June 25, 2014

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

Dear Commissioner McPeak and Superintendent Torti:

On behalf of the American Academy of Actuaries1 Life Practice Council (LPC) and the PBR Strategy Subgroup (PBRSS), we appreciate the opportunity to comment on the exposed June 4, 2014 Report of Rector & Associates, Inc. to the Principle-Based Reserving Implementation (EX) Task Force (June Report).

Following are some general comments on each of the modified recommendations.

1) Adopting the Framework Approach.

The LPC agrees that adopting a framework approach as the first step, followed by charges to the appropriate NAIC committees and working groups, is the most efficient way to approach this issue given the NAIC’s indicated urgency in implementing a new regulatory regime for captive arrangements. However, the LPC has some preliminary concerns with specific elements of the June Report described below and has not had sufficient opportunity to determine fully if other elements of the current framework as proposed in the June Report merit adoption without change or additional specification. We welcome the opportunity to hear further public comment and discussion on the many implementation details.

Among the items still being examined by the LPC, as noted in our comment letters of March 21, April 11, and April 23, we do not believe that the Net Premium Reserve (NPR) should be included in the VM-20 calculation used to determine the Primary Security Requirement. Please see our further comments on this issue below.

2) Actions to be taken by the (Life Actuarial) Task Force.

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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.
**Charge 3 of Exhibit 2** - On Charge 3 to the Life Actuarial (A) Task Force (LATF), we agree that this is the right group to study these issues. In addition, as we said in our April 23 letter, we believe the Actuarial Method, including the mortality assumption, should be the current version of VM-20, as may be modified from time-to-time.

In Charge 3, it states, “The Actuarial Method should consist of the NAIC Valuation Manual, VM-20, Requirements for Principle-Based Reserves for Life Products, modified to incorporate changes to mortality tables as developed by the American Academy of Actuaries and any other appropriate modifications determined by LATF, and should explicitly keep (in current or modified form) or eliminate the “net premium reserve” component of the current VM-20.” We have the following comments:

- The charge to LATF (#3) refers to the mortality tables developed by the American Academy of Actuaries. To clarify, the mortality tables used in the valuation are the joint work product of the Academy and the Society of Actuaries. The SOA’s role is to gather basic mortality experience, while the Academy’s role is the development of valuation margins. As we stated in our March 21 comment letter, “Consistent with Section 9.C.3.g. of VM-20, a set of improvement factors has already been developed by the SOA and the Academy’s Life Experience Subcommittee and published on the SOA website ([http://www.soa.org/Research/Experience-Study/Ind-Life/Valuation/research-2014-mort-imp-rates.aspx](http://www.soa.org/Research/Experience-Study/Ind-Life/Valuation/research-2014-mort-imp-rates.aspx)) to be applied to the 2008 VBT table to true up that table to year end-end 2013.”

- Further, regarding “any other appropriate modifications determined by LATF,” as indicated in our March 21 comment letter, we do not believe it is in the best interests of implementing PBR to make ad hoc adjustments to any of the current requirements for the VM-20 modeled reserves for this purpose. These ad hoc changes to VM-20 identified in the Rector Report may not be made to VM-20.

- Also, as we said in our April 11 comment letter, we do not believe that the NPR should be included in the VM-20 calculation used to determine the Primary Security Level, since the purposes for including a formula-based NPR floor in the Valuation Manual do not apply to the aspects of captive arrangements covered in the June Report. Applying the NPR to captive reinsurance transactions, which generally involve more narrowly defined product blocks issued over a limited period of time, could result in a Primary Security Level that significantly misses the mark in either direction. This could result either in artificially increasing the Primary Security Level or causing significant calculation work and the devotion of resources to develop a reserve that is never used. For these reasons, the NPR component is not suitable and does not add value as a basis for the Primary Security Level.

- Furthermore, while the LPC was not involved in either its development or testing, we understand the NPR to be a formula-based reserve with fixed industry level
assumptions established at policy issue. The NPR was developed with an intention of being consistent with the existing U.S. Internal Revenue Code, (IRC) thereby potentially serving as a basis for the deductible tax reserve. The NPR uses assumptions that have been calibrated to the current Commissioners Standard Ordinary (CSO) mortality table; as such, it is our understanding that the NPR may need to be recalibrated once a new CSO mortality table becomes effective.

**Charge 5 of Exhibit 2** – See our comments on Recommendation #3.

**Charge 8 of Exhibit 2** – See our comments on Recommendation #7.

3) **Actuarial Opinion Memorandum Regulation (AOMR).**

The modified recommendation provides that the AOMR Actuarial Guideline should specify that “the opining actuary for a ceding insurer (1) must follow the methods and assumptions developed as individual components of the framework to determine whether the ceding insurer’s net reserves are appropriate, and (2) must issue a qualified actuarial opinion if the ceding insurer has entered into a reserve financing transaction that does not adhere to the framework.”

There appear to be three proposed additional requirements of the Appointed Actuary as part of the actuarial opinion requirements:

1) The requirement of a certification that the Primary Security Level was determined by following the Actuarial Method;

2) The requirement of a certification that either (i) the Primary Security Level is at least as great as the Primary Security Requirement, or (ii) a defined remedy was put in place by March 1 of the following year to address any shortfalls of the Primary Security Level related to the Primary Security Requirement.

3) The requirement that the Appointed Actuary issue a qualified opinion if any of the company’s affiliated reinsurers do not comply with (2) above.

While we do not have an objection to the first two requirements, we do not believe that they should be included in the AOMR. The AOMR is designed to ensure the overall adequacy of an insurer’s reserves based on asset adequacy analysis and is not designed or intended to implement reinsurance specific requirements. The Appointed Actuary’s Opinion is based on state insurance laws and regulations, Actuarial Standards of Practice, experience, analysis and professional judgment.

If a state implements requirements surrounding the Primary Security Requirement, not meeting this requirement would necessitate the inclusion of some consideration in the Actuarial Opinion, but may not result in a qualified opinion. Fundamentally, the Appointed Actuary’s Opinion is just that – a professional opinion; we are strongly
opposed to the notion that the Appointed Actuary be required to form a qualified Opinion for a specific circumstance.

If, after consideration of our comments, the Principle-Based Reserving Implementation (EX) Task Force decides to proceed with implementing the Rector recommendations in this regard, we offer the following specific comments on the Exhibit 3 draft Actuarial Guideline pertaining to the AOMR:

- Item III.B. states that the Appointed Actuary issue a qualified opinion if the reinsurance doesn’t conform to the requirements of the Rector Framework (i.e., the Actuarial Method.) However, Item II implies, but doesn’t specifically state, that the company can avoid issuing a qualified opinion if it complies with one of the required remedies. We recommend that Item III.B. be clarified to state that an unqualified opinion can be issued if one of the specified remedies is put into place.

- Item III.C. should be limited, at most, to the case where an affiliated reinsurer receives a qualified opinion under the scope of the guideline on business, some portion of which was ceded to it (either directly or through a chain of retrocessions) from the another affiliate. In such a case, one could consider cascading the qualified opinion back down to the original affiliated source, through the chain of retrocession, as reflecting risk to the original or intermediate cedants. However, we do not believe that automatically extending a qualified opinion from one affiliate to another by virtue of mere affiliation in the holding company system is justified.

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.

No comment.


No comment.

6) Disclosure of Key Aspects of XXX/AXXX Reinsurance Arrangements.

We are generally in favor of additional disclosure and increased transparency, as long as it is not unnecessarily complicated.

7) Risk-Based Capital (RBC) Changes.
If, after consideration of our comments, the Principle-Based Reserving Implementation (EX) Task Force decides to require qualified opinions for non-adherence with the Primary Security requirement, we would not support increasing capital requirements as a consequence of such an Opinion. Currently, the additional C-3 RBC charge is associated with excessive interest rate risk. A company whose assets and liabilities exhibit disintermediation risk greater than the disintermediation risk assumed and which has received a qualified actuarial opinion is required to hold additional RBC. Simply put, if a company has excessive disintermediation risk, then additional RBC must be held.

Requiring additional capital because a company is not complying with the regulations associated with captives is not consistent with the intent of the RBC framework. Current RBC requirements are based on an insurer’s risk exposures and the minimum capital deemed necessary by regulators to avoid regulatory intervention. If a company is not complying with the regulations related to captive arrangements, then the appropriate remedy should be to bring the captive transaction into compliance, rather than to allow the transaction to remain out of compliance with an arbitrary amount of additional capital. In addition, we note that under current RBC rules, any increase in the C-3 RBC factor due to a qualified opinion would apply to the entire C-3 exposure of the company, including business that is not involved in a captive transaction.

If, after consideration of our comments, the Principle-Based Reserving Implementation (EX) Task Force decides to go ahead with their plans to require additional capital for qualified opinions under the captive framework outlined, we wanted the Task Force to be aware of the following:

1) The June Report states “As described in our February Report, we recommend (1) that the RBC instructions be amended to ensure that at least one party to the reserve financing transaction holds an appropriate RBC “cushion”,…” The February Report states, “We recommend that full Risk-Based Capital (“RBC”) calculations using traditional NAIC methodology be performed by at least one party to the financing transaction.” Although the term “RBC cushion” is used extensively in the June Report (Item 3 and definition #6 of Exhibit 1, and Charges 8.a. and 8.b. of Exhibit 2), neither the February Report nor the June Report specifically define the term.

