requirement would eliminate all the problems associated with applying an RBC-type requirement to captive transactions (see pages 7 and 8), and, if calibrated as a reserve requirement, the Primary Asset Requirement would not be too different from the reserves that we expect PBR to produce once it is a more mature methodology. This would retain the regulators’ goal of naturally phasing out these types of captives over time. Furthermore, Asset Adequacy Analysis has been used by companies and regulators for more than 20 years, so it is well understood and tested. We have spent a considerable amount of time developing an approach based on Asset Adequacy Analysis, and we hope that you would be interested in having us share those details with you and regulators.

**Primary Assets**

There is no question that cash and securities listed by the NAIC SVO as qualifying as admitted assets would be included in any determination of the Primary Asset Requirement for a captive reinsuring XXX/AXXX business. The ACLI believes that clean, irrevocable, unconditional letters of credit issued by a qualified U.S. financial institution should also be included in such a determination. These types of letters of credit are explicitly included in the Credit for Reinsurance Model Law as acceptable forms of collateral and are every bit as secure as the other explicitly acceptable forms of collateral – cash and securities listed by the SVO. We cannot understand why regulators might want to limit the total amount of these types of letters of credit that would count towards the Primary Asset Requirement, as these are convertible directly to cash and fully back the reserve credit. Furthermore, we believe that any assets available to the captive reinsurer to meet its reinsurance obligations should be counted towards meeting the Primary Asset Requirement, regardless if those assets are specified as collateral for the ceding company or as capital/surplus for the captive. This is imperative if these new requirements are to be applied to captive transactions that do not entail collateral requirements.
Other Assets

ACLI believes that any security that is acceptable to the commissioners of both the ceding company and the captive reinsurance should be counted as an asset of the captive and towards the collateral requirement for reserve credit. It is clear that the Credit for Reinsurance Model Act explicitly allows for this commissioner discretion in determining the collateral requirement. There does not appear to be a valid reason to allow a form of security to be counted as collateral, but not as an asset of the captive reinsurer. It becomes even more evident that no restriction on commissioner discretion for valid forms of collateral should apply if VM-20 becomes the Actuarial Method because:

1. As previously stated, the initial version of VM-20 has been designed to be ultra-conservative. We strongly believe that VM-20 will require reserves that will exceed the present value of expected claims even under adverse scenarios and even with possible modifications to deal with the issues itemized above.

2. VM-20 is the future PBR reserve standard, and a requirement to hold ANY asset above the VM-20 level is at least as conservative as the future PBR standard, even if that asset ultimately has no value. More likely, the asset will have value, and the captive structure will be more conservative than VM-20.

3. Although concerns have been expressed about “other assets” being the only “asset” in a captive, the Primary Asset Requirement will eliminate that possibility. These “Other Assets” would back up the hard assets needed to meet the Primary Asset Requirement.

Having said that, ACLI is aware that some regulators would like to prescribe these “Other Assets”. We feel that is a very hard task to accomplish, which is why the Credit for Reinsurance Model Law has a “catch-all” category. We believe that commissioners should continue to have discretion and, again, believe this is obvious if VM-20 becomes the Actuarial Method. In the event that the NAIC decides to prescribe “Other Assets”, we suggest that the prescription be focused on the characteristics of security that would be deemed not acceptable, rather than itemize acceptable forms of security. Frankly, we do not believe itemizing every acceptable form of security is possible.

RBC Requirements

Currently, capital requirements for captives vary by jurisdiction and the definition of “capital” depends on accounting basis for the captive, especially relevant for offshore captives likely to have completely different accounting bases but also relevant to some U.S. captives. The ACLI does not believe that it is feasible for the NAIC to seek to have states and foreign jurisdictions change their captive laws to make NAIC RBC requirements applicable to captive reinsurers. As stated above, our preference would be to develop a Primary Asset Requirement that would test a Regulation XXX/AXXX-type captive reinsurer’s ability to meet its obligations by using an Actuarial Method that is calibrated to a level of confidence comparable to the NAIC RBC requirements (approximately 95th percentile). Following this model eliminates the need to consider how RBC requirements should be applied to captive transactions.

If, however, the NAIC chooses an Actuarial Method that is calibrated to a similar confidence level as statutory reserves (regardless of whether it is VM-20 or Asset Adequacy Analysis), there remains a question of whether the combined capital levels of the ceding insurer and captive reinsurer are adequate. ACLI believes the best tool with which to address this question is the NAIC’s recently adopted ORSA. An insurance group’s ORSA report should include information concerning the capitalization level of the group, including affiliated captives.

In absence of relying on ORSA or a Primary Asset Requirement calibrated to a high degree of confidence, calculation of the RBC of a combined ceding company and captive reinsurer can be difficult. We can think of three potential ways to address this issue, but all would be time-intensive to modify appropriately for this purpose.
1. As a condition of full reserve credit, ensure that the captive has an RBC level that would not draw regulatory action if the captive had been regulated under the insurance company RBC laws and accounting rules.

Directly calculating the RBC of a captive would be difficult. There are no RBC factors for “Other Assets”. Captive reinsurers, both foreign and domestic, have different accounting bases (not U.S. Statutory) that impact the calculation of surplus. We do not think the latter can be overcome, and the former can only be overcome with a significant effort on the NAIC’s part to develop such factors.

2. Develop a “consolidated” RBC with modifications, and only allow full reserve credit if the combined modified RBC ratio would not draw regulatory action.

Given that the reason to create a Primary Asset Requirement is to allow low-cost financing for the portion of the assets backing the extreme tail of the statutory reserve, rote consolidation of the balance sheets of the two entities (and then non-admitting the clean, irrevocable, unconditional letters of credit issued by qualified U.S. financial institutions included in the Primary Assets and all of the “Other Assets”) would simply move the extreme tail requirement from reserves to required capital and disallow the financing secured for that extreme tail. That would defeat the purpose of using the captive reinsurance. For the RBC calculation to work appropriately, one of two modifications would have to happen in the consolidation of the entities’ balance sheets before applying the RBC formula and calculating an RBC ratio:

   A. The clean, irrevocable, unconditional letters of credit issued by qualified U.S. financial institutions included in the Primary Assets and all of the “Other Assets” of the captive reinsurer would have to be considered admitted assets for the purposes of the RBC calculation (but there would still be the question of what RBC charges to apply); or,

   B. The liabilities of the captive reinsurer would have to be set equal to the Primary Asset Requirement less any clean, irrevocable, unconditional letters of credit issued by a qualified U.S. financial institution included in the Primary Assets for the purposes of the RBC calculation.

By making either of these modifications, the net effect is that the calculation of the surplus (the numerator in the RBC ratio) would be the sum of the surplus of the ceding company and the captive, using the accounting rules applicable to each. The required capital would be based on the combined assets and the combined liabilities of the two entities. Should the NAIC decide to use this method of determining adequacy of capital for Regulation XXX/AXXX-type captives, ACLI recommends the results of the calculation not be made part of the Financial Statement Blank, but rather in the confidential “Captives Supplement” patterned on New York’s Supplement.

3. Disclosure of the RBC impact of the captive transaction

This is the direction that New York has taken with its Supplement. The primary concern with this is that it is not indicative of the Regulation XXX/AXXX-type captive reinsurer’s ability to meet its obligations. Therefore, it does nothing to indicate whether the reduced RBC is appropriate due to a reduction in risk, or whether there is a true regulatory issue that should be further investigated. Therefore, it is a misuse of RBC, as the calculation does nothing more to help identify a weakly capitalized company.

Due to the problems associated with all three of the possible ways to look at RBC, we cannot recommend any of them.

Disclosure Requirements

As you are aware, the ACLI developed a set of disclosure and transparency requirements (Enhanced Transparency and Regulatory Disclosures and Risk Analysis for Life Insurer-Affiliated U.S. Captive
Transactions) that we believe are robust and would provide non-domiciliary regulators with the information that they need to understand captive transactions. Nevertheless, you have asked us to provide feedback concerning the possible use by the NAIC of a modified version of New York's Supplement Exhibit. ACLI's primary concern with the NY Supplement is that it contains proprietary and confidential information, and should be treated as such. The New York Department of Financial Services understood these concerns, and made provisions to keep the information confidential under Article 15 of their holding company statute, which states:

Article 15, Section 1504 (c): The superintendent shall keep the contents of each report made pursuant to this article and any information obtained in connection therewith confidential and shall not make the same public without the prior written consent of the controlled insurer to which it pertains unless the superintendent after notice and an opportunity to be heard, shall determine that the interests of policyholders, shareholders or the public will be served by the publication thereof. In any action or proceeding by the superintendent against the person examined or any other person within the same holding company system a report of such examination published by the superintendent shall be admissible as evidence of the facts stated therein.

We ask that, should the NAIC decide to adopt a modified version of the New York Supplement, that similar accomodations for confidentiality be made.

The one piece of information contained within the New York Supplement that ACLI recommends eliminating is the column concerning the RBC impact of the transaction (Column 23). As stated above, ACLI's primary concern is that it is a misuse of RBC, in that it ignores any real risk reduction, and therefore does nothing to help identify a weakly capitalized company. Furthermore, for some of the same reasons enumerated above, the calculation of the requested information is confusing at best, and difficult to accurately calculate at worst. It also assumes that in the absence of the captive arrangement, the ceding company would not have executed a different reinsurance arrangement.

We would also point out that a more specific definition of scope of applicability will need to be used for this schedule. New York simply gathers information for all affiliates.

Scope of Applicability (Exemptions)

It is very important that the scope of applicability of the Primary Asset Requirement is accurately defined. We understand that it is your intent to limit the applicability to Regulation XXX/AXXX-type captives, and that it will apply prospectively only. ACLI strongly encourages that this requirement be limited to those types of captive transactions. The more difficult part of defining the applicability is defining the types of reinsurance companies to which the Primary Asset Requirement applies.

You have suggested that the scope of applicability be defined by listing specific exceptions to applicability;

1. exempting “certified” reinsurers from the new requirements; and,
2. exempting “licensed” and “accredited” reinsurers from the new requirements if (1) the reinsurer complies with NAIC statutory accounting, including RBC, and (2) the reinsurer has not been granted any permitted practices for their admitted assets.

