Update to February Report Executive Summary—June 13, 2014

During the telephonic meeting of the Principle-Based Reserving Implementation (EX) Task Force on June 12, 2014, we were asked to provide a document that describes how our Modified Recommendations—June 4, 2014 compare to the Executive Summary of our February Report (Section I, F of the February Report).

The standard font of the following is the Executive Summary from the February Report. The bolded and italicized font beneath each item is a brief description of how that item is dealt with in our Modified Recommendations.

1. In substance, we recommend that the 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.

   For transactions subject to the requirements, the substance of this item is the same in our Modified Recommendations. This concept is described in Exhibit 1 of the Modified Recommendations, item 3, 2nd bullet.

2. The remainder of the credit for reinsurance may be supported by any assets approved by the regulators for both the direct/ceding insurer and the assuming insurer, subject to certain regulatory protections and oversight.

   For transactions subject to the requirements, the substance of this item is the same in our Modified Recommendations, with two modest alterations:

   • First, the Modified Recommendations only require that transactions be approved by the direct/ceding insurer’s regulator rather than by regulators for both the direct/ceding insurer and the assuming insurer. (See, Exhibit 1, item 3, 5th bullet). We made this change to assure compliance with Dodd-Frank. We recognize that the regulator for the assuming insurer will also be involved in most instances, and we encourage that involvement, but we wanted to limit the formal requirement to the direct/ceding insurer’s regulator since the approval is a condition to the ability of the direct/ceding insurer to obtain credit for reinsurance.
   • Second, the formulation of “Other Security” under our Modified Recommendations is that it should consist of “any other security as to which the NAIC has developed an RBC ‘asset charge’.” (See, Exhibit 1, summary of terms, 1 Report of Rector & Associates, Inc. to the Principle-Based Reserving Implementation (EX) Task Force, dated February 17, 2014.)
item 5 (Other Security)). On the surface, that seems different from the formulation in our February Report of “any [approved] asset.” However, because our Modified Recommendations also include a recommendation that an RBC “asset charge” be developed for any asset that might be used as Other Security—specific charges for anticipated categories of Other Security and an appropriate “catch-all” charge to apply to assets that are not specifically listed (See, Exhibit 1, summary of terms, item 5 (Other Security))—and because the transaction must be approved by the direct/ceding insurer’s regulator (See, Exhibit 1, item 3, 5th bullet), the substance is essentially the same.

3. We recommend that full Risk-Based Capital (“RBC”) calculations using traditional NAIC methodology be performed by at least one party to the financing transaction.

For transactions subject to the requirements, the substance of this item is the same in our Modified Recommendations. This concept is described in Exhibit 1 of the Modified Recommendations, item 3, 4th bullet.

4. We recommend that key information about the use of financing transactions and assets supporting such transactions be publicly disclosed.

The substance of this item is the same in our Modified Recommendations. This concept is described in our Modified Recommendation 6 (Disclosure of Key Aspects of XXX/AXXX Reinsurance Arrangements).

5. We recommend that direct/ceding insurers and their auditors annually determine compliance with the requirements.

The substance of this item is the same in our Modified Recommendations. This concept is described in Exhibit 1 of the Modified Recommendations, item 4, 2nd bullet.

6. All reinsurance involving XXX/AXXX reserves is within the initial scope; however, exemptions are provided for most traditional reinsurance arrangements, including for arrangements with reinsurers that follow NAIC accounting and RBC rules.

The substance of this item is the same in our Modified Recommendations. (See Exhibit 1, item 2). The substance as to the new requirement that certain insurers need to “follow NAIC accounting and RBC rules” in order to be exempt from the requirements is described more fully in Modified Recommendation 4 (Specific Provisions Relative to Reserve Financing Transactions Involving Licensed and Accredited Reinsurers and Reinsurers Domiciled in a State other than that of the Ceding Insurer).

7. The concept of “financing” the reserves at the direct insurer level (without the use of reinsurance) is theoretically viable, but more work remains before recommendations can be made as to how to implement the concept.

The Modified Recommendations document is silent relative to this item. However, we continue to feel about it as we did in February: the concept is theoretically viable, but it
does not make sense to perform further work relative to it without first identifying several insurers that might wish to use it.

8. The proposed effective dates for the new requirements are:
   • 7/1/14 for newly created financing structures
     *Although the February Report could perhaps have been clearer on the point, this 7/1/14 date was always intended to consist of a “voluntary” application of all or portions of the Framework approach by states that were asked to approve new financing structures on and after 7/1/14. That “voluntary application” concept continues to be a part of the Modified Recommendations, although without a specific date attached. See Modified Recommendation 1 (Adopting the Framework Approach).*
   • 12/31/14 for the new “Disclosure Requirements”
     *This effective date is the same in our Modified Recommendations. See Modified Recommendations 6 (Disclosure of Key Aspects of XXX/AXXX Reinsurance Arrangements).*
   • 1/1/15 for business ceded to existing financing structures
     *The Modified Recommendations are silent as to this effective date. We anticipate that the date of 1/1/15 that we recommended in the February Report will still be appropriate, but we wanted to hold off making a formal recommendation regarding the date until more of the technical implementation work is completed.*
   • 12/31/15 for the new RBC rules
     *This effective date is the same in our Modified Recommendations. See Modified Recommendations 7 (Risk-Based Capital (RBC) Changes), first paragraph.*

9. We recommend a new “XXX and AXXX Model Reinsurance Regulation” as an NAIC Accreditation Standard to “codify” the new requirements; however, the concepts can be implemented for most financing transactions without any change to law or statute.

*In response to the comments received, the approach used to “codify” the new requirements is significantly different in our Modified Recommendations than it was in our February Report. The approach recommended now is described in Modified Recommendations 3 (Actuarial Opinion Memorandum Regulation (AOMR)), 4 (Specific Provisions Relative to Reserve Financing Transactions Involving Licensed and Accredited Reinsurers and Reinsurers Domiciled in a State other than that of the Ceding Insurer) and 5 (Specific Provisions Relative to Reserve Financing Transactions Involving Unauthorized Reinsurers).*