2) With regard to the recommendation that the NAIC evaluate whether the current RBC “charge” relative to qualified opinions is appropriate (also discussed in Charge 8.c. of Exhibit 2, although the effective date in recommendation #7 in 12/31/14 and the effective date in Charge 8.a. it is 12/31/15), if the Principle-Based Reserving Implementation (EX) Task Force decides to require qualified opinions for non-compliance with the Primary Security Requirement, we do not approve of imposing an increased C-3 capital charge.

8) Evaluate risk-transfer rules.
No comment.

9) **Financial Analysis Handbook.**
   No comment.

10) **Note to Audited Financial Statement.**
    No comment.

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We hope these comments are helpful. Please contact Bill Rapp, the Academy’s Assistant Director of Public Policy (rapp@actuary.org or 202-223-8196) if you have any questions.

Sincerely,

Mary Bahna-Nolan, FSA, MAAA, Vice-President,
Life Practice Council
American Academy of Actuaries

Cande Olsen, FSA, MAAA, Chair
PBR Strategy Subgroup
American Academy of Actuaries
June 25, 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

RE: Exposure of Modified Recommendations of Rector & Associates dated 6/4/14 to the PBR Implementation Task Force

Dear Commissioner McPeak and Superintendent Torti:

The ACLI1 appreciates the opportunity to provide our comments on the Modified Recommendations of Rector & Associates dated 6/4/14 concerning the regulation of companies ceding business to captive reinsurers (“the Recommendations”).

The ACLI would like to thank the Task Force and Neil Rector for considering the concerns expressed in our previous letters in the development of the Recommendations. We feel that the proposed Framework has improved considerably from the prior version and we appreciate the effort required to bring it to this stage. We also believe this version of the Recommendations provides a path toward resolving the captives issue that obviates the need to amend the Accreditation Standards Preambles to include a definition of “multi-state reinsurer“. While we are in substantial support of many of the Recommendations, certain portions of the modified Framework, detailed below, trigger technical, legal and procedural concerns, which could benefit from further review and discussion. As requested by Mr. Rector, our comments focus on the Modified Recommendations and Exhibits 1 and 2. We have detailed our specific thoughts to the enumerated recommendations in Appendix 1 to this comment letter. Our comments on Exhibit 1 and Exhibit 2 as well as our recommendation for a two-phase approach on actions to be taken by the Task Force are shown in Appendices 2 and 3.

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.
Introduction

The Recommendations leave important details to be decided by technical groups. However, many of these details are critically important to the overall efficacy of the Framework and to the companies which shall be subject to that Framework. While ACLI recognizes that the technical details are not the responsibility of the Task Force, the Task Force should provide sufficient guidance to the technical groups to address the goals of the Task Force. To make the best use of the short timeframe within which the NAIC is working, we request an interim meeting following the June 30th conference call or extended meeting time at the Summer NAIC national meeting to delve into agreed upon technical and legal issues raised by the Framework. It is essential to the success of this initiative that regulators and interested parties discuss, develop, and document the high level guidance for the technical groups in a way that develops a cohesive, workable, and legally defensible Framework.

ACLI's goals for the Framework are as follows:

1. The Framework must not be in conflict with other laws or regulations. A solution that requires no law change would be ideal, but any required changes to law must be made in accordance with due process;
2. The Framework must only apply to Regulation XXX/AXXX-type captive arrangements and be prospective only. XXX/AXXX captive structures in existence before a specified date, such as 1/1/2015, should not be impacted by the Framework, including when re-financed;
3. The Framework must allow future Regulation XXX/AXXX-type captive arrangements to be permitted under the laws and regulations of the states;
4. The Framework must allow future Regulation XXX/AXXX-type captive arrangements with third-party financing providers to continue to be viable;
5. The Framework must increase uniformity and transparency of future Regulation XXX/AXXX-type captive arrangements;
6. The Framework must not capture traditional reinsurers; and
7. The Framework must not derail efforts to perfect and implement PBR on its current timeline.

Executive Summary

ACLI recognizes that in order to accomplish all of Mr. Rector's recommendations, amendments to the Credit for Reinsurance Model Law and Regulation likely will be needed. However, as described below, we believe significant strides toward the NAIC's goals of captives regulation can be made without such measures being addressed immediately. We are also sensitive to concerns about the time required to go through all regulatory processes and believe that the NAIC would be able to accomplish comparable regulatory goals in a shortened timeframe as follows:

1. As stated in the Recommendations, ACLI agrees that the NAIC could use the authority granted in the Actuarial Opinion and Memorandum Regulation (AOMR) to promulgate an Actuarial Guideline that acts as the vehicle for specifying the Primary Security Requirement, based on a modified VM-20, for future Regulation XXX/AXXX-type captive reinsurance arrangements. This Actuarial Guideline would set forth definitions used in the Framework, define the scope of applicability, provide remedies available for companies failing to meet the Primary Security Requirement, and stipulate conditions for issuing a qualified actuarial opinion. The Actuarial Guideline would provide uniformity in the states and allow for the Actuarial Method to be kept up-to-date as future changes to VM-20 are made. This is the heart of the Rector Recommendations and while not a perfect solution, could go a long way toward resolving the issues that the regulators have identified.
Section 3 of the AOMR gives authority for a commissioner to specify specific methods of actuarial analysis and actuarial assumptions when deemed necessary. We believe it grants the commissioner authority to require appointed actuaries to partly base their Actuarial Opinion on whether future Regulation XXX/AXXX-type captive arrangements meet a prescribed test. Actuarial Guidelines are in the Accounting Practices and Procedures Manual, which is adopted under the laws of every state, and as such, are part of the Financial Accreditation requirements. In this context, it would provide a uniform approach to the actuarial analysis of XXX/AXXX captive transactions. Any material permitted practices with respect to the Accounting Practices and Procedures Manual must be fully disclosed, along with the financial impact of the permitted practice. Therefore, modifying the AOMR to implement the Primary Security Requirement while additional required changes are identified and incorporated where needed could be a viable and uniform way to quickly implement this requirement.

As a follow-up to the step above, guidance should be made more permanent by amending the AOMR. An Actuarial Guideline would still be needed to ensure nationwide uniformity of the Primary Security Requirement and to allow future changes in the Actuarial Method as changes are made to VM-20.

2. As stated in the Recommendations, ACLI agrees that the NAIC should develop disclosure requirements pertaining to Regulation XXX/AXXX-type captive transactions that can be effective as of 12/31/2014 to ensure consistent disclosure by ceding companies in all states. ACLI has previously submitted disclosure recommendations.

3. As stated in the Recommendations, ACLI acknowledges Mr. Rector’s suggestion that at least one party to the reserve financing transaction hold an RBC “cushion” via a required RBC capital calculation with attendant regulatory consequences if available capital is insufficient. We also observe that Mr. Rector is recommending a review of RBC charges related to qualified actuarial opinions, with an implication that such charges may need to be increased.

Mr. Rector’s proposed requirement for an RBC “cushion” raises several challenging issues. If the captive performs an RBC calculation, we acknowledge the need for new risk charges to be developed for “Other Security”. Great care must be taken when developing these factors, as excessive RBC charges will simply cause excessive capital requirements to replace excessively conservative reserve requirements. If, on the other hand, the ceding company performs the calculation, it is not completely clear how the calculation would work mechanically or what the meaning of the resulting calculation would be.

With respect to risk charges related to qualified actuarial opinions, we believe that Mr. Rector may be misinterpreting certain technical details of the existing RBC risk framework, and we cannot support the introduction of a new risk charge for qualified actuarial opinions.

4. As stated in the Recommendations, ACLI agrees that the NAIC should prepare a new section of the Financial Analysis Handbook to set out procedures and provide guidance to regulators as they evaluate future Regulation XXX/AXXX-type captive transactions. ACLI has previously submitted such a set of uniform guidelines that would form a good basis to review captives.

ACLI believes that introduction of the Framework through the above steps would provide uniform guidance for new requirements as well as promote uniformity of regulatory review, transparency, and public disclosure. This approach provides regulators with tools they need now to ensure that policyholders’ interests are adequately protected when ceding companies reinsure XXX/AXXX business with captives. This approach would also help identify unintended consequences that may be a result of
the Framework and give regulators an opportunity to determine whether other proposed changes, such as changes to the Credit for Reinsurance Model Law, are necessary.

**Items of Critical Concern to ACLI**

In order to meet the ACLI's goals listed above, we note the following items of critical concern in regards to the Recommendations:

1. We continue to believe that the scope of application is defined in a way that would inappropriately sweep in traditional reinsurance arrangements between regularly licensed, public blue-book filing, traditional insurers and reinsurers- for example, a traditional reinsurer assuming XXX/AXXX business from an unrelated party, or a direct writer assuming XXX/AXXX business from another (affiliated or unaffiliated) direct writer. This is because the current framework assumes, incorrectly, that licensed and accredited insurers and reinsurers can be divided between "regular companies" and "captives" on the basis of whether the insurer and reinsurer has any permitted practices. As you know, many traditional insurers and reinsurers have been granted one or more permitted practices (fully disclosed in accordance with the APPM) unrelated to "reserve financing" or "captives use." The allowance for commissioner approval of such permitted practices for traditional insurers and reinsurers is long-standing and far from nefarious. To ensure that traditional insurance and reinsurance transactions are not swept in, we recommend the following concept be used:

   **Entities to which the Primary Security Requirement applies are those entities that reinsure life insurance policies subject to Section 6 (with the same exclusions set forth in subsections 6.E., 6.F., and 6.G.) 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.