Unfortunately, we do not believe this will work. For example, if an accredited reinsurer is based in a foreign jurisdiction, but not certified, that entity should not be subject to these requirements that are to apply to captives. As we develop our language we will be guided by the following principles:

1. Traditional reinsurers and reinsurance transactions should be regulated consistently and according to the existing state statutes and regulations governing credit for reinsurance;
2. Reinsurance from a U.S. subsidiary of a foreign parent to the foreign parent should not fall within the scope of applicability; and,
3. The wording must not conflict with the federal preemptions set forth in the Non-admitted
Reinsurance Reform Act, Section 532 of the Dodd-Frank Act.

We hope to provide you with our suggested wording soon.

**Conclusion**

We thank you for your consideration of our views and look forward to working with you on the further
development of the Actuarial Method to determine the Primary Asset Requirement for Regulation
XXX/AXXX-type captive reinsurers. We should note that, depending on which of ACLI’s ideas that you
decide to incorporate into your recommendation, there could be additional items that would need to be
addressed. If that occurs, we will work with you to identify and solve those issues once you publish your
report and we are able to review it in its entirety. If you have any questions or concerns, please feel free
to call me at (202) 624-2164.

Sincerely,

Paul S. Graham, III, FSA, MAAA

cc: Julie McPeak, Co-chair, NAIC PBR Implementation Task Force
    Joe Torti, Co-chair, NAIC PBR Implementation Task Force
March 12, 2014

Mr. Joseph Torti III  
Superintendent of Insurance – Rhode Island Department of Business Regulation

Ms. Julie Mix McPeak  
Commissioners – Tennessee Department of Commerce and Insurance

Co-Chairs - Principle-Based Reserving Implementation (EX) Task Force  
National Association of Insurance Commissioners  
2301 McGee Street, Suite 800  
Kansas City, MO, 64108-2662

Dear Superintendent Torti and Commissioner McPeak:

The American Institute of Certified Public Accountants’ (AICPA) AICPA/NAIC Task Force (the Task Force) appreciates the opportunity to comment on the February 17th report prepared by Rector & Associates Inc. and exposed for comment by the Principles-Based Reserving Implementation (EX) Task Force on February 27, 2014.

The Task Force has read the report exposed for comment by the Principles-Based Reserving Implementation (EX) Task Force, and we believe that additional information is needed to clarify the designated role of the independent auditor as discussed in the proposal. Specifically, it is unclear to us whether the contemplated scope of the independent auditor’s involvement is intended to go beyond subjecting the information that would be included in the audited financial statements of the insurer based on the proposed “Disclosure Requirements” (discussed in Part IV of the report) to auditing procedures.

As this proposal moves forward, we would like to work with the Principles-Based Reserving Implementation (EX) Task Force and other technical groups of the NAIC, as appropriate, to ensure that any role proposed for the independent auditor is appropriately defined and can be performed in compliance with our professional requirements and standards framework. The Task Force looks forward to being involved and working with the NAIC on this important project.

Please contact me at (440) 893-0010 or Kim Kushmerick, AICPA at (212) 596-6160 with any comments or questions.

Sincerely,

Jean Connolly  
Chair of AICPA/NAIC Task Force

CC: Doug Stolte, Chair NAIC AICPA Working Group
March 21, 2014

The Honorable Julie Mix McPeak  
Commissioner, Tennessee Department of Commerce and Insurance  
Co-Chair, Principle Based Reserving Implementation Task Force

The Honorable Joseph Torti III  
Superintendent of Insurance, Rhode Island Department of Business Regulation  
Co-Chair, Principle Based Reserving Implementation Task Force

Commissioner McPeak and Superintendent Torti:

Thank you for the opportunity to share our comments on the February 17, 2014 Report of Rector & Associates to the Principle-Based Reserving Implementation (EX) Task Force (the Rector Report).

We appreciate the significant amount of work that members of the Task Force and Rector & Associates have done on this project. We recognize and in principle support regulators’ desire for the development of some clear standards that can be applied uniformly by the states responsible for reviewing the financing transactions under review, as well as the desire for enhanced transparency concerning the details of those transactions, in particular the confidential disclosure of information to interested regulators. We also acknowledge regulators’ expressed concerns about the perceived impact on the financial condition of insurers that use financing structures to support reserves required for term life and universal life secondary guarantee business.

The Rector Report makes valuable contributions toward meeting those objectives. We support the recommendation that captive structures in place as of the effective date of the new standards will not be impacted. We do believe, however, that the Rector Report raises some significant questions and concerns that we urge the Task Force to consider. These include some very practical concerns about the approach and timing, as well broader concerns that implementation of some of these recommendations would have on consumers as well as the insurance carriers that make term life and universal life with secondary guarantees available to consumers.
1. **Use of the Hazardous Financial Condition Model Regulation**

The Rector Report recommends creating a presumption that any company failing to comply with the new rules regarding financing transactions is presumed to be in a hazardous financial condition. As we read this recommendation, this penalty would apply even in instances of technical non-compliance, or for events that are immaterial to the financial condition of the enterprise. The implications for a company being identified as being in hazardous financial condition for even a minor non-compliance could be severe – adverse rating agency action, possibly triggering additional SEC filings, adverse reaction by investors – and are reasonably foreseeable. An additional concern is that as proposed the recommendation would penalize a ceding company for actions taken by an assuming company over which the cedant has no control.

From a legal perspective we also believe that the recommendation conflicts with the Credit for Reinsurance Model Law by impermissibly imposing conditions on a ceding company’s ability to take credit for reinsurance that are not required in that law. We also believe the recommendation conflicts with Dodd-Frank pre-emptions.

2. **The Scope is Unreasonably Broad**

As drafted, the proposed test would apply to all transactions that involve the reinsurance of XXX and AXXX business, whether or not to an affiliated entity unless the assuming entity meets the criteria for exemption. The exemptions contained in the Rector Report seem to be based on faulty assumptions. For instance, the Rector Report would exempt licensed and accredited U.S. reinsurers only if they do not have any permitted practices. This exemption appears to be premised on the belief that all commercial, traditional U.S. reinsurers would meet that exemption. As Task Force members are well aware, permitted practices are commonly used for a variety of reasons that are completely unrelated to the reinsurance of XXX and AXXX reserves. This assumption, therefore, simply doesn’t stand up.

Mr. Rector’s proposal would also exempt certified insurers. This appears to be based on the assumption that all non-U.S. traditional, commercial reinsurers that assume this type of business would fall into the exemption because they would be certified. This assumption is faulty for several reasons. Certification under the Credit for Reinsurance law is a relatively new concept and was made an optional section of the Model Law. Only a few states have adopted this optional section of the Model. Moreover, the certification process has several components to it that are unrelated to the assets/solvency of the entity being certified, including the requirement that the entity be domiciled in a jurisdiction qualified by the NAIC.
3. Effective Dates

The effective dates are in our view unrealistic. We are concerned particularly about the July 2014 date and the recommendation that regulators voluntarily adhere to the proposed regulation provisions as of that date. This operates in direct conflict with the stated regulatory goal of uniformity across the states. Given the work that needs to be done before the Actuarial Method is finalized, it is highly optimistic to think it will have been developed to a point in four months where it would not be subject to a lot of interpretation, which would arguably vary by each regulator who tried to apply it. It is difficult to see how a soft July compliance date offers any real regulatory benefit.

4. Use of VM-20 as the Actuarial Method

While we understand Mr. Rector’s explanation as to how he arrived at the conclusion that VM-20 is the best available option for the Actuarial Method, the selection of VM-20 also raises some very real concerns. As stated above, we do not see how the proposed methodology can be completed and implemented within the stated timeframes. VM-20 was not designed for the purpose being proposed and will require significant modifications before it can be used as the Actuarial Method. Notably, mortality and the interest rate scenarios generator will need to be modified before the Actuarial Method could be used as proposed. This will require significant effort and the involvement of the American Academy of Actuaries, making the suggested implementation dates highly unrealistic.

Additionally, the net premium reserve component of VM-20 makes no sense in the current context, having been developed at the suggestion of industry to address certain tax concerns that would otherwise arise under the implementation of PBR. These concerns have absolutely nothing to do with any of the reserve financing issues that the Task Force has raised. We understand that the Task Force wants to ensure that no incentive exists after the implementation of PBR to enter into these types of transactions. To that end, we suggest that the net premium floor become effective as part of the Actuarial Method once PBR is effective.

Additionally, the net premium reserve component of VM-20 is inappropriate for this use because it uses assumptions that are not company specific, are fixed at issue and are not appropriately calibrated for purposes of the Actuarial Method. We understand that the Task Force wants to ensure that no incentive exists after the implementation of PBR to enter into these types of transactions. To that end, we suggest that the net premium floor component of VM-20 be made effective as part of the Actuarial Method only for new business issued after PBR becomes effective.
5. **Primary Assets**

The Rector Report recommends that the only assets that should count in meeting reinsurance collateral requirements for XXX and AXXX captives be those held in trust or funds withheld and that these assets must be cash or SVO rated securities. He would allow only for limited use of LOCs, even if clean, unconditional and evergreen. In fact, LOCs provide liquidity comparable to cash. Nor does it make sense in our view to count only those assets held in trust or as funds withheld as the captive’s assets. Typically, all of a captive’s assets are available to respond to obligations under the reinsurance treaty, ensuring that ceding companies can meet policyholder claims. We believe that LOCs meeting the requirements to serve as reinsurance collateral under the Credit for Reinsurance Model Law should be given full credit for Primary Asset designation as they are readily available to respond to claims as needed.

6. **New RBC Requirement**

While we don’t object in principle to the recommendations concerning the development of a new RBC requirement for these transactions, a lot of questions remain, including what the elements of that calculation would be. We also see the need for reasonable factors to apply to alternative assets for which RBC factors that don’t currently exist. It also seems appropriate to add this as part of current RBC stress testing so that it is available only to regulators.

7. **Disclosure**

As with the proposed new RBC requirement, our view concerning the public disclosure advocated by the Rector Report will depend upon the nature and extent of such disclosure. It would be helpful, for example, to see additional details concerning how this would work in practice. Were the disclosure to be consistent with the sort of disclosure that already occurs with reinsurance transactions that might not be objectionable. Should Mr. Rector have additional disclosure in mind that would almost certainly raise additional concerns and would need to be carefully reviewed.