2. In order for the AOMR to provide a robust regulatory solution, some clarifications and/or changes will be necessary.
   a. Recognizing that certain reinsurance transactions do not require collateral, it should be clarified that the Primary Security Requirement can be met in two ways in the AOMR. For captive arrangements in which collateral is required by the Credit for Reinsurance Model Law, the Primary Security Requirement should be compared to the collateral held by the ceding company. However, for those arrangements in which collateral is not required, the Primary Security Requirement should be compared to the assets of the captive reinsurer, less the assets held as the required capital of the captive.
   b. We have previously noted that there is a fundamental mismatch that occurs if VM-20 is used to measure assets held at market value. It is important that regardless of whether the collateral is funds withheld or assets held in trust, that the Primary Security Requirement be applied to the book value of the collateral. We ask that LATF be charged with investigating this issue and developing a solution.
   c. ACLI believes that LATF should also be charged specifically with investigating whether changes could be made to VM-20 to reduce the volatility of the calculation from year to year. It is very difficult to arrange for a third party to enter a transaction where volatility
of financing requirements is expected. LATF is looking into this issue in regards to PBR, and we believe it is even more important if VM-20 is used in this context. ACLI will work with LATF to quickly identify some potential fixes.

d. In the event the Actuarial Guideline or subsequent AOMR changes would indicate a qualified opinion would be warranted because of a non-compliant captive transaction, that opinion should be limited to the entity in question and should not necessarily trigger a qualified opinion at any other affiliate within the holding company system of which it is part. This should depend on the facts and circumstances of the relationship between the ceding company and the affiliated company.

3. The Net Premium Reserve (NPR) should be removed from the Actuarial Method specifying the Primary Security Requirement. For the following reasons, ACLI is very concerned about the use of the Net Premium Reserve (NPR) in the calculation of the Primary Security Requirement:

a. The current NPR uses the 2001 CSO Mortality Table, and is calibrated to approximate a reasonable floor for deterministic reserves calculated based on the 2008 VBT. As Mr. Rector has proposed, the Actuarial Method is expected to use industry experience mortality tables currently under development by the American Academy of Actuaries (completion expected in early 2015). There is an expectation that this will reduce the deterministic and stochastic reserves, possibly significantly. This will leave the NPR poorly calibrated to the resulting modeled reserves, and the NPR will almost always dominate the modeled reserves. We believe this is an inappropriate outcome of the Actuarial Method, and this outcome is not expected once PBR is implemented. LATF will likely need to re-calibrate the NPR prior to the effective date of PBR, once the new CSO mortality table is also completed.

b. As Mr. Rector previously 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.

c. 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.

d. It is not a trivial exercise to calibrate the NPR for use within the Primary Security Requirement. The initial calibration of the NPR took close to two years to calibrate for the current versions of mortality tables. ACLI does not believe that re-calibration could be completed in a timely manner.

e. The NPR is incomplete. 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 absence of a specified calculation, the Valuation Manual currently states that the NPR defaults to current reserve requirements. 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 proposes that the NPR be added to the Actuarial Method no sooner than the date PBR becomes effective. Presumably, most of the remaining issues will be worked out by then by LATF. A possible way to implement such a solution would be to incorporate a “sunrise” of the NPR, where the NPR becomes part of the Actuarial Method after PBR becomes effective (and, presumably, the NPR has been re-calibrated as part of the PBR work being done).
4. RBC charges for “Other Security” should be reasonably related to default risk. Excessive charges will simply cause excessive capital requirements to replace excessively conservative reserve requirements. ACLI suggests that the Task Force give specific guidance to the Capital Adequacy Task Force in regards to the development of these RBC charges.

5. Clean, unconditional LOCs should be allowed without limit for meeting that Primary Security Requirement for captives that must provide collateral as they are explicitly allowed by the Credit for Reinsurance Model Law. We note that the recommendations are silent on the clean, unconditional LOCs for “Other Security”. It should be clarified that they can be used without limit.

We appreciate the opportunity to provide comments and look forward to discussing these matters with the Task Force.

Sincerely,

Paul S. Graham, III, FSA, MAAA

cc: Members, NAIC PBR Implementation Task Force
    Neil Rector, Rector & Associates
Appendix I
Specific Comments on Enumerated Recommendations

Recommendation 1. Adopting the Framework Approach – ACLI understands the NAIC’s desire to adopt a conceptual Framework as soon as practicable. However, we believe that the issues detailed in this comment letter need to be addressed before adoption of the entire Framework occurs. Therefore, we suggest that the portions of the Framework listed in our Executive summary be adopted as soon as possible. This will allow charges to be given to the technical groups in a timely manner. We request that the remainder of the Framework only be adopted after more review and discussion between regulators and industry. We note that adopting the Framework prior to the determination of the “Primary Security Requirement” or the RBC charges for “Other Security” is unlikely to result in greater uniformity, as it is impossible to “voluntarily comply” with the Framework without these critical components.

Recommendation 2. Actions to be Taken by the Task Force - We agree that charges can be developed for the Blanks (E) Working Group, Financial Analysis Handbook (E) Working Group, and the Life Actuarial Task Force prior to complete adoption of the Framework. However, based on our suggestions detailed in the Executive Summary, we believe that the following three charges are needed:

A. Blanks (E) Working Group – “Adopt a XXX/AXXX Reinsurance Supplement to be filed by insurers ceding XXX/AXXX business beginning with the 2014 data year. The Principle-Based Reserving Implementation (EX) Task Force’s XXX/AXXX Reinsurance Framework Exhibit 5 should be considered for this supplemental filing requirement, modified as appropriate by the Working Group.” – Essential

NOTE: The goal of the supplemental filing is for the ceding insurer to provide transparency regarding the assets and reserves pertaining to reinsurance of XXX/AXXX policies, especially when the assuming reinsurer is not subject to public disclosure requirements for these data points.
• Tables 2 and 3 reference terms that are defined in Actuarial Guideline AOMR.

B. Financial Analysis Handbook (E) Working Group – “Develop for year-end 2014, a new section for the Financial Analysis Handbook that specifies procedures for domestic/lead/captive states’ review of XXX/AXXX reinsurance transactions with captives/SPVs to be performed initially and on an on-going basis, consistent with recommendations from the Financial Analysis (E) Working Group (FAWG). These procedures should be modified in the future as the detailed proposals from other work streams for the XXX/AXXX Reinsurance Framework are adopted by the NAIC.” - Essential


C. Life Actuarial Task Force - “Develop an Actuarial Guideline that incorporates the Primary Security Requirement into the appointed actuary’s analysis when developing the annual Actuarial Opinion. The Actuarial Guideline shall specify that the Actuarial Method to determine the Primary Security Requirement is based upon the NAIC Valuation Manual, VM-20, Requirements for Principle-Based Reserves for Life Products, modified to incorporate anticipated changes to mortality tables as developed by the American Academy of Actuaries and any other appropriate modifications as determined by LATF. LATF should explicitly consider eliminating the “Net Premium Reserve” component of the current VM-20 in the
Actuarial Method based on the stated goals of the PBR Implementation Task Force, or at least significantly recalibrating the “Net Premium Reserve” if it determines that component should remain. LATF should investigate whether changes could be proposed to reduce the volatility of the VM-20 calculation. LATF should also investigate whether the method described in VM-20 is appropriate for use with assets valued at market value and report back to the PBR Implementation Task Force on its findings and recommendations regarding such. The Actuarial Guideline should also set forth definitions used in the Framework, define the scope of applicability, describe remedies for failure to meet the Primary Security Requirement in order to avoid a qualified or adverse opinion, and describe additional requirements for the actuarial opinion and memorandum for companies that must test their reinsurance agreements pursuant to the Actuarial Guideline. This Actuarial Method should be applicable irrespective of whether the captive reinsurer is licensed, accredited, or unauthorized. Upon adoption of the Actuarial Guideline, develop recommended changes to the Actuarial Opinion and Memorandum Regulation (AOMR) that place the new requirements directly into the AOMR, although the part of the requirements that define the Actuarial Method should remain in an Actuarial Guideline to maintain uniformity across the states and to allow for the Actuarial Method to be kept up to date as future changes to VM-20 are made.” - Essential

NOTE: This should be completed as soon as possible and sent back to the Principle-Based Reserving Implementation (EX) Task Force for adoption. This Actuarial Method should be included in the Financial Analysis procedures referenced in item 2 above as an appropriate and consistent method for determining whether (1) the ceding insurer has received sufficient collateral to support its policy obligations; or (2) the captive reinsurer has sufficient assets to meet its obligations to the ceding company.