**Conclusion**

As the Task Force considers the Rector Report and how to best move forward we think its worth recalling that when ALIA first called - in March of 2005 - for the development of a modern, principle-based approach for the valuation of life insurance reserves we identified the elimination of the need for companies to seek capital relief from the sort of financing transactions that now give regulators cause for concern. As we said at the time, once reserves bore some reasonable relationship to a company’s risk the “escape hatch” that these sort of financing transactions represented would become unnecessary.
That is not where we are with PBR today, however. The level of prescription in the current version of VM-20 ensures that the capital strain associated with PBR reserves will remain well in excess of the economic reserve. While companies were perhaps willing to absorb the costs associated with financing their excess reserves it’s unlikely they will be willing to absorb their direct cost. Eliminating the “escape hatch” will ensure that the cost of those additional levels of conservatism will be born directly by consumers in the form of higher prices, reduced benefits, limited product offerings or even the unavailability of certain products.

In 2005 we thought in 2005 that PBR was the answer, and we still think that’s the case. The prescriptive elements in VM-20 that will drive reserves higher are well known. With the implementation of PBR still several years away its not too late to re-open those items and fix VM-20 so that when PBR does go into effect it achieves “the right reserve” in fact, not just in name.

Thank you for the opportunity to submit our comments.

Respectfully Submitted,

Scott R. Harrison
Executive Director
From: Kurt Regner [mailto:kregner@azinsurance.gov]
Sent: Thursday, March 20, 2014 3:52 PM
To: DeFrain, Kris
Cc: Ellingson , Darren
Subject: PBRI Task Force: Feb. 17 Rector Report

Kris,

On behalf of the Arizona Department of Insurance I would like to take this opportunity to provide commentary regarding the February 17, 2014 Report of Rector & Associates, Inc. that was submitted to the Principle-Based Reserving Implementation (EX) Task Force.

Arizona’s captive program has been in existence for approximately 13 years and has maintained consistent standards with respect to the manner in which it has managed and regulated pure captives that have been established to assume XXX and AXXX reserves from affiliated ceding insurers. It has always been this Department’s position that these transactions must adhere to the fundamental provisions of the Model Reinsurance Law, without the use of Director discretion (e.g. allowance of unconventional security alternatives or the allowance of letters of credit as admissible assets). The Department feels that this approach (i.e. adhering to fundamental reinsurance rules) goes a long way to addressing the widely held concerns regarding the adequacy of reserves and security of the XXX and AXXX captive transactions.

Based upon the Report, there are a number of fundamental reinsurance security provisions found in the Model Reinsurance Law that have been utilized across all lines of business and accepted by insurance regulators and industry for decades, that are, intentionally or unintentionally, discounted by the Report’s recommendations. I will not go into details, but feel the fundamental provisions of the Reinsurance Model Law should be the foundation for the standards that govern transactions with XXX and AXXX captives.

I suggest the Model Reinsurance Law be utilized, excluding Director discretion and allowance of letters of credit as assets, to set the standard for affiliated captives that assume XXX and AXXX reserves. Additionally, I suggest the establishment of an RBC standard for the captives themselves or an additional RBC standard upon the ceding insurer that consolidates its captive’s assets and liabilities. I also support the incorporation of appropriate disclosure requirements. With respect to grandfathering, if it is not possible to impose these standards retroactively, then, for companies with existing transactions that fall outside the established standards, there should be an expectation that they would want to bring their existing transactions into compliance. I believe this can be accomplished by requiring thorough disclosure of the details of existing transactions that would not be acceptable under the current agreed upon standards, including the financial impact of the disallowance of reinsurance credit and/or asset non-admission.

If you wish to discuss please feel free to contact me. Kurt

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March 21, 2014

Superintendent Joseph Torti III (RI)
Commissioner Julie Mix McPeak (TN)
Co-Chairs of the NAIC Principle-Based Reserving Implementation (EX) Task Force

Sent Via Email: kdefrain@naic.org

RE: California Comments on the Rector Report dated February 17, 2014

Dear Superintendent Torti and Commissioner McPeak,

The Rector report and its proposal (Alternative A only is being discussed) is an attempt to address the issue of captive transactions in the short term, and in advance of the implementation of PBR, which may not be fully implemented for several years. There seems to be widespread acknowledgement among regulators, insurers and rating agencies that current formulaic reserve requirements generally create excessive statutory reserve requirements, especially for XXX and AXXX reserves, and some insurers have engaged in the formation of captives in order to provide surplus relief from the excessive reserve requirements over and above the “economic” reserves. In current insurer-owned captive transactions the insurer unilaterally establishes the “economic reserves,” which is supported by admitted assets, and cedes to captives the excess over the economic reserves, which may be supported by questionable assets at the captive reinsurer or the obligations may be collateralized by forms of collateral that are of a lesser quality than states typically require. These transactions have also come under scrutiny for their lack of regulatory review and transparency.

The Rector proposal is an attempt to establish guidelines and parameters for reinsurance transactions that provide relief of the current redundant statutory reserve requirement for XXX and AXXX (term life products). Rector recommends that this be accomplished by requiring the insurer to maintain “primary assets” (certain admissible assets) to support the
reserve requirements under VM20 (PBR), (insurers will no longer be able to unilaterally establish the “economic” reserve to be supported by admitted assets), and allow “other assets” to support the reserve requirement between the VM20 economic reserve levels and the current statutory reserve requirements (the redundancy). Credit would be allowed for these “other assets” in the form of reinsurance collateral credit (under the Alternative A proposal), but depending on the types of other assets, the insurer would be subject to additional RBC charges that reflect the additional risk associated with reliance on such “other assets” so as to create an additional financial “cushion” to recognize this additional financial risk. Rector also recommends that insurers that decide to avail themselves of this new process be required to make additional disclosure.

The objective of this proposal would be to provide more transparency to regulators by bringing the redundancy relief onto the financial statements of the insurers, cap the redundancy relief so that it is measured by VM20 requirements, establish VM20 reserves as the “economic reserve” level and require insurers to demonstrate that they have primary assets supporting XXX and AXXX obligations equal to or greater than the VM20 reserves.

While this proposal attempts to address some of the regulatory concerns with current captive transactions, we have concluded that there are significant reasons why this proposal is not viable. Many of the problems and issues outlined below could take a considerable amount of time and regulatory resources to resolve. Thus we question whether it is worthwhile to spend a considerable amount of time and resources on an interim proposal. The time and resources may be better spent on addressing the broader PBR proposal and implementation. Time and resources spent on an interim proposal could potentially further delay the broader implementation of PBR.

**Potential issues/problems to be considered:**

- The Rector proposal essentially provides PBR type surplus relief to insurers for XXX and AXXX reserves. These reserves are generally known to be redundant. However, under the broader PBR implementation, other products such as Universal Life with secondary guarantees are also covered. These products may actually result in higher reserves under PBR, and therefore this proposal potentially weakens statutory reserves by recognizing potentially redundant XXX and AXXX reserves and ignoring potential under reserving of other products.

- This proposal potentially expedites the implementation of VM20 for XXX and AXXX reserves. California does not believe that regulators are ready for earlier implementation of VM20. The NAIC has acknowledged
the need for additional resources, expertise and training under PBR and this proposal proposes expediting the implementation of VM20 without addressing how those regulatory resource, experience and training needs will be satisfied. California does not believe that regulators will have the resources and expertise required to implement and evaluate the VM20 reserves within the time period proposed in the Rector report.

- This proposal recommends that “primary assets” support the VM20 reserves. However, the discussion of what would be allowed as primary assets is not fully developed. Guidance of what would be allowed as primary assets would need to be discussed, exposed, and adopted which could take considerable time. Further, the solvency implications of relying on “primary assets” that are anything other than admitted assets have not been addressed. It would be premature to adopt such a major change in solvency regulation without fully vetting the implications of such a change.

- There may still be a difference between what some insurers consider the “economic reserve” and what the reserves that regulators would require under VM20. The process by which regulators would prohibit insurers from continuing to engage in such transactions is unclear and not fully developed.

- The proposal suggests modifications to VM20 for purposes of this proposal. Those modifications have not been fully identified. California does not believe such changes can be developed and properly vetted within the time periods proposed by Rector given the amount of time it has taken to develop VM 20 thus far.

- The proposal recommends creating changes/charges under the RBC formula for the “other assets” that will be allowed as reinsurance credit. Determining what these charges should be would also likely take a considerable amount of time, but these charges are an integral part of allowing the reinsurance credit for other assets and thus an integral part of the proposal. Again any such proposal would need to be discussed, exposed and adopted, potentially a lengthy process. California does not believe that reserve relief should be granted unless the related increased risk is recognized through a change to the RBC calculation.

To codify the new XXX and AXXX requirements and ensure that states comply with the new requirements Rector recommends a new Model Reinsurance Regulation as an NAIC Accreditation Standard. The report assumes, however, that the concepts can be implemented for most financing transactions without any change to law or statute. The core problem with this assumption, upon which his recommendation is based, is that the “existing authority” is the same authority that some states have relied upon to create this problem in the first place. Some states have
used this authority to permit insurers to accept lower quality collateral and reinsurance captives to hold lower quality assets. The suggestion that this same provision would authorize the implementation of the recommendations in the Rector report does not address how to stop such practices. California does not believe that the recommendations of the Rector report can be enforced without a change to law or regulation. Further, California does not believe that the timelines proposed in the Rector report for implementation of the significant changes are realistic.

As a result, California cannot support the recommendations.

As discussed above, California is concerned that the proposals set forth in the Rector report will not be able to be implemented in the short term. As a result, unless some other form of action is taken insurers will continue to enter into these captive transactions. Instead of leaving these issues unaddressed while a solution to this problem is developed, we should stop the proliferation of these affiliated captive reinsurance transactions immediately so that insurers do not unilaterally decide whether, and to what extent, to comply with existing reserving requirements. California agrees with New York that until effective changes can be implemented there should be a moratorium on new transactions. We agree with the recommendations in the Rector report regarding enhanced disclosure and believe that the enhanced disclosure on all existing transactions should be implemented immediately. We also believe that once a moratorium is imposed the NAIC should expeditiously move to develop an interim step to update the most egregious aspects of the current reserving requirements to eliminate any truly excessive reserving requirements related to XXX and AXXX reserves. Further, once new reserving requirements are established, insurers should be required to support the revised required reserves with assets that qualify as admitted assets (not some new form of "primary assets"), whether the reserves are maintained by the policy-issuing insurer or by an affiliated captive reinsurer.