Recommendation 3. Actuarial Opinion and Memorandum Regulation - We note that the Framework, as drafted, would ultimately require all captives to provide collateral, and will scope in certain non-affiliated licensed or accredited reinsurers (those reinsurers with permitted practices). We note that the AOMR cannot be used to add these new requirements, thus attempting to override existing law. However, if the changes that we have recommended in regards to scope of application and collateral requirements are adopted as part of the Framework, it may reveal alternatives to making changes to the Credit for Reinsurance Model Law and Regulation.

The effective dates need to be explicitly identified and should allow for a short period of time for which new policies can be ceded to existing captive arrangements. Therefore, we recommend that the Primary Security Requirement should be effective for new captives established on or after 1/1/2015 and for any new business ceded into existing arrangements issued on or after 1/1/2016. To encourage quick state adoption of AOMR changes, we further recommend that any interim Actuarial Guideline developed before the changes are made to the AOMR be effective until the earlier of: (a) the date the requisite changes are incorporated into the AOMR, and (b) a specified date, such as 1/1/2017.

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 - While we believe it may be necessary to open the Credit for Reinsurance Model Law to effect Recommendation 4, we question the need to add collateral requirements to captive arrangements utilizing licensed or accredited reinsurers if the ceding insurer meets the Primary Security Requirement. The Model does not require licensed or accredited reinsurers to provide collateral. No reason has been articulated to treat licensed or accredited captives any differently than other licensed or accredited reinsurers in regards to the need for collateral. Captives have to meet the same requirements to become licensed or accredited as other types of reinsurers, and hence should receive the same treatment as other types of reinsurers.
Recommendation 5. Specific Provisions Relative to Reinsurance Financing Transactions Involving Unauthorized Reinsurers – While there could be a need for an amendment to the Credit for Reinsurance Model Regulation, it may be possible to shape modifications to the AOMR and accompanying Actuarial Guideline to include applicability, definitions of Actuarial Method, Primary Security, and Primary Security Level, thus avoiding the need to revise the Model. The other sections of the Model Regulation in Exhibit 4 are unnecessary if all future Regulation XXX/AXXX-type captive arrangements are subject to the Primary Security Requirement promulgated by the AOMR.

Recommendation 6. Disclosure of Key Aspects of XXX/AXXX Reinsurance Arrangements – ACLI has consistently supported additional disclosure of XXX/AXXX reinsurance transactions and has provided our recommendations to the NAIC. We note that the specific elements shown in Table 2 of Exhibit 5 cannot be calculated until 12/31/2015 because the Actuarial Method will not be in place until 1/1/2015 (at the earliest). In addition, specific elements of Table 2 and all of Table 3 should not apply to captives established prior to the effective date. We also note that the recommended disclosure requiring funds withheld and modco reserves to be reported at market value rather than statutory book value is problematic.

Recommendation 7. RBC Changes - As stated in the Executive Summary, the proposal to require one of the parties to the financing transaction to hold an RBC "cushion" via a required RBC calculation raises several issues, as does the proposed risk charge related to the qualified actuarial opinions.

First, the use of the new term "RBC cushion" has caused confusion. We note that the purpose of RBC is, technically, to identify weakly capitalized legal entities for purposes of regulatory action, not to specify an additional "cushion", although holding a capital "cushion" is generally the practical effect of an RBC calculation. We also note that the existence of "Other Security" already provides a "cushion" that is unique to financing transactions. Pending additional clarification of what the framework intends, at this time we cannot definitively support or oppose the RBC portion of the framework.

Second, with respect to a required RBC calculation, a major issue of concern would be the specification of RBC charges for LOCs or "Other Security". Such charges must be determined fairly, with due process, and be reasonably related to the true risk of default of the securities. If not, a new problem (excessively conservative capital requirements) will simply replace the remediated problem (excessively conservative reserve requirements).

In addition, if the ceding company were to perform the RBC calculation, it is not clear how the calculation would be done mechanically or what the meaning of the result would be. Mr. Rector could be envisioning a hypothetical calculation assuming the unwinding of the financing transaction, or a combined cedent-plus-captive RBC calculation, or an increase to the current C-1 risk charge applied to ceded reserves, or something else.

Third, with respect to the proposed review of risk charges related to qualified actuarial opinions, we believe that Mr. Rector may be misinterpreting certain technical details of the existing RBC framework. Mr. Rector has correctly observed that the type of actuarial opinion, qualified versus not, impacts the risk charges related to asset-liability mismatch risk (the "C3 RBC" charges). A discounted C3 RBC risk charge is allowed if an opinion that is not qualified is provided. However, the reason for the current discount for an opinion that not qualified is tied tightly to the matter of asset/liability mismatch risk, which is the target of the C-3 risk charge and also a central consideration, some would say "the" central consideration, in asset adequacy testing. An unqualified actuarial opinion on reserves suggests that asset-liability interest rate mismatch risk has been assessed and is not at extreme levels, so an unqualified opinion merits a reduced mismatch risk charge. Removing the C3 RBC discount on account of an opinion qualified on grounds other than asset/liability mismatch would impose an RBC penalty of a
size and amount completely unrelated to the reserve financing concern triggering the qualified opinion. Accordingly, the NAIC should make changes to the RBC instructions so that a qualified opinion based solely on the failure to meet the Primary Security Requirement does not preclude the ceding company from using the discount allowed for companies with otherwise unqualified opinions in the determination of C-3 risk charges.

Finally, the existing RBC framework assigns no explicit, across-the-board risk charge for unqualified actuarial opinions. We believe this is appropriate. The actuarial opinion relates to reserves, not risk-based capital. The remedy for a qualified opinion has historically been addressed through the reserves themselves or through strengthening processes underlying their testing. Experience has shown that the additional regulatory scrutiny resulting from a qualified actuarial opinion has provided a powerful incentive to avoid such opinions, and we envision that incentive will only increase under Mr. Rector’s proposed framework. We do not perceive a need for a new risk charge related to qualified actuarial opinions.

**Recommendation 8. Evaluate Risk Transfer Rules** – ACLI does not believe that Risk Transfer Rules need to be evaluated. The rules are designed to protect policyholders of the ceding company. They focus on risk being transferred from the ceding company at the legal entity basis. As long as the ceding company does not retain the risk, risk transferred to a captive or holding company has no more impact on the policyholders than that ceded to any unaffiliated reinsurer.

**Recommendation 9. Financial Analysis Handbook** – As stated in our recommended Framework, we agree with this recommendation. ACLI has previously submitted such a set of guidelines that would form a good basis to review captives. It is important to note that these guidelines should be only for Regulation XXX/AXXX-type captive arrangements entered into on or after 1/1/2015.

**Recommendation 10. Note to Audited Financial Statement** - We do not believe that a new note to the Audited Financial Statement is necessary. The Actuarial Opinion is a public document, and the Appointed Actuary must determine compliance or non-compliance with the Primary Security Requirement. Additionally, the calculations will need to be documented in the Actuarial Memorandum, which is available to every regulator in which the ceding company does business upon request. We believe that adding a note to the Audited Financial Statement will be a very expensive “check the box” exercise with little, if any, added value.
Appendix 2
Specific Comments on Exhibit 1 and Exhibit 2

Exhibit 1 - XXX/AXXX Reinsurance Framework

ACLI believes that Exhibit 1 should be re-drafted after decisions are made on ACLI’s concerns identified above regarding the Framework.

Exhibit 2 – Summary of Actions to be taken by Task Force Relative to the XXX/AXXX Reinsurance Framework

ACLI recommends a two-phase approach:

Phase 1:

ACLI recommends that charges to Blanks (E) Working Group, Financial Analysis Handbook (E) Working Group, Life Actuarial Task Force, and Statutory Accounting Practices Working Group should be acted upon at this time (Steps 1, 2, 3, 5, and 7.a). Charges for the Blanks (E) Working Group, Financial Analysis Handbook (E) Working Group, and Life Actuarial Task Force should be amended as specified in Appendix 1. The charge in Step number 7.a to the Statutory Accounting Principles Working Group should be amended to read:

“Develop the proposed definition for “Primary Security” for use in the Principle-Based Reserving Implementation (EX) Task Force’s future consideration of a proposed NAIC XXX/AXXX Reinsurance Model Regulation Actuarial Guideline AOMR and any future changes to the AOMR.” - Essential

ACLI believes that step number 4 (Adoption of the XXX/AXXX Reinsurance Framework and Exhibits 1 and 2), should be split into two parts. As part of Phase 1, step number 4.a, that portion of the Framework outlined in our Executive Summary, could be adopted in the near-term.

ACLI also believes that Step numbers 8.b and 8.c (with changes) can be included in this Phase 1 approach:

The charge in Step number 8.b (Develop appropriate asset charges for the forms of Other Security) should be changed to read:

“Develop appropriate asset RBC charges for the risk of default for the forms of “Other Security” used by insurers under the NAIC XXX/AXXX Reinsurance Model Regulation in satisfying the Primary Security Requirement as described in the Actuarial Guideline AOMR. These charges should be considered for incorporation into the RBC Cushion developed per the previous charge.” - Essential

The charge in Step number 8.c should be changed to read:

“Determine whether the current RBC C-3 treatment of qualified actuarial opinions is adequate for the purposes of the risks of XXX/AXXX reinsurance transactions that receive qualified actuarial opinions should be extended to qualified opinions made solely due to failure to meet the Primary Security Requirement for Regulation XXX/AXXX-type captive transactions.” - Essential

Phase 2:

ACLI believes step number 4.b, adoption of the remainder of the Framework, should be completed after further discussion and experience begins emerging under the adoption of Step 4.a. The suggested
further discussion should be the focus of a special interim meeting or an extended meeting at the Summer National Meeting. We believe that the Task Force should further discuss the desirability and need to open up the Credit for Reinsurance Model Law and Regulation.

Consistent with our comments on Step 4, the charges in Step 6 to the Reinsurance (E) Task Force should not be adopted in the near-term. However, this Step should be included on the list of Phase 2 items that need future discussion and focus.

Consistent with our comments in Appendix 1, charges in Step numbers 7.b (Develop a note to the Audited Financial Statements), 8(a) (Develop an Appropriate RBC Cushion), and 9 (Evaluate Risk Transfer Rules) should not be adopted.

We have no suggested changes to Step 10 (Charges to the Financial Accreditation Standards and Accreditation (F) Committee).
Appendix 3
Summary of ACLI’s Proposed Regulation XXX/AXXX-type Captive Reinsurance Framework

Phase I

1. Implementing the Primary Security Requirement - Using the authority granted in the Actuarial Opinion and Memorandum Regulation (AOMR), promulgate an Actuarial Guideline that acts as the vehicle for specifying the Actuarial Method for determining the Primary Security Requirement, based on a modified VM-20, for future Regulation XXX/AXXX-type captive reinsurance arrangements. This Actuarial Guideline should also set forth definitions used in the Framework, define the scope of applicability, provide remedies available for companies failing to meet the Primary Security Requirement, and stipulate conditions for issuing a qualified actuarial opinion. The Actuarial Guideline should also indicate documentation requirements for inclusion in the Actuarial Memorandum. This Actuarial Method should be applicable irrespective of whether the captive reinsurer is licensed, accredited, or unauthorized. Incorporate the Actuarial Guideline into the NAIC Accounting Practices and Procedures Manual. This should be an interim step to placing the new requirements directly into the AOMR, although the part of the requirements that define the Actuarial Method should remain in an Actuarial Guideline to maintain uniformity across the states and to allow for the Actuarial Method to be kept up to date as future changes to VM-20 are made.

2. Providing Transparency - Develop disclosure requirements pertaining to Regulation XXX/AXXX-type captive transactions. The specific elements of disclosure pertaining to the Primary Security Requirement and other Framework components. These requirements should only apply to future Regulation XXX/AXXX-type captive reinsurance transactions. They should also avoid inclusion of traditional reinsurance with professional reinsurers. Determine whether some disclosure requirements should be in a regulator-only supplemental filing.

3. Ensuring Appropriate Capital - Develop RBC charges for “Other Security”. The RBC charge should be a function of the default risk of the “Other Security” being provided. These requirements should only apply to future Regulation XXX/AXXX-type captive reinsurance transactions. Make changes to the RBC instructions so that a qualified opinion solely based on failure to meet the Primary Security Requirement does not preclude the ceding company from using the discount allowed for companies with unqualified opinions in the calculation of C-3 risk charge.

4. Developing Regulator Guidance - Prepare a new section of the Financial Analysis Handbook to set out procedures and provide guidance to regulators as they evaluate future Regulation XXX/AXXX-type captive transactions.

Decisions to be made to implement Phase I

1. Determine the appropriate scope of applicability of the Framework in regards to the types of reinsurers that trigger the necessity for the ceding company to include an analysis of their captive reinsurance arrangements in their AOMR. ACLI requests using our wording for scope of application.

2. Determine to what extent, if any, clean, irrevocable, unconditional “evergreen” letters of credit should be allowed as Primary Security in meeting the Primary Security Requirements consistent with the Credit for Reinsurance Model Law and Regulation. ACLI believes that all amounts of
clean, irrevocable, “evergreen” letters of credit should be allowed, as specifically defined by the Credit for Reinsurance Model Law.

3. Determine the need for a “capital cushion” for captive reinsurance transactions. ACLI believes that no “capital cushion” is necessary once the Primary Security Requirement is in effect.

4. Determine the need for the Net Premium Reserve to be included in the Actuarial Method.

5. Make technical decisions regarding the Actuarial Method and the application of the AOMR.

**Phase 2**

1. Based on decisions made on scope of application, collateral, and risk-transfer (see below), investigate the need for opening up the Credit for Reinsurance Model Law and Regulation.

2. Add a requirement for a Note to the Annual Audited Financial Statements, if needed based on decisions of the Task Force.

**Decisions to be made to implement Phase 2**

1. Determine the necessity of having collateral requirements for all Regulation XXX/AXXX-type captive reinsurance transactions. The Credit for Reinsurance Model Law does not include collateral requirements in connection with reinsurance ceded to “licensed” or “accredited” reinsurers. ACLI questions the need for collateral for captives that are licensed or accredited. Those captives should be treated no differently than other licensed or accredited reinsurers meeting the requirements of the Credit for Reinsurance Model Law for those statuses.

2. Determine whether Section 2.C. of the Credit for Reinsurance Model Law is applicable if the captive reinsurer is not subject its domestic state’s standards regarding credit for reinsurance, regardless of whether those standards are substantially similar to the standards of the domicile of the ceding company. If applicable, determine whether collateral requirements are needed for such companies. ACLI does not believe that captives fall under the scope of Section 2.C. of the Credit for Reinsurance Model Law.

3. Determine the necessity of evaluating risk-transfer rules in regards to future Regulation XXX/AXXX-type captive reinsurance transactions. ACLI does not believe that the risk-transfer rules are lacking in regards to captive transactions.

4. Determine the necessity of adding a Note to the Annual Audited Financial Statement requiring the ceding company and its independent auditor to indicate whether the Framework is being followed. ACLI does not think a Note in the Audited Financial Statements will add to the regulatory tools already being developed as a function of this Framework.
June 25, 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

Re: Comments to June 14, 2014 Rector & Associates Modified Recommendations

Commissioner McPeak and Superintendent Torti:

Thank you for the opportunity to share our comments on the June 4, 2014 Modified Recommendations to the February 17, 2014 Report of Rector & Associates to the Principle-Based Reserving Implementation (EX) Task Force (the Modified Rector Report, or Report). As requested we are limiting our comments to The Framework Approach (Exhibit 1) and Actions to be Taken by the Task Force (Exhibit 2).

We continue to appreciate the significant amount of work that members of the Task Force and Rector & Associates have expended on this project. Rector and Associates are to be commended for their methodical approach to outlining the numerous and in many instances highly technical issues that will need to be addressed to achieve the NAIC’s stated goal of developing regulatory standards for reinsurance specific to XXX and AXXX reserves. We also want to acknowledge the consideration that was given to comments from various groups to the February 17, 2014 Report regarding the timetable for the project, its scope, as well as expressions of concern about the so-called hazardous financial condition presumption.

Overall we find this description of the Framework to be an improvement over the prior version. While a number of highly technical details remain to be resolved there is much in the Framework with which we can agree. We have had the opportunity to review the comments submitted by the ACLI and generally find ourselves in agreement with their statements of support and recommendations. While in the interest of brevity we’ll not repeat all of those here there are a few particularly important points that we’d like to emphasize for the Task Force:
1. As described in the Framework, this project will be a complex task that will involve considerable time, effort and coordination amongst a number of standing NAIC technical committees. While delegation of the technical work to those groups would be entirely appropriate, it will be vital for the Task Force to provide clear guidance and ongoing direction to those committees. To assist the Task Force we recommend that it establish a project management function responsible to ensure proper communication and coordination amongst the various technical groups and with the Task Force, and to ensure that the entire project remains focused and on track.

2. While we acknowledge having some reservations supporting a Framework before the technical details have been identified, the Task Force should quickly establish a process by which those issues can be identified and the Task Force can provide the necessary guidance to the technical committees before they begin work.

3. The Framework should not delay or otherwise disrupt the ongoing work being done on PBR.

4. The Framework must be consistent with existing state laws and must not interfere with existing regulatory discretion provided by the laws in each state.

5. The Framework should be limited to XXX/AXXX captives, should ensure that future XXX/AXXX captives will be permitted, and should be applied prospectively only to captive arrangements formed after the implementation date.

6. The net premium reserve should not be included as a component of the Actuarial Method.

Thank you for the opportunity to submit our comments. We look forward to working with the Task Force and technical working groups on this important project.

Respectfully Submitted,

Scott R. Harrison
Executive Director
June 25, 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

RE: Comment on the Rector & Associates, Inc. Exposure Draft

Dear Co-Chairs Torti and McPeak:

I am writing to note my support of the Framework recommended in the Rector & Associates, Inc. Exposure Draft dated June 4th (the “Draft”). 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.

In particular, I strongly support the recommendation to require disclosure of XXX/AXXX Reinsurance transactions in a format similar to that provided in Exhibit 5 of the Draft. As stated in my last comment letter (dated March 21, 2014), 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 should be accorded “top-secret” status and recommend the Task Force should further whether it is appropriate to allow captive insurers to avoid public financial disclosure requirements.¹

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

Sincerely,

/s/

Brendan Bridgeland
Director

¹ As noted in my prior comment, CIR believes that disclosure requirements should apply to all parties and that obstacles concerns due to confidentiality laws in some captive jurisdictions are less important than assuring consumers that their insurance benefits are secure.
June 25, 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 additional comments, supplementing those we provided on the February 2014 report, regarding the recent June 4, 2014 Rector & Associates Report to the PBR (EX) Task Force. Many of our comments are simply to reaffirm our support for the recommendations that have been previously proposed. Connecticut feels that this report and the proposed “Framework” provide a sound foundation for regulating reinsurance financing transactions.