Sincerely,

DAVE JONES
Insurance Commissioner
March 20, 2014

Via email: kdefrain@naic.org
National Association of Insurance Commissioners
Attn: Kris DeFrain
1100 Walnut Street
Suite 1500
Kansas City, MO 64106


To: The Members of the Task Force

These comments are submitted on behalf of the Captive Insurance Companies Association ("CICA"). CICA is the leading domicile neutral trade association representing the global captive insurance industry. CICA’s members are individual captives, companies that own and utilize captives and service providers (such as actuaries, accountants, attorneys, and insurance consultants).

The issue of a life insurer seeking to reduce its effective net retention of XXX and AXXX reserves by employing a captive insurer came to the attention of the Captives and Special Purpose Vehicles (SPV) Use (E) Subgroup and was mentioned in its Report dated June 6, 2013. **Without commenting on the details of the Rector Report, CICA would like to endorse several of the principal conclusions of the Rector Report.**

First, with the understanding that a reinsurance or alternative financing mechanism should not be used by commercial insurers to avoid reserving requirements under state law, the approach of the Report places its emphasis on the “...regulation of the direct/ceding insurer rather than on that of the assuming entity”. Report p. 33. In our view, this is the correct approach because the regulator of the ceding carrier is in the best position to determine what assets should be allowed to offset XXX and AXXX reserves. In fact, the Report notes that its emphasis is on the assets allowed to support reserves, not the reserve level. Report p. 5.

Second, the Report is clear that it is “not an attempt to regulate captives”. *Id.* The Report further states that: “[i]n our opinion, addressing the regulatory concerns regarding reserve financing transactions by focusing on the regulation of assuming insurers will ultimately fail and will lead to financing transactions moving off-shore or otherwise out of the reach of US regulators.” *Id.*
Indeed, US regulators will generally not have jurisdiction over non-US entities, but will have authority over the commercial carriers that may cede risk to them. We believe this to be a practical and appropriate approach, which will not result in the development of unnecessary regulatory requirements for captives, which in the vast majority of cases do not involve XXX or AXXX reserves.

In sum, we would like to commend to the Task Force the basic approach of the Rector Report, which is to "...focus almost exclusively on regulation of the direct/ceding insurer and on trying to ensure that high quality assets in an appropriate amount will be available to the direct/ceding insurer to allow it to pay policyholder claims as they come due." \textit{Id.}

Thank you for this opportunity to provide comments to the Task Force.

Very truly yours,

Dennis P. Harwick
PRESIDENT

Cc: CICA Board of Directors
    Captive Association Leadership Council
    American Council of Life Insurers

Reply to:\n□ CICA Administrative Office
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March 21, 2014

Superintendent Joseph Torti, Co-Chair  
Commissioner Julie M. McPeak, Co-Chair  
Principle-Based Reserving Implementation Task Force  
NAIC Central Office  
1100 Walnut Street, Suite 1500  
Kansas City, MO 64106-2197


Dear Co-Chairs Torti and McPeak:

I am writing to offer my comments on the Report of Rector & Associates, Inc. (the “Report”), provided to the Task Force on February 17th. I am one of the members of the NAIC consumer funded liaison program and the Director of the Center for Insurance Research. The Center for Insurance Research (CIR) is a nonprofit, public policy and advocacy organization founded in 1991 that represents consumers on insurance matters nationally.

I have been following the discussion and analysis regarding the use of captive insurers and non-standard assets and wish to voice a few concerns from my perspective as a consumer advocate.

In particular, I concur and support the following recommendations made in the Report:

- “[T]hat [a] direct/ceding insurer only get credit for reinsurance if it retains (on a funds withheld or trust basis) “Primary Assets’ in an amount approximately equal to what the statutory reserve would be under PBR.” (Report at 7);
- “[T]hat key information about the use of financing transactions and assets supporting such transactions be publicly disclosed.” (Report at 7);
- The “Actuarial Method selected should effectively eliminate the financial incentive for further financing transactions once PBR become effective.” (Report at 8-9);
- That the “cash flow testing approach” suggested by the ACLI is not a viable approach here for the many reasons identified by Rector & Associates. (Report at 10);
- “[T]hat captives/SPVs not be used as a way to avoid statutory accounting requirements,” (Report at 32); and
- That “conditional LOC’s [lines of credit] and parental guarantees could not be used to satisfy the Primary Asset Level.” (Report at 34.)
While I agree with the recommendation in the Report that focusing on the ceding insurer (Report at p. 5) is important, I do not believe that regulators should focus “exclusively” on the ceding entities and disregard the regulation of assuming insurers.¹

In particular, I remain concerned about the lack of disclosure regarding captive reinsurance transactions and captives in general. As a consumer advocate, I do not believe that captive entities and their financial statements should be accorded “top-secret” status and that reinsurance contracts with any entities that do not offer any public report of their financial state cannot be treated as creditable reinsurance transactions.²

I recommend that disclosure requirements should not apply only to the direct/ceding party. Whether this creates obstacles due to “confidentiality laws in some captive jurisdictions” (Report at 17) is irrelevant to consumers interested in know their insurance benefits are secure. CIR believes no credit for reinsurance should be given under SAP for contracts with an entity whose assets and financial status are “confidential.”

I also fully concur with the Report’s statement that “unless key information about the direct/ceding insurer’s use of reserve financing transactions is made public, at approximately the same level of detail as contained in existing public documents such as statutory financial statements, the financial condition of the insurer reported in such public documents may be incomplete or misleading.” (Report at 18, emphasis added.) I also strongly agree that “there should be a regulatory presumption in favor of public disclosure.” Id.

Thank you for the consideration of my comments on this important matter.

Sincerely,

/s/

Brendan Bridgeland
Director

¹ While the Report observes that increasing regulatory scrutiny on assuming insurers may lead to transactions moving off-shore, I do not believe this should be a determinative factor. Regulators will still have the authority, after all, to refuse to credit questionable off-shore reinsurance transactions for financial reporting purposes.

² I believe that disclosure by captives is a critical issue the Task Force should not overlook, because the question of whether “atypical, non-admitted assets should be allowed to support portions of the reserve that have a low probability of being needed to pay claims” (Report at 5) is truly relevant only when consumers are informed about what sort of “atypical” assets are being used to support their insurance contracts.
March 21, 2014

Kris DeFrain
Director, Research and Actuarial
NAIC Central Office
1100 Walnut St., Suite 1500
Kansas City, MO 64106-2197


Dear Kris:

Connecticut would like to offer comments regarding the February 17, 2014 Rector & Associates Report to the PBR (EX) Task Force. The amount of work that Rector & Associates performed for this report is to be commended, and they respectfully attempted to fulfill the charges they were given by the EX task force. Connecticut feels that this report ultimately will provide a framework for handling the financing and accounting for AXXX/XXX reinsurance transactions.

That being said, we feel that the task force should (1) allow a broader use of this framework (e.g. VM22 and AG43) and (2) recognize that there will always be the need to back reserves with other than primary assets for reserves above the statutorily required reserve level.

Our comments are as follows:

1. Primarily due to the conservative nature of the deterministic reserve in the VM-20 calculation, we believe that an incentive will remain for life insurance companies to continue using captives for AXXX and XXX reinsurance financing transactions. For example, our understanding from the Report leads us to conclude that the amount of non-economic reserve will ultimately be driven by the amount by which the deterministic reserve exceeds the stochastic reserve.
2. The framework described in the Rector report should be applied to situations in which economic and non-economic reserves differences exist beyond AXXX/XXX reinsurance financing transactions structured by life and annuity insurance companies.
3. Though the exact details of disclosure will need to be finalized, there should be the same disclosure and transparency rules for both future and existing captives.
4. We support the recommended framework which focuses on the direct/ceding company as opposed to the assuming company.

5. Given that companies already make provisions for the additional admitted assets required to support the humpback reserve pattern of AXXX/XXX products, we do not support that use of non-traditional assets as primary assets for reinsurance subsidiaries owned by life and annuity insurance companies (for example, marginally using LOC’s, as proposed in the Rector report).

6. We support the use of an appropriately modified VM-20 reserve* as the Actuarial Method.

7. We support the use of a group similar to the current Emerging Actuarial Issues Work Group (EAIWG) to issue interpretative guidance regarding key implementation matters.

8. If a cedant is allowed to own a captive, safeguards are needed to prevent traditional non-admitted assets from being indirectly carried on a cedant’s balance sheet as an admitted asset.

9. “Alternative B,” as discussed in the report, is not currently a viable alternative.

The Connecticut Insurance Department looks forward to being involved in refining and shaping this regulatory framework, through participation in committee, task force and working group initiatives. We are aware that direct/ceding companies are continually seeking to optimize their capital in terms of cost and structure. Please let us know if you have any questions.

* The industry and some regulators perceive that the deterministic (standard) scenario as overly conservative and may be unwilling to support this proposal. Additional support for this proposal can be gained if we limit the primary asset level to the stochastic reserve whenever it is less than the deterministic reserve. This is an example of a VM-20 modification that could be used for the Actuarial method and is topic for future discussions as this proposal moves forward.

Sincerely,

John C. Thomson
Manager, Captive Insurance Programs

Andrew J. Rarus
Life & Health Actuary

cc: Thomas B. Leonardi, Commissioner of Insurance
Anne Melissa Dowling, Deputy Commissioner of Insurance
Kathryn Belfi, Director, Financial Regulation
James Jakielo, Life & Health Actuary
KAREN WELDIN STEWART  
INSURANCE COMMISSIONER  

March 21, 2014  

To:  Superintendent Joe Torti and Commissioner McPeak, Co-Chairs, Principle-Based Reserving Implementation Task Force  

From:  Steve Kinion, Director, Bureau of Captive and Financial Insurance Products  

Re:  Comments Regarding Report of Rector & Associates to the PBR Task Force  

On behalf of Commissioner Stewart, I present these comments regarding the Rector Report (“Report”). In summary, the Delaware Department of Insurance recommends that the PBR Task Force not adopt the Report. Both the Report and the process for its development contain a number of shortcomings which are:

1. **The Report fails to answer how its recommendations will impact the consumer.**  
   The Report fails to address the effect on consumers if the Report’s recommendations are adopted. On page 6 the Report concedes that without the use of financing transactions in which captive reinsurers assume excess reserves, costs will increase for both companies and moreover – consumers. With the admission that life insurance will become more costly and less affordable without the use of captives, every commissioner must ask themselves, “What is an acceptable alternative in the absence of these captives?” A germane policy consideration for every insurance commissioner is whether they are willing to adopt the recommendations while at the same time not know the consequences for the insurance consumers of their states. As a result, there are further questions that the Report must address. These are, “If the Report’s recommendations are adopted by the NAIC, what will be the cost for consumers? Will the adopted recommendations make life insurance more costly and less affordable?”