Our comments are as follows:

- We support that idea of a “Framework,” even as this continues to be finalized. We encourage regulators to look at the big picture and to not get mired in the minutiae at this critical juncture.
- We feel that this should not be limited to just AXXX/XXX captive transactions. There are many aspects of the Framework that could and should apply to all captive transactions. Most of the recommendations that the report makes (beginning on page 1 of the latest report) can apply to any transactions. One example is the rules for “Other” assets/securities that back the non-economic reserves, which should apply to all captive transactions.
- An example of one feature that does not apply across all captive transactions is the use of a modified VM-20 as the “actuarial method.” That said, we encourage sweeping in a similar actuarial method for captives involving AG-43 (which is already a form of PBR), and ultimately, VM-22 once adopted. For captives related to reserves other than VM-20 or AG-43, it should be up to the commissioner’s
discretion until such time there is an actuarial method in the Valuation Manual for that product.

- In Exhibit 1, #3, the third bullet point states “Portions of the statutory reserve exceeding the Primary Security Requirement may be collateralized by Other Security.” We want to receive clarification on whether these non-economic reserves must truly be collateralized by (i.e. held in trust) or simply “backed” by other securities.

- With respect to using letters of credit as “Primary Assets” on a limited basis, we still do not support using these “non-traditional” assets as primary assets.

- In Exhibit 3, III.C, the report states the following: The Appointed Actuary may not issue a non-qualified actuarial opinion if one of the company’s affiliated reinsurers issues a qualified actuarial opinion. We feel there needs to be more guidance on this section and should be reworded.

  For example, is it the intention of the report to force one of a companies’ appointed actuaries (e.g. ABC Life and Annuity) to file a qualified opinion if an affiliate company (e.g. ABC Life and Accident company) has issued a qualified opinion just because ABC Life and Annuity is an affiliate company even if the captive transaction in question doesn’t involve both companies? We do not believe this was the intention.

  Also, if the qualified opinion is on a small block of policies which is immaterial to a company higher up the holding company chain, does that higher company really have to issue a qualified opinion if the size of the liabilities at the lower company are small? We suggest that rules to account for materiality should be included in this instance.

The Connecticut Insurance Department continues to offer its support in refining and shaping this regulatory framework. Please let us know if you have any questions.

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
June 25, 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 for Revised Rector Report

On behalf of Commissioner Stewart, I present the following in regard to the revised Rector Report.

1. For the second time, the Rector Report fails to address the impact of the proposed changes for the consumer? Despite the fact that Commissioner Stewart has repeatedly called upon the PBR Task Force and the authors of the Rector Report to consider the impact on the consumer, this important question has been repeatedly ignored. Once again, the Rector Report fails to address the effect on consumers if the Report’s recommendations are adopted.

A very germane policy consideration for every insurance commissioner is whether they are willing to adopt the Report’s recommendations while at the same time ignore the fact that a vote in favor of adopting the recommendations is also a vote to make life insurance more costly and less affordable for the policyholder.

Commissioner Stewart is very concerned that the recommendations once implemented will make certain forms of life insurance more costly and less affordable. The recommendation will result in insurers facing much greater significant capital demands. A result can be that 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, the long-term consequences are that insurers will have to contribute more capital depending upon the insurer’s determination of appropriate company
action level capitalization ratios. If the recommendations are adopted, premium rates could soon rise by an amount the regulatory community has yet to identify. Because the regulatory community does not know or understand the impact on consumers, the PBR Task Force must address the consequences of the recommendations before adopting a proposed framework.

2. There is no evidence that life reinsurance captive insurers create a systemic risk or there is a particular risk related to a specific captive insurer. To date, no one has identified an actual risk related to captives on either a systemic or specific basis. A systemic risk is an issue inherent in the concept of using captive reinsurers, while a specific basis is when a particular captive presents a risk of failure. Are insurance commissioners ready to cast a vote that will make certain life insurance products more costly and less affordable in the absence of either a systemic or specific risk?

3. The question of whether the regulators will prohibit the use of captive insurers after the implementation of Principle-Based Reserving is a major policy decision that deserves open and transparent debate. The revised Report continues to rely upon a directive from the PBR Task Force that the use of captives should be prohibited after PBR’s implementation. Unfortunately, the directive to prohibit captives was neither voted upon nor debated. To illustrate, on page 5 of the original report, the authors write that they received direction from the PBR 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.

4. The Actuarial Method recommended by the Report should eliminate the Net Premium Reserve (NPR). The revised report does address the 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.

5. Transfer the captive insurance discussion to the Captives (EX) Working Group.

Last summer the members of the NAIC voted to adopt the Principles-Based Reserving Implementation Plan. This plan created the Captives (EX) Working Group. Page 12 of the PBR Implementation Plan reads,

The NAIC needs to further assess the solvency implications of life insurer-owned captive insurers and other alternative mechanisms in the context of PBR. The solution for captives and SPVs within the context of PBR will be largely based on Captives and Special Purpose Vehicle (SPV) Use (E) Subgroup’s report as adopted by the Financial Condition (E) Committee and referred to the PBR Implementation (EX) Task Force. The Task Force will create a Working Group to concentrate on this issue and propose the way forward.

Via the captive white paper and PBR Implementation Plan, the NAIC has created a road map for addressing life insurer-owned captives. Unfortunately, the NAIC is not following the map it created. Instead of one centralized working group to address captives, there are three separate approaches. First, the Financial Analysis Working Group (FAWG) conducted a survey of life-insurer owned captive insurers. Second, the F Committee has taken comments whether life-insurer owned captive insurers should be subject to the accreditation standards. Third, the PBR Task Force is continuing to consider the Rector Report. Instead of this fragmented approach, Commissioner Stewart believes that a working group whose single focus is captive insurance should “concentrate on the captive insurance issue and propose a way forward.” As a result, the members of the Captives (EX) Working Group should be appointed as soon as possible primarily with regulators knowledgeable and familiar with captive insurance transactions and regulators whose domestic ceding companies transfer risk to captives.

Thank you for considering these recommendations and I look forward to addressing the Task Force during the August meeting.
From: Mark Birdsall [mailto:MBirdsall@ksinsurance.org]
Sent: Wednesday, June 25, 2014 4:10 PM
To: DeFrain, Kris
Cc: Fleming, Dave; Abitz, Kenneth
Subject: Kansas comments on updated captives framework

Kris,

Hi! The following represents comments from the Kansas Insurance Department regarding the revised Rector Report recommendations:

With respect to the issue raised on a recent PBR ITF call regarding the current impact of a qualified actuarial opinion on RBC, our research has shown that the current charge for a qualified opinion is located on lines (10) and (26) of LR027 and is equal to (0.0231-0.01564) times the respective Exhibit 5 reserves for single premium life, non-variable annuities and miscellaneous reserves, which includes substandard, deficiency reserve, IPC, and additional actuarial reserves due to asset adequacy analysis. Therefore, lines (10) and (26) of LR027 would likely need to be modified to properly address the following recommendation from the updated Rector Report: “We also recommend that the NAIC evaluate whether the current RBC “charge” relative to qualified actuarial opinions is appropriate.”

Please note also that the RBC factors on LR027 are decreased by one-third if the company submits an unqualified actuarial opinion based on asset adequacy testing. Thus, the treatment of a qualified opinion is to assign a non-reduced factor. The charge to CATF may need to be revised to be more consistent with this approach in the RBC Instructions.

The 12/2014 date on page 4 in the body of the report is inconsistent with the 12/2015 date under number 8 in Exhibit 2. Clarification of this is needed with the understanding that 12/2014 would be problematic.

We have questions regarding how the RBC calculation requirements would be applied to an entity not subject to RBC requirements. If inputs would need to be provided by such an entity that do not conform with statutory inputs currently required for RBC calculations, there are comparability and auditability issues.

With respect to the CATF charge to develop RBC factors for the “Other Assets” contemplated in the captives framework, we note that CATF would have until June 30, 2015, to meet this charge for these new factors to be effective at year-end 2015. We believe this is an adequate time-frame to accomplish the required work.

We support the use of a modified version of VM-20 as the basis for calculation of the amount of Primary Assets in the Rector Report recommendations. We believe it is very important to recognize that to achieve the stated goal of reducing or eliminating the need for captives being used to finance redundant statutory reserves, the material implicit margins currently in VM-20 would need to be removed. One of the largest of these implicit margins is in the mortality assumption. Updating the mortality table to 2014 VBT/CSO will certainly help, but unless the projection of mortality improvement is permitted in the Primary Asset calculations, the captives framework may not achieve its stated goal. Both the recent New
York estimate and the estimate from the PBR Impact Study indicate that projected mortality improvement has a material impact on reserves. Therefore, as one of the modifications of VM-20 for the purposes of the captives framework, we strongly urge consideration of projections of mortality improvement. We note that reliable estimates of mortality improvement could be derived from the current analysis underlying the development of the 2014 VBT/CSO mortality tables. A process for updating these estimates of mortality improvement from time to time should also be established.