To begin the process of answering these questions, Delaware has started an inquiry among the captives it regulates. Initial results are that the Actuarial Method, proposed to be a modified form of VM-20, will continue to result in significant redundancies in reserves and will
require a material increase in capital. Faced with much greater significant capital demands, insurers will be forced to raise premiums charged to consumers to meet market return on equity expectations, and surplus requirements. For a short period of time, some insurers will absorb the extra cost of capital. However, initial estimates start at $1.00 per thousand or more of additional capital, depending upon the insurer’s determination of appropriate company action level capitalization ratios. If the recommendations are adopted, premium rates will soon rise by perhaps as much as 40 percent. Until the regulatory community knows and understands the impact on consumers, the PBR Task Force should not adopt the Report.

2. The Report is a solution looking for a problem. To date, no one has identified an actual risk related to captives on either a systemic, an issue inherent in the concept of using captive reinsurers, or a specific basis, that is a particular captive that presents a risk of failure. All evidence seen by the Delaware Department of Insurance points to the conclusion that economic obligations are being sufficiently reserved.

3. The existing credit for reinsurance model law works well and regulators should not create a new law. The Report recommends creating a new credit for reinsurance model regulation specifically tailored to life reinsurance captive transactions. The creation of such a law is unneeded and unnecessary, because the existing model law provides regulators with sufficient regulatory capability.

4. The regulators do not know the consequences of adopting the recommendations. Sir Isaac Newton’s third law of physics is that for every action there is an equal and opposite reaction. At this juncture, the regulatory community does not know what the reaction will be. The Report recommends unrealistic dates for implementation because the Actuarial Method which is the central basis of the Report will not be developed. The recommended effective dates are July 1, 2014 for new captive transactions and January 1, 2015 for existing transactions that assume new business. The Report mandates no less than six referrals to other working groups and task forces in order to develop the Actuarial Method. No one knows what the final product for the Actuarial Method will look like, how it will be applied, when it will be ready, and how it will be implemented. Yet, the NAIC members may face the decision to adopt the Report’s recommendations as soon as early April in order to meet the effective dates. Consequently, a vote to adopt the Report so that it can become effective is also a vote favoring uncertainty and a vote to apply standards that have not been developed.

5. The Actuarial Method recommended by the Report should eliminate the Net Premium Reserve (NPR). If a modified form of VM-20 becomes the Actuarial Method then the following must be recognized:

   i. VM-20 is designed to be highly conservative in the early years.
ii. There are still unresolved issues with VM-20.

iii. The Net Premium Reserve (NPR) must be removed from the calculation.

Removal of the NPR is particularly noteworthy. Unlike the Deterministic and Stochastic reserves, the NPR does use standard assumptions. The Report did not recommend that the NPR “floor” be eliminated. However, it did recommend that Life Actuarial Task Force be charged to consider whether adjustments should be made to the NPR assumptions and, if so, to develop such adjustments for use in connection with the Actuarial Method. At least the Report recognizes that there are issues with the NPR, which is why the use of the NPR should be eliminated if the Report’s recommendations are adopted.

6. The Report relies upon direction from the Task Force that was not publicly debated and voted upon. The Report relies upon direction from the PBR Task Force that was neither voted upon nor debated. To illustrate, on page 5 the Report’s authors write that they received direction from the Task Force that captive reinsurance financing transactions should continue only until Principle-Based Reserving is effective, but not thereafter. Unfortunately, the PBR Task Force never publicly debated and voted on adopting such a policy. At a time when the NAIC is under criticism for being less transparent, important decisions regarding the use of captive insurers must be matters of open debate and not behind the scenes directives from the PBR Task Force. It is ironic that some regulators on one hand complain that captive transactions require more disclosure because they are not transparent, yet on the other make a significant policy decision that impacts consumers in a non-transparent process.

Thank you for your consideration of these comments and I look forward to addressing the Task Force on March 31, 2014.
March 21, 2014

Commissioner Julie Mix McPeak, Co-Chair
Superintendent Joseph Torti III, Co-Chair
Principle-Based Reserving Implementation (EX) Task Force
National Association of Insurance Commissioners
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Reinsurance Model Regulation

Dear Commissioner McPeak and Superintendent Torti:

The following are my comments on the Rector & Associates report to the Task Force:

- **Proposed effective dates** – Since we do not have a model regulation, the 7/1/14 date for newly created financing structures is overly aggressive. I would suggest a 1/1/15 date as this will give time to finalize the model regulation and get adopted in states. I believe in Iowa, we would have a hard time passing a regulation with a retroactive date.

- **Transactions Affected** – There are legitimate business reasons that a company, who entered into an arrangement before 1/1/15, may have to amend the reinsurance treaty, these amendments should not subject them to the proposed regulation. Transactions entered into before 1/1/15 should be grandfathered.

- **Presumption of Hazardous Financial Condition** – I have concerns with this approach since scope of the regulation is so broad.
  a) A domestic that ceded business to an unaffiliated company on an YRT basis that would be covered under the proposed regulation. The assuming insurer has a prescribed or permitted practice unrelated to the transaction, how is my domestic going to find out if it is used in the RBC calculation? Do we make the RBC calculation public? Also, the above transaction does not need regulatory approval since it is with an unaffiliated company. It appears, under this proposal the company will now have to seek approval, wasting limited regulatory resources on something that is not necessary.
  b) The proposal could and likely will have unintended consequences on the ceding insurance company. Would simply the hazardous financial condition presumption that a large life insurance company, that is part of a publicly traded entity, trigger a reporting event to the public? Would other regulators take regulator action? Would competitors use this against them? This presumption is wrong and should not be used.
c) Is it the intent to try to impose RBC on foreign insurers? I would suggest, the task force adopt a set of criteria that if a transaction does not meet, it should be reviewed by FAWG.

- **Exemptions** – I do not believe a certified reinsurer should be exempt from this regulation. How is it good regulation to allow a certified reinsurers to do a transaction that would normally fall under this regulation? I would suggest exempting them from the level of the primary asset requirement only.

- **Fair Value of Assets** – The regulation states that assets held on a funds withheld basis with a fair value not less than the primary asset level shall be reviewed once a year to see if additional collateral is needed. Why the difference from Statutory Accounting? I suggest that funds held should follow the SSAPs.

I plan on attending the meeting in Orlando and would be happy to answer any questions.

Best regards,

James N. Armstrong  
Deputy Commissioner
Kris,

I am submitting these comments on behalf of Mark Birdsall, Chair of the Life Risk-Based Capital (E) Working Group:

Hi! As chair of the Life RBC Working Group and with deep involvement in a number of NAIC issues related to both reserves and capital, I would like to make the following comments about the Rector report recommendations:

1. Rector & Associates did a great job developing a compromise proposal for AG 38. The key issue with respect to the “older” AG 38 business in this bifurcated approach was reserve adequacy and that issue was addressed by utilizing the Deterministic Reserve approach in the then-current VM-20. KS supported this compromise whole-heartedly, but the issues with regard to captives are well beyond reserve adequacy. To reduce or eliminate the need for captives, we need to do a much better job of “right-sizing” statutory reserves for different product types than we currently have in the Valuation Manual. VM-20 does not come close to doing that for life insurance products and is very complicated and expensive to implement for companies, auditors and regulators. Thus, it is not a good solution for the “actuarial method” required for the Rector report recommendations to be implemented. I will briefly describe below in 2. what I think is a much better alternative that perhaps Rector & Associates was unaware of at the time of its analysis.

2. The timing of this proposal seems forced. There are a number of NAIC working groups that are working diligently and creatively on issues related to captives, but due to the timing of this proposal, the work of those groups will not be completed and then considered in this discussion. One area in particular that I have spent a great deal of time working on is the development of VM-22, which takes a significantly different approach to PBR calculations than VM-20. In short, the VM-22 methodology is based on a current estimate reserve plus aggregate statutory margin. Can you see how that approach might fit the issues that have created captives? KS is sponsoring a Field Test of this methodology that we hope will be completed by either the Summer or Fall NAIC meetings. I am making an hour and 15 minute presentation at next week’s LATF meeting on this field test. The Field Test, if successful, could point the way for a consistent PBR calculation approach for all long-tail product types.

3. Along with improving the basic reserve calculation methodology for PBR, another key issue is strengthening asset adequacy analysis. Stress testing is under review for testing the statutory Total Asset Requirement (TAR) and may be considered for strengthening the reserve adequacy testing as well. Current asset adequacy analysis is based on a paradigm that is 20+ years old and assumed that the primary risks are interest rate risk and market risk. While these risks are certainly important, products have become significantly more complex over the last 20-25 years and more holistic, multi-risk analysis is needed to test reserve adequacy. The AOMR has been opened for review for improving communication and LATF has briefly discussed the possibility of
strengthening the reserve testing requirements. Again, the Rector group may not have been aware of this possible initiative (as well as others, such as the previously mentioned stress-testing the statutory TAR).

4. The Rector report does not specify which RBC working group should develop a description of other assets or determine the related factors. It seems like the Investment RBC Working Group could be charged with these tasks. I am a member of that Working Group and it will take some time to respond to such a charge, measured in months I would guess.

5. The following is a comment directly from Dave Fleming: “The charge to require at least one party to the financing transaction perform the RBC calculation is problematic. If the captive is not subject to RBC, the inputs required for RBC, specifically and primarily statutory accounting and reported inputs, may not be available or the basis for this calculation. This poses a substantial verifiability issue. Additionally, to avoid this, I’m not sure requiring the entity subject to RBC to include a calculation for items that would otherwise not be included in RBC is supported by the RBC model law.”

6. I have every confidence ion Neil Rector and his team. I have spoken with him several times in connection with AG 38 and have been very impressed. However, with so many projects in the works, they may not have been aware of related work currently under way and, in some cases (such as VM-22 and the KS Field Test), far advanced in its development. If we go forward with this proposal as currently drafted, we will be creating yet another reserve methodology as an ad hoc solution. Let’s take some more time and see if the Field Test is successful. If it is, it would provide the calculation basis that is needed to more successfully eliminate captives than using VM-20 as it stands.

Thanks for your consideration of these comments!

Mark
March 21, 2014

Superintendent Joseph Torti III, Co-Chair
Commissioner Julie Mix McPeak, Co-Chair
Principle-Based Reserving Implementation (EX) Task Force
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604


Dear Commissioner McPeak and Superintendent Torti,

The Nebraska Department of Insurance (Department) appreciates the opportunity to provide comments for consideration with respect to the Rector Report. The Department has been and will continue to be supportive of appropriate regulation of insurers, including life insurers’ use of captive reinsurance which we see as a critical issue in solvency regulation. The Department is optimistic that Principle-Based Reserving and the NAIC Model Standard Valuation Law will appropriately allow for a more robust and economically rational reserving system but much work is left to do and even after implementation, adjustments are anticipated in the first few years to fine-tune the process.

Use of a Modified Version of VM-20
The Department feels that the focus of these captive transactions should be on the adequacy of assets supporting the obligations assumed by an insurer. The Department is supportive of the principle-based approach for the determination of asset adequacy, but has concerns on the whether the approach should be limited to the use of a modified version VM-20. The Department’s review of these transactions to date has focused on an in-depth actuarial analysis of the risks associated with the transaction and consideration of the asset and liability cash flows involved. In order to gain comfort with this analysis, sufficient sensitivity testing of key assumptions which consider specific details of a company’s products and capital position should be included in evaluating whether adequate policyholder protections are in place. Therefore, the Department would prefer to proceed with a process within the framework that the Department is currently utilizing as we feel it has worked well to date in our reviews.

The Department is supportive of requiring approvals of ceding domestic regulator in addition to assuming domestic regulator, but regulatory authority (including Commissioner discretion and permitted practices) should not be taken away. If the proper analysis and disclosures are provided to
the regulators in reviewing these captive transactions, the regulators should be able to gain adequate comfort with the transaction or else disapprove the structure. The Department is concerned that since each of these transactions are unique, the recommendation within the Rector report to use a modified version of VM-20 may overly standardize the calculations and may, in certain situations, remove the regulator’s control to disapprove or amend the transactions to protect the policyholders.

**Definition of Primary Assets**
The Rector Report recommends that Primary Assets, as defined under Section 2(C), include only those assets held in trust or funds withheld and that these assets must be cash or SVO rated securities. The Department believes unconditional Letters of Credit meeting the Credit for Reinsurance Model Act, adopted by Nebraska in Title 210 Chapter 65 and Statute 44-416.07 should be allowed and considered as Primary Assets as they do for all other lines of business.

**Exemptions**
The proposed exemptions within the Rector Report allow for cessions to be made to 1) “certified” reinsurers and 2) licensed and accredited reinsurers without permitted practices that are not in one of the “action levels” of risk-based capital. The Department has yet to adopt the new Reinsurance Model Act, and therefore do not have any certified reinsurers. Permitted practices are common in the industry and disqualifying an accredited reinsurer or licensed reinsurer due to this fact does not appear to be the underlying intent but more of an unintended consequence. This also appears to be in direct conflict with the Credit for Reinsurance Act which allows for cedents to take full credit for reinsurance ceded to an accredited reinsurer or licensed company.

**Use of Hazardous Condition Model Regulation**
Section 3(D) of Model Regulation 385 already gives the Commissioner the authority to deem a company in potential financial hazardous condition by taking into consideration, “the ability of an assuming reinsurer to perform and whether the insurer’s reinsurance program provides sufficient protection for the insurer’s remaining surplus after taking into account the insurer’s cash flow and the classes of business written as well as the financial condition of the assuming reinsurer”. The Department believes additional changes to the Model are not needed or warranted.

**Effective Dates**
Clarification is needed on the proposed effective dates within the Rector Report which states business written by the direct insurer on or after January 1st, 2015 would be subject to the new requirements. Does this exempt business written before January 1st, 2015 but ceded after that date? The Department also feels that the proposed effective dates (July 1, 2014 for newly created structures and January 1, 2015 for all structures) are too aggressive as many referrals (especially LATF and the RBC Working Group) are very important to this process, should not be taken lightly or rushed, and may not be able to be worked through within this timeline.

**The FAWG’s Review of Captive Transactions**
Finally, the Department is fully supportive of the work that the FAWG has done in collecting information pertaining to captive transactions already in place and we look forward to the FAWG providing guidance...
to the regulators on what best practices, concerns, and gaps have been identified. We would recommend allowing the FAWG to complete its work before moving forward to minimize duplication and efficiently work to a long-term solution.

The Department is not convinced that Principle-Based Reserving alone will eliminate the incentive for captive reinsurance or similar financing structures. The Department appreciates the efforts of Rector & Associates Inc. in this area. The Department would be happy to discuss any aspects of this letter during the upcoming Principle-Based Reserving Implementation (EX) Task Force meeting in Orlando.

Sincerely,

Justin C. Schrader
Chief Financial Examiner
Nebraska Department of Insurance

Sincerely,

Annie Elliott
Deputy Chief Examiner
Nebraska Department of Insurance
March 21, 2014

The Honorable Julie Mix McPeak
Commissioner
State of Tennessee Department of Commerce and Insurance
Davy Crockett Tower
500 James Robertson Parkway
Nashville, TN 37243-1220

The Honorable Joseph Torti, III
Superintendent
State of Rhode Island Department of Business Regulation
1511 Pontiac Avenue, Building 69-2
Cranston, RI 02920-4407


Dear Commissioner McPeak and Superintendent Torti:

The Northwestern Mutual Life Insurance Company appreciates this opportunity to comment on the Second Rector Report. Our comments on the Initial Rector Report, in November 2013, built on core principles of uniformity, transparency and effective risk transfer – principles that are key to preserving and strengthening the state-based system of insurance regulation. We commend Rector & Associates for making recommendations that further these principles, and we encourage the NAIC to move quickly to implement these recommendations.

In particular, we applaud the Second Rector Report's recognition that, to be effective and avoid pushing transactions offshore, regulation must focus on the writer of the financed insurance policies, not the captive reinsurer. Likewise, we support the recommendation to use the NAIC's Principles-Based Reserving (PBR) valuation methodology – we agree that a lesser standard will reduce the probability of PBR being adopted. Expediting the work remaining to make PBR operational for term and universal life with secondary guarantee (ULSG) products will benefit regulators and the industry. And, while some of this work will no doubt remain to be done when the new regulatory framework for reserve financing takes effect, the existence of the framework will support far greater regulatory uniformity than exists today.

That said, there are several key points where the Second Rector Report does not satisfy the core principles we have articulated. We suggest that the NAIC address the following:

- Disclosure. As we noted in November, uniform public disclosure of the impact of financing transactions in accordance with NAIC accounting and reporting standards is
key to ensuring confidence in the strength of insurers' reserves and capital, and to allowing all interested parties to respond to financial market innovations. The NAIC should apply its standard for public disclosure of permitted practices, including disclosure of the monetary effect on statutory surplus, to all captives transactions – new or old – that result in statutory reserves being supported by assets that would not be admitted under uniform NAIC rules. Disclosure of impact on surplus is the best way for the public to see when a reserve financing transaction increases leverage.

- **RBC.** The Second Rector Report rightly recommends that full RBC calculations be made to include business and assets subject to reserve financing transactions, as this will close an existing gap in regulatory capital requirements. We believe, however, that regulators should apply the RBC test to all business and transactions, not just to business and transactions after a specified date. While we understand arguments that transactions which have received regulatory blessing should be grandfathered for purposes of the proposed "Actuarial Method" and "Primary Asset" rules, it does not follow that a gap in the regulatory capital requirements should be allowed to persist for old business and financing transactions. Without this correction, the RBC calculation will disregard the possibility of default for assets used to support financing transactions.

- **Other Assets.** The Second Rector Report leaves it up to the domestic regulators for the ceding insurer and assuming insurer, with oversight provided by the NAIC's Financial Analysis Working Group (FAWG), to decide what kinds of "Other Assets" may be used to support reserves exceeding the level established under the "Actuarial Method". The NAIC should strive for uniform standards for all assets supporting statutory reserve requirements. Accordingly, we recommend that the NAIC develop uniform rules for "Other Assets".

In addition, now that a solid framework has been developed for addressing the use of captives and special purpose vehicles for term and ULSG reserve financing transactions, we strongly encourage the NAIC to broaden its scope and address the use of these vehicles for other purposes. Insurers may have good and valid uses for captives, but their use should be made consistent with uniform application of insurance regulatory standards.

We submit these comments with the objective of supporting and strengthening the state-based system of insurance solvency regulation. Please advise if you require any additional information or have any questions regarding these comments.

Sincerely,

David R. Remstad, FSA, MAAA
Senior Vice President & Chief Actuary

The Northwestern Mutual Life Insurance Company
March 21, 2014

Joseph Torti III  
Julie Mix McPeak  
Co-Chairs, Principles-Based Reserving Implementation (EX) Task Force  
National Association of Insurance Commissioners


Dear Superintendent Torti and Commissioner McPeak:

Thank you for the opportunity to comment on the February 17, 2014 report of Rector & Associates, Inc. ("Rector Report"), which offers for consideration a new framework for the uniform treatment of "captive" reinsurance insurance transactions ("shadow insurance") by state regulators.

The Rector Report wisely and appropriately acknowledges that it is imperative for states to develop a consistent and transparent regime to govern shadow insurance transactions. In furtherance of those objectives, the Rector Report laudably sets forth an aggressive timeframe for changing the status quo; indeed, some of the new requirements for the review of transactions would become effective as soon as July 31, 2014.