In the same vein, we believe it would be most appropriate to consider the calculation of a Current Estimate Reserve as a modification to VM-20 for use in the Primary Asset calculations. The Current Estimate Reserve would include no implicit margins, but would be loaded with explicit margins calculated either using the individual assumption margin approach from VM-20 or the aggregate margin approach developed for VM-22. In either case, the size of the total margins should be explicitly calculated in order to determine whether the reserves are at an appropriate level of conservatism for the calculation of Primary Asset amounts. Such an evaluation would be very difficult if there are material implicit margins in the calculation of the Primary Asset amount.

To properly calculate the Current Estimate Reserve, the risk profile of the particular products under review must be adequately reflected. For both term insurance and UL with secondary guarantees, risks other than interest rate risk are likely to be significant. Ideally, actuaries would like to calculate reserves using stochastic modeling of all the material risks associated with a product group. However, these calculations would be challenging to audit and time-consuming to make using current computer software and hardware. A practical alternative would be the Representative Scenarios Method developed by the American Academy of Actuaries Annuity Reserve Work Group for use with VM-22. Currently, Kansas is sponsoring a field test of these calculations that should be completed by early September. The basic idea is to select a relatively small number of representative scenarios at specified probability levels that will approximate the results from full stochastic modeling.

One of the revised recommendations from the updated Rector Report is to develop a new Actuarial Guideline with respect to the Actuarial Opinion and Memorandum Regulation. As noted on a recent PBR ITF call, LATF also had discussed creating an AG for the AOMR. The purposes for such a Guideline would include improving consistency of company actuarial practice in asset adequacy analysis and strengthening asset adequacy analysis to reflect the more complex multi-risk products and emergence of PBR. While it is clear that these purposes must not delay the implementation of the captives framework, we ask that consideration of these additional objectives be incorporated into the AOMR AG development as far as possible.

Respectfully submitted,

Mark Birdsall, FSA, MAAA, MBA
Chief Actuary
Kansas Insurance Department
785-296-1056
June 24, 2014

The Honorable Julie Mix McPeak, Commissioner
The Honorable Joseph Torti III, Superintendent
Co-Chairs, Principle-Based Reserving Implementation (EX) Task Force
c/o Kris DeFrain
Director, Research and Actuarial Department
NAIC Center for Insurance Policy and Research
National Association of Insurance Commissioners


Dear Commissioner McPeak and Superintendent Torti:


The North Carolina Department of Insurance (“NCDOI”) is pleased to see that the modified recommendations continue to address the PBR issues through regulation of the direct/ceding insurers. In the NCDOI’s attached letter dated April 10, 2014, to the Honorable John M. Huff, Chair of the Financial Regulation Standards and Accreditation (F) Committee, the NCDOI expressed its agreement with the Rector and Associates, Inc. statements in the February 17, 2014 report about the importance of focusing on the regulation of the direct/ceding insurers with regards to these PBR issues. However, the NCDOI does have concerns with the modified recommendations presented by Rector & Associates, Inc. for the following reasons:

- The “problem” that Rector & Associates, Inc. was directed to address has not been clearly identified with any degree of specificity. Therefore, additional regulation is unwarranted until a specific problem is identified. Item 2 of the NCDOI’s April 10, 2014, letter to Director Huff provides additional comments regarding this issue.
- The recommendations include a double hit to the RBC of certain ceding insurers due to the capital charge on “Other Assets” supporting noneconomic reserves and the RBC charge due to an insurer ceding to a reinsurer that is not subject to RBC. The NCDOI does not agree that both RBC charges are necessary.
Certain target dates included in the recommendations do not provide enough time for discussion, development, and implementation. Given the number of loose-ends that must be addressed, it appears more time will be necessary.

The proposal does not contain materiality thresholds.

The approach appears to be cumbersome, requiring action on numerous issues by various working groups, task forces and committees.

There are still outstanding issues relating to the reserves developed through the use of VM -20.

Commissioner Karen Weldin Stewart of Delaware, in her May 16, 2014, memorandum to Director John Huff, Chair of the NAIC F Committee, recommended the use of one centralized working group, the Captive (EX) Working Group, to address all captive issues. As Commissioner Stewart explained in her memorandum, this working group was created by the Principles-Based Reserving Implementation Plan, but no state has been appointed to the working group. The NCDOI agrees with this approach and believes the working group should be populated.

The NCDOI appreciates the consideration of the above comments by the Principle-Based Reserving Implementation (EX) Task Force.

Sincerely,

Wayne Goodwin
North Carolina Commissioner of Insurance

cc: Principle-Based Reserving Implementation (EX) Task Force
    Steve Kinion, Director, Bureau of Captive and Financial Insurance Products
June 25, 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 XXX/AXXX Reinsurance Framework (the "Framework") proposed by the Modified Rector Recommendations. We continue to advocate for a Framework that upholds principles of uniformity, transparency and effective risk transfer in order to preserve and strengthen the state-based system of insurance regulation. We appreciate the diligent effort by Rector & Associates, state regulators and others to develop the Framework in the face of the many obstacles that have been raised.

This exposure of the Modified Rector Recommendations presents an opportunity for a fresh assessment. If the proposed Framework is implemented, will the regulation of insurer use of captives meet the principles of uniformity, transparency and effective risk transfer? Or will gaps remain that leave the state system of insurance regulation open for criticism? We encourage policymakers to consider the following observations and make policy decisions to strengthen the Framework:

- Uniformity and effective risk transfer are not achieved unless all XXX and AXXX captives transactions are backed by appropriate assets. While the credit for reinsurance models allow for certain types of letters of credit or other contingent assets to secure a reinsurance obligation, a captive is not a traditional reinsurer. The proper focus should be on the assets available to meet policyholder obligations. (For this reason, we prefer
the term "primary assets" to "primary security". The ceding insurer must have access to traditional assets up to what the Framework now describes as the "Primary Security Requirement". Transactions that use letters of credit should not be left outside the Framework. Instead, such transactions should be subject to the Framework and letters of credit should not count towards the Primary Security Requirement.

If the Framework is implemented without these changes, have policymakers assessed whether transactions will migrate to letters of credit, and so sidestep the "Primary Security Requirement"?

- Effective risk transfer is unlikely to occur when a guarantee by a non-insurance affiliate of the ceding insurer keeps the risk within the group. This is so whether the guarantee is direct (the captive is capitalized with a guarantee) or indirect (the affiliate guarantee backs a letter of credit or "asset" issued by a third party). The NAIC should stipulate in the Framework that an "asset" backed by an affiliate guarantee does not count towards the Primary Security Requirement.

If the Framework continues not to account for risk being retained by non-insurance affiliates, are policymakers comfortable that effective risk transfer will be achieved?

- The ultimate goal of the Framework must be to restore uniformity to the capital and reserving rules insurance companies follow, whether they use captives or not. The NAIC has concluded that Principles-Based Reserving (PBR) is the ultimate solution. In order to remain true to that conclusion, the NAIC needs to make the Framework's Actuarial Method identical to the reserves under PBR, including the net premium reserve (NPR). Modeled reserves can be extremely sensitive to assumptions. The NPR provides assurance that minimum standards will be maintained. Proponents of the status quo with respect to captives have argued that some parts of PBR are flawed. If true, the response should be to modify PBR, which can be accomplished through changes to the valuation manual. The response shouldn’t be to perpetuate a second, lower reserve standard.

If the NPR is not included in the Framework, have policymakers considered the possibility that support for PBR will wane, thereby jeopardizing eight years’ worth of work?

- RBC is the state regulators' primary metric for determining whether an insurer is adequately capitalized. RBC has proven itself an effective tool. If that metric is going to retain its value in ensuring solvency, the ceding insurer should be required to maintain the "RBC cushion" described in the Modified Rector Recommendations, and that cushion should be applied universally.

We support the increased disclosures and the proposed note to the ceding insurer's audited financial statements, recognizing that these will improve transparency. We believe that the Framework should go further. Consistent with the treatment of permitted practices, there should be disclosure of the effect on surplus of using assets not admitted under uniform NAIC rules to support reserves. This disclosure should apply to both new and existing captives. Proponents of captives state that there is no weakening of solvency standards. The NAIC should require disclosure which allows all stakeholders to verify this claim.
In order to preserve state-based insurance solvency regulation, there is no substitute for regulators making difficult decisions in order to achieve a strong framework for regulating XXX and AXXX captives. We encourage the NAIC to do this expeditiously and to move on to addressing other uses of captives that were not contemplated by current regulation.

Sincerely,

David R. Remstad, FSA, MAAA
Senior Vice President & Chief Actuary
June 25, 2014

Via Electronic Delivery

The Honorable Julie Mix McPeak
Commissioner
State of Tennessee Department of Commerce and Insurance
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The Honorable Joseph Torti, III
Superintendent
State of Rhode Island Department of Business Regulation
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Re: Rector & Associates, Inc. Modified Recommendations concerning the regulation of XXX/AXXX reserve financing structures

Dear Commissioner McPeak and Superintendent Torti:

We have reviewed the Modified Recommendations issued by Rector & Associates, Inc. ("Rector & Associates") dated June 4, 2014 (the "Modified Recommendations") that have been exposed for comment by the National Association of Insurance Commissioners’ (the "NAIC") Principle-Based Reserving Implementation Task Force.