While the Rector Report has some positive aspects, especially with respect to its suggestions regarding heightened transparency and public disclosure, New York nevertheless harbors serious reservations to the extent that the report enshrines "VM-20" – the relaxed reserving methodology that serves as the underpinning for the NAIC’s principles-based reserving ("PBR") initiative – as the lodestar around which its recommendations revolve. In essence, the Rector Report would create a beachhead for a deregulatory principles-based reserving approach that puts policyholders and taxpayers at greater risk.

New York believes that the NAIC should fundamentally rethink the interconnection between PBR and captives. PBR is often offered by its proponents as a solution to eradicating the need for risky and opaque shadow insurance transactions. However, investigations conducted by New York, as well as statements made by the life insurance industry itself, clearly demonstrate that such an argument is a fiction. Rather, PBR and shadow insurance are both symptoms of the same disease: a desire to divert policyholder reserves, juice financial results, and make company balance sheets look artificially rosy.
The Rector Report’s attempt to link the reform of shadow insurance to the utilization of PBR essentially tries to solve one serious problem by creating an even larger one. The problematic nature of this approach is evident given that (a) there is no assurance that PBR ever will be widely adopted by the states; (b) PBR is deregulatory in nature, and ultimately will imperil policyholders by siphoning off the financial cushion that enables insurers to stand strongly behind their products; and (c) the life insurance industry has given no indication that it has any intention of ending its use of shadow insurance transactions.

In June 2013, the New York State Department of Financial Services (“DFS”) issued a report titled, “Shining a Light on Shadow Insurance”, upon concluding a nearly year-long investigation into the use of captives and special purpose vehicles by life insurers. The report found that New York-based insurers and their affiliates engaged in at least $48 billion in transactions that enabled them to reduce reserves – the financial cushion that insurers maintain to pay claims to policyholders – and artificially inflate their balance sheets (by an average increase in risk-based capital of approximately 250%) simply by shifting risk within their holding company systems.

Soon after DFS characterized the transactions that it examined as the “tip of the iceberg,” Moody’s Investor Services issued a report in August 2013 called “The Captive Triangle: Where Life Insurers’ Reserve and Capital Requirements Disappear.” That report provided additional support for New York’s findings. Moody’s concluded that through the use of captives, the life insurance industry has realized more than $324 billion of so-called accounting “relief.” (A subsequent study by the London Business School put the figure at more than $360 billion.) Most tellingly, Moody’s noted that “the use of captives tends to weaken overall capital adequacy” of insurers, and that the way companies utilize the structures “is not consistent with prudent risk management.”

Shadow insurance transactions put policyholders and taxpayers at greater risk by diverting reserves away from their intended purposes. (The practice is particularly problematic at a time when interest rates have been at historic lows.) The use of captives in this manner allows insurers – many of which are publicly traded stock companies – to deploy capital in a way that maximizes short-term benefits, such as by declaring dividends to shareholders, at the expense of long-term financial security.

Given this state of play, DFS offered three recommendations. First, the report urged more detailed disclosure regarding these transactions. To that end, New York has developed for its annual statement filings a new template that, as of December 31, 2013, will require any life insurer doing business in the state to report to New York regulators the details of any shadow insurance matters. Second, DFS called for an examination on a national basis of the full extent of how shadow insurance is utilized by insurers throughout the country. Third, DFS encouraged fellow state insurance commissioners not to approve any further shadow insurance transactions until a fuller and more complete picture emerges that can inform collective decision-making.

The NAIC declined New York’s moratorium recommendation and instead has moved to address the captives issue as part of its continuing work regarding the implementation of PBR for life insurers. To that end, the NAIC engaged Rector & Associates.

To its credit, the Rector Report acknowledges many of the harms associated with shadow insurance transactions. Indeed, shadow insurance should not be permitted to the extent that it simply constitutes a shell game that allows insurers to realize accounting advantages and better ratings under the guise of "risk transfer" that amounts to little more than the movement of capital within the holding company system. This is the very reason why New York called for a national moratorium in the first place.

The Rector Report, however, anchors its suggestions for shadow insurance transactions by latching on to the very same relaxed reserve standard that serves as the basis for PBR. By offering the loose framework of VM-20 as the standard to which companies must adhere in establishing the "economic reserve" for any shadow insurance transactions, the Rector Report aims to link the reform of captive reinsurance transactions to the standards that undergird PBR, as a means of incentivizing the insurance industry to support the reform of shadow insurance. Indeed, the Rector Report expressly notes that its proposals are not intended to "serve as a roadblock to the adoption of PBR or to full compliance with PBR if [PBR] is adopted."

New York is on record, of course, in stating that PBR represents an unwise move away from reserve requirements that are established by formulas and diligently policed by insurance regulators in favor of internal black box models developed by insurance companies themselves. In many respects, the Rector Report is a Trojan Horse that would advance and help entrench a risky principles-based reserving approach.

Again, PBR and the use of life insurance captives are the product of the same problem: A desire to reduce reserves in a deregulatory fashion that threatens company solvency in the long-term and leaves policyholders at future risk.

Worst of all, the proposed "fix" offered by the Rector Report will not necessarily put the clamps on the life insurance industry's desire to engage in future shadow insurance transactions. The industry has maintained that shadow insurance will be necessary even after PBR goes into effect, because PBR does not go far enough in allowing companies to shed reserves. If PBR were truly the magic bullet for the issues they have raised with the formulaic regime, then the life industry would be leading the charge to do away with the use of shadow insurance, instead of looking for ways to continue to legitimize its use.

As we have previously stated, New York is willing to work constructively with other regulators and insurers to make smart, targeted, limited adjustments to the historical reserving formulas where there is strong empirical evidence for doing so. DFS certainly does not think the reserve formulas are perfect, or that the formulas always result in the right reserves. Yet that does not mean that we should throw the baby out with the bathwater and discard the formulaic system entirely. If we continue with the unyielding march toward PBR, we will look back one day on the decision to proceed as a fateful and tragic mistake.
A healthy and ongoing dialogue between insurance companies and their regulators about how best to safeguard solvency and secure consumer protection is the hallmark of insurance regulation. But at the end of the day, regulators must develop standards that enforce those aims, instead of enabling continuing conduct that undermines them.

Sincerely,

[Signature]

Benjamin M. Lawsky
Superintendent of Financial Services

cc:

Adam Hamm
NAIC President
North Dakota Insurance Commissioner

Monica J. Lindeen
NAIC President-Elect
Montana Commissioner of Securities and Insurance

Sharon P. Clark
NAIC Vice President
Kentucky Insurance Commissioner

Michael F. Consedine
NAIC Secretary-Treasurer
Pennsylvania Insurance Commissioner
March 21, 2014

Via Electronic Delivery

The Honorable Julie Mix McPeak
Commissioner
State of Tennessee Department of Commerce and Insurance
Davy Crockett Tower
500 James Robertson Parkway
Nashville, TN 37243-1220

The Honorable Joseph Torti, III
Superintendent
State of Rhode Island Department of Business Regulation
1511 Pontiac Avenue, Building 69-2
Cranston, RI 02920-4407

Re: Comments regarding Final Report of Rector & Associates concerning the regulation of XXX/AXXX reserve financing structures

Dear Commissioner McPeak and Superintendent Torti:

We have reviewed the report issued by Rector & Associates, dated February 17, 2014 (the “Report”), that was exposed for comment by the National Association of Insurance Commissioners’ Principle-Based Reserving Implementation Task Force on February 27 and offer the following comments.

We commend Rector & Associates and the NAIC for their thorough and thoughtful approach to recommending a framework addressing XXX/AXXX reserve financing structures. As we have stated in our prior comment letters, this issue is critical to the ongoing health of the life insurance industry, upon which millions of Americans rely for long-term financial protection.

We continue to believe that statutory reserving requirements must be set at appropriately conservative levels and that any demonstrated reserve redundancies should be addressed directly and uniformly through the underlying valuation requirements. As such, we strongly support the adoption and immediate implementation of any framework that moves in the direction of strong and uniform regulation of XXX/AXXX reserve financing structures, such as that presented in the Report. However, following adoption of the Report, we encourage completion of the reform of the underlying minimum statutory reserving standards.
In this letter, we focus on three critical issues identified in the Report: (1) timing for the implementation of the recommended framework; (2) the vital importance of public disclosure regarding XXX/AXXX financing structures; and (3) the necessity to carefully define the scope of the new framework so as to discourage attempts to avoid the rules. In these three critical areas, we believe that the recommendations in the Report, if implemented, would represent a meaningful improvement over the status quo. In some respects, we believe that the recommendations do not go far enough, and outline below several areas that should be strengthened further.

1. Timing

The NAIC and others have been closely studying the use of captive life reinsurers over the last several years. Over this time, there have been considerable resources devoted to the issue as well as a multitude of reports and analyses released, including the NAIC White Paper as well as reports by individual regulators, rating agencies, financial analysts, academics and others. Given the substantial time and attention that has already been devoted to the issue, the NAIC should act now to protect insurer solvency, the state-based insurance regulatory system and the financial security our industry provides to so many Americans.

The Report notes that while more work is needed to flesh out various aspects of the proposal, implementation of the new requirements need not wait for this more detailed work. Instead, regulators could begin to use the outlined concepts immediately, without the need to modify any statute or regulation or finalize every detail of the proposed actuarial method. We fully support this recommendation, and believe that it appropriately recognizes the urgency of the issue. Even without finalizing all of the details, the framework provides substantially more guidance, uniformity and transparency than exists today.

Moreover, allowing the status quo to continue for any additional period of time simply encourages a chaotic rush of transactions designed to avoid the requirements of the proposed framework. For these reasons, we support immediate implementation of the framework for all new business ceded to both new and existing XXX/AXXX financing structures as well as all re-financings of existing structures. While there are practical and political considerations that may lead regulators to conclude that pre-existing XXX/AXXX financing structures should not be subject to the framework, we believe that any modifications to such structures, whether by adding additional business or changing the financing structure (including re-financing of expiring letters of credit), certainly should be subject to the requirements set forth in the Report.

2. Transparency and Disclosure

As identified in the Report, robust public disclosure of XXX/AXXX financing structures is critical. Public disclosure provides crucial information to regulators and the marketplace, and also serves as an important safeguard for policyholders and the public. Moreover, disclosure promotes uniformity and consistency from insurer to insurer and regulator to regulator.

Although the Report includes strong disclosure recommendations that are consistent with these principles, we feel it does not go far enough. Specifically, we believe the full panoply of proposed disclosure requirements should apply to all existing and new XXX/AXXX cessions, including those
cessions that are exempt from the substantive requirements of the recommended framework. For exempt transactions, we believe the additional disclosures would provide valuable information, and would impose only modest additional costs on insurers. Public information about otherwise exempt transactions would allow regulators, the public, rating agencies, creditors and others to assess the level of risk presented, and would act as a powerful protection against potential abuse of the exemptions.

3. Scope

Given the creativity with which life reserve financing transactions have been crafted and may be crafted in the future, it is critical that the scoping mechanism be flexible in its ability to identify structures that may pose risk without fitting neatly into existing or contemplated definitions. For this reason, we strongly support the recommendation in the Report that the proposed framework apply broadly to XXX/AXXX reinsurance transactions, rather than attempting to define a structure that is based on a definition of “captives” or linked to the assets held by captives. This type of scoping mechanism addresses the underlying regulatory issues, mitigates the risk of transactions moving offshore or otherwise outside the reach of regulators, and would not adversely affect “pure” captive structures established by non-insurers or life insurer captive structures in which there is real risk transfer and adequate collateral.

Moreover, consistent with the Report’s recommendations, we believe it is imperative to focus the analysis on ceding companies and the reinsurance collateral available to them, rather than on captives and their assets. We support the implementation of this approach via the proposed new “XXX and AXXX Reinsurance Model Regulation,” including the presumption of a hazardous financial condition if the model’s requirements are not met. Ultimately, policyholders look to the ceding company for payment of claims. Thus, ensuring that the ceding company holds assets, or has access to collateral sufficient to support its reserves, best protects the company and its policyholders in times of stress. If the ceding company’s assets or collateral fall short, a presumption of hazardous financial condition is appropriate.

Similarly, requiring full risk-based capital calculations using the traditional NAIC methodology, as recommended by the Report, is essential. Regulators must be comfortable with the level of capital held by the ceding insurance company and can obtain this comfort only via a uniform risk-based capital calculation. In addition, for the reasons discussed above, we believe that the full, traditional risk-based capital calculation should be public to allow appropriate market and consumer transparency.

*   *   *

The current use of XXX/AXXX financing structures undermines the safety and solvency of the U.S. life insurance industry by thwarting the uniform application of statutory reserving standards. Although the framework set forth in the Report is a positive first step toward a sound and uniform solution, we believe the ultimate goal must be an end to these transactions and this needs to be made explicit. Statutory reserving requirements must be set at an appropriately conservative level and must apply uniformly and without opportunities for arbitrage.

We appreciate the efforts of Rector & Associates and the NAIC to move toward a swift and effective solution to address the issues surrounding XXX/AXXX financing structures and your consideration of
this comment letter. We are happy to further discuss this letter with you and provide additional information or address any questions regarding our comments that you may have.

Sincerely,

George Nichols III
SVP in Charge of the Office of Government Affairs

Joel M. Steinberg
SVP, Chief Risk Officer & Chief Actuary
Via Email directed to Kris DeFrain (kdefrain@naic.org)

March 21, 2014

The Honorable Julie Mix McPeak
Commissioner
Tennessee Department of Commerce
and Insurance
500 James Robertson Parkway
Nashville, TN 37243-1220

The Honorable Joseph Torti, III
Superintendent
Rhode Island Department of Business
Regulation, Insurance Division
1511 Pontiac Avenue
Cranston, RI 02920-4407

Re: USAA’s Comments Regarding the Report of Rector & Associates, Inc. to the
Principle-based Reserving Implementation (EX) Task Force, February 17, 2014 (the
“Report”)

Dear Commissioner McPeak and Superintendent Torti:

In the interest of our members - the men and women of the U.S. military and their families - we are pleased to offer our observations on the Report, which seeks to resolve the current controversy over the use of captives and special purpose vehicles (“life captives”) to finance life insurance reserve obligations. We support the general direction of the Report and we commend Rector and Associates for the thoughtfulness and thoroughness of its recommendations. The NAIC should, we believe, move expeditiously to resolve the remaining issues and establish an aggressive timeline for implementation of the Report’s recommendations.

General Comments and Key Principles

When we wrote to you previously, we suggested that any resolution of the life captive controversy should follow certain key principles. We offer the following comments on the Report as it relates to those principles:

- **Maintain incentives for Principle-based Reserves (“PBR”).** Solving the underlying problem of outdated reserve requirements is critical to the future of our industry and our system of state regulation. For this reason, we ardently support the direction of the Task Force that the Report’s proposals “not serve as a roadblock to the adoption of PBR.” We also agree with the recommendation to tie the “primary assets” measure to VM-20, which we believe will help maintain incentives for and serve as a bridge towards PBR.

- **Promote uniformity between captives and increase transparency.** We support the Report’s recommendations for reasonable regulatory and public disclosure of life captives and for the uniform regulation of the “primary asset” requirement. While we understand why the Task Force may allow more flexibility for the “other asset” requirement, we urge the Task Force to recommend appropriate uniform standards to ensure that assets supporting that portion of reserves are real and meaningful.
> **Provide consistent accounting treatment between captives and direct writers.** If the Task Force accepts the Report's recommendation to allow life captives to use alternative assets to back portions of reserves, we hope the Task Force will further consider giving direct-writing insurers the same flexibility. We agree with the Report that there are challenges to this approach, but we would welcome the opportunity to work with the Task Force and other interested parties to explore the "Alternative B" concept.

### Specific Comments

While we support the general direction of the Report, we offer the following considerations to help assure compliance with the Report's recommendations and to further the goal of modernizing our system of reserving through the adoption of PBR:

> **Letters of Credit ("LOCs") are not Admitted Assets.** We are concerned about the Report's recommendation to allow some use of LOCs in lieu of more traditional assets, even for the "primary assets" requirement. It is true LOCs currently allow ceding companies to take reserve credit for business ceded to unauthorized reinsurers, but it is important to note the reason for that: regulators want collateral to be certain that there will be on-shore funds available in the event an unauthorized reinsurer becomes insolvent. Traditional insurance accounting rules have never allowed LOCs to be treated as admitted assets, and even life captives are only allowed to apply such preferential treatment, in some cases, to support reserves in excess of "economic" reserves. Moreover, allowing LOCs to be used as a "primary asset," even in a limited fashion, could make life captive arrangements more economically attractive than PBR - a result that would be counter to the express direction of the Task Force. For these reasons, we believe LOCs are better suited for the "other assets" portion of reserves - that portion with a low probability of being needed - than for the "primary assets" portion with a higher probability of being needed.

> **PBR's governance and reporting controls are vital.** We believe strongly that all aspects of PBR, including its corporate governance and regulatory reporting requirements, should be applied to any use of VM-20 as the basis for establishing the "primary assets" requirement. Partially adopting PBR without the governance and oversight controls of the new Standard Valuation Law and VM-20 could lead to failures and criticism that put full adoption of PBR in jeopardy.

> **Consider a sunset clause.** Even though the Report's recommendations, if adopted, will strengthen the regulation of life captive arrangements, these structures will continue to offer their companies competitive advantages over those companies, such as USAA Life, that do not use them. Applying a sunset clause will limit this inequality and will encourage all parties to move swiftly towards PBR. If insurers that are not currently employing life captives conclude that it will be many years before PBR is adopted, more and more of them will succumb to competitive pressures and resort to using these structures. Winding up in a place where most, if not the entire, domestic life industry is
using captive reinsurers to manage overly redundant reserve requirements will not be
good for either the industry or its regulators.

In closing, we thank the NAIC for its efforts to resolve the life captive controversy and we
applaud the Task Force for making the advancement of PBR such an important consideration in
this process.

We appreciate the opportunity to comment and please let one of us know if we can answer
questions or provide further assistance.

Sincerely yours,

Steven Alan Bennett
Executive Vice President
General Counsel & Corporate Secretary

William H. McCartney
Senior Vice President
Assistant to the General Counsel
For Special Projects
March 20, 2014

Via email: kdefrain@naic.org

National Association of Insurance Commissioners  
Attn: Kris DeFrain  
1100 Walnut Street  
Suite 1500  
Kansas City, MO 64106


To: The Members of the Task Force

The Vermont Captive Insurance Association (“VCIA”) appreciates the opportunity to comment on the Report of Rector & Associates, Inc. to the Principle-Based Reserving Implementation (EX) Task Force (the “Rector Report”). VCIA also appreciates the Subgroup’s careful consideration of the comments submitted by VCIA and other interested parties with regard to the initial draft of the White Paper.

VCIA is composed of nearly 500 member companies, representing entities ranging from Fortune 100 Companies to small non-profits, and is the largest captive insurance trade association in the world. VCIA appreciates the time and effort expended by the task force and National Association of Insurance Commissioners (“NAIC”) staff to review insurers’ use of captives and special purpose vehicles and develop conclusions and recommendations based on the report submitted. In general, VCIA continues to be supportive of reasonable efforts to provide guidance to commercial insurers with regard to appropriate use of special purpose vehicles.

The issue of a life insurer seeking to reduce its effective net retention of XXX and AXXX reserves by employing a captive insurer came to the attention of the Captives and Special Purpose Vehicles (SPV) Use (E) Subgroup and was mentioned in its Report dated June 6, 2013. VCIA believes that the Report’s basic approach to insurer regulation in these cases has merit and would like to specifically endorse a primary focus of the Rector Report.
The Report is clear that its recommendations are not an attempt to “regulate captives.” It correctly states that focusing on the regulation of assuming insurers will ultimately fail and will lead to financing transactions moving off-shore or otherwise out of the reach of US regulators. VCIA strongly supports the Report’s recommendation to focus almost exclusively on regulation of the direct/ceding insurer, instead of focusing on regulation of the assuming insurer. As the Report states, the goal is “to ensure that high quality assets in an appropriate amount will be available to the direct/ceding insurer to allow it to pay policyholder claims as they come due.” In our view, this is the correct approach because the regulator of the ceding carrier is in the best position to determine what assets should be allowed to offset XXX and AXXX reserves.

In conclusion, we would like to commend to the Task Force the basic approach of the Rector Report, which is that States have authority to regulate the ceding company. Thank you again for this opportunity to provide comments to the Task Force.

Sincerely,

[Signature]

Richard Smith
President