We appreciate the effort by the NAIC and Rector & Associates to develop the Modified Recommendations. From the outset of the NAIC’s work on the captives issue, beginning with the development of the NAIC’s white paper, New York Life has consistently stated that any regulatory reform should include a uniform and appropriately conservative framework to govern the use of captive structures to finance life insurance reserves. Unfortunately, the Modified Recommendations fall short of meeting that goal.

Unlike the original recommendations included in the report issued by Rector & Associates, dated February 17, 2014 (the “Original Report”), the most effective enforcement mechanism included in the Modified Recommendations will take years to implement, allowing the very transactions the NAIC is trying to eliminate to continue unabated in the meantime. In effect, if the NAIC adopts the Modified Recommendations, it would be endorsing the status quo.
Unpersuasive Legal Arguments

In comments on the Original Report, some representatives of the life insurance industry questioned the legality of the enforcement mechanisms proposed. We disagree with the arguments advanced by these critics. It is difficult to imagine that when enacting the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") in the aftermath of the financial crisis, Congress intended to protect captive life reinsurance structures designed to circumvent uniform national reserving and solvency requirements for life insurers. In reality, Dodd Frank’s preemptive regulation and regulation of credit for reinsurance and reinsurance agreements was intended to facilitate transactions with third party reinsurers. By interpreting Dodd Frank in a way that does not allow implementation of the recommendations in the Original Report in a timely manner, the NAIC is allowing Dodd Frank to be used to perpetuate structures that undermine strong solvency regulation and therefore diminish consumer protections – outcomes directly contrary to the goals of Dodd Frank.

Legitimizing the Status Quo

If the NAIC adopts the Modified Recommendations, it would allow unpersuasive legal arguments that have not been tested in the courts to forestall an effective regulatory solution to a pressing solvency issue. Ironically, by preserving the status quo, the NAIC would jeopardize the implementation of its self-proclaimed long-term solution to the captives issue – principles-based reserving ("PBR").

In our view, adopting the Modified Recommendations would actually be worse than doing nothing at all. By adopting an inadequate framework, the NAIC would legitimize questionable financing structures that undermine important solvency protections. Without effective and uniform regulation of captive structures, PBR, even if it becomes effective, will be rendered meaningless. Individual companies and regulators can and will continue to set reserves on an ad hoc basis via captive structures. The added modeling work and complexity associated with PBR will be a wasted effort.

Others argue that captive structures increase availability and lower prices on insurance products and therefore benefit consumers. However, lowering prices at the expense of effective solvency regulation actually harms, rather than helps, policyholders. As evidenced by the strength of the state-based insurance regulatory system over many years, strong uniform reserving and solvency regulation is the best consumer protection.

The NAIC Should Simply Fix the Reserving Requirements

As we have stated in previous comment letters, we believe that statutory reserving requirements should be set at appropriately conservative levels and that any demonstrated reserve redundancies should be addressed directly and uniformly through the underlying valuation requirements. This fundamental principle should guide any regulatory solution
to the problem of captives. As currently contemplated, the Modified Recommendations do not support this goal.

Rather than adopt the approach set forth in the Modified Recommendations, we respectfully urge the NAIC to instead focus its attention on immediately reforming the underlying formulaic reserving requirements on an interim basis until PBR is implemented nationwide. While it may be difficult, if not impossible, to achieve a “perfect” formulaic solution, it is certainly possible to implement an interim solution that would provide meaningful relief in a reasonably short timeframe. The recent proposal by the New York State Department of Financial Services to reform the term reserving formula could serve as a useful starting point for this effort. By right-sizing reserve requirements directly, and eliminating the use of captive structures to finance life insurer reserves, state regulators can both address a serious solvency issue in a rigorous and uniform way and increase the likelihood that PBR will become effective as quickly as possible.

**Action is Urgently Needed**

Captive structures have been subject to discussion and debate by state regulators for over two years, and the NAIC issued its white paper on this topic over a year ago. A multitude of third parties, ranging from the Federal Insurance Office, Financial Stability Oversight Council and international regulators to rating agencies and academics, have weighed in on the use of captives by life insurers and expressed significant concerns. This is a critical solvency issue – perhaps the most critical solvency issue facing state insurance regulators today. Given the importance of the issue, and the significant time and resources devoted to it, we respectfully urge the NAIC to immediately begin developing revised formulaic reserving standards, to be effective for business written on and after January 1, 2015. In the interim, state insurance regulators should strongly consider implementing an immediate national moratorium on life reinsurance captive transactions by denying reinsurance reserve credit for any future cessions to such captives (regardless of when the captive was formed or when the underlying policies were written).

While we expect captive using companies and captive domicile jurisdictions to oppose such action, it should be noted that all have been on notice since at least June 6, 2013, the date of the final NAIC Captives and Special Purpose Vehicles White Paper, that state regulators are seriously considering fundamental changes to the regulation of life insurer captives. The fact that questionable structures have continued to be used since that date should not be allowed to impede the ability of regulators to address the issues raised in the white paper in a timely manner. Quite simply, companies will not be incented to fully support the development of interim revisions to the formulaic reserving requirements unless a moratorium is in place.

**Specific Concerns with the Modified Recommendations**

Turning to the specifics of the Modified Recommendations, we want to highlight two high-level concerns with the current proposals:
1. Unlike the presumption of Hazardous Financial Condition included in the Original Report, the “interim” approach using the Actuarial Opinion and Memorandum Regulation (the “AOMR”) is an inadequate deterrent to non-compliance and therefore will jeopardize support for the longer term revisions suggested in the Modified Recommendations, and potentially PBR.

While we appreciate that the AOMR approach can be implemented relatively quickly, we are skeptical that this approach will meaningfully change the practices of insurers and state regulators. Simply put, there is no effective enforcement mechanism – if there are no meaningful adverse consequences from a qualified opinion, insurers will not be incented to comply. As noted in the Modified Recommendations, there is an increased risk-based capital charge if an insurer’s actuarial opinion is qualified. However, unless a significantly higher charge is imposed, we do not believe this will serve as an effective deterrent for many companies given the risk-based capital benefits presented by many captive transactions. In addition, some have suggested that a qualified opinion will come with a stigma that companies will want to avoid. We doubt that this will be the case, particularly given that the ceding insurer’s domestic regulator would have approved the non-compliant captive structure.

We believe proponents of the AOMR approach find it to be attractive precisely because non-compliance will bring no meaningful consequences. Conveniently, this feature also allows the approach to sidestep the legal arguments that critics have raised in an effort to thwart the quick implementation of the more powerful enforcement mechanisms proposed in the Original Report. At their core, these legal arguments are premised on the idea that any meaningful adverse consequence for non-compliance with the framework is effectively a denial of reinsurance reserve credit. If that denial is not enforced by the domestic state, then the critics argue that it violates Dodd Frank’s preemption of extraterritorial regulation of credit for reinsurance and reinsurance agreements. If the denial is not expressly authorized by state credit for reinsurance law, then the critics assert that it violates the legal principle that a regulation (such as the AOMR) cannot override a statute. If a qualified opinion came with real consequences, it too would amount to an effective denial of reinsurance reserve credit in accordance with the critics’ own view of the legal analysis.

The longer term recommendations in the Modified Recommendations, including the proposed revisions to the Model Credit for Reinsurance Law, have the potential to meaningfully reform the use and regulation of life insurer captives. If the NAIC chooses to pursue implementation of the Modified Recommendations, the revisions to the model law form an integral part of the proposal that should be adopted. However, implementing these recommendations will take considerable time, in large part because individual state legislative action is required. If insurers are able to effectively maintain the status quo in the interim because the interim measures lack a viable enforcement mechanism, they may stall, delay, weaken and perhaps ultimately fight any long term solution.
2. Even the full package of recommendations fails to provide a uniform floor for the Primary Security Requirement, and leaves many questionable structures unregulated.

We continue to believe that it is critical that the net premium reserve (the “NPR”) be included in the Primary Security Requirement. Quite simply, no NPR means no uniformity across the states or even within the same state. We acknowledge that the current NPR is imperfect. However, an appropriate formulaic floor is a critical component of both PBR and the captives framework. Moreover, the current NPR was developed largely by industry, through the American Council of Life Insurers, and therefore reflects considerable input and analysis from both industry and regulators.

Much of the discretion and judgment permitted in the modeled reserve components of PBR is acceptable due to the existence of the formulaic NPR. Without this formulaic floor, there would be an overwhelming reliance on models and assumption setting and increased pressure on actuaries to take aggressive approaches. The only way that PBR could result in consistent, appropriately conservative reserves without a formulaic floor would be to add a great deal of additional prescription and oversight to the modeled reserve components (much like the approach taken in other jurisdictions that use a principles-based system, where company models are often reviewed and approved in advance by regulators). As currently contemplated, the deterministic reserve simply does not have this level of prescription.

In addition, if the NPR is removed from the Primary Security Requirement, but is retained in PBR, industry may lose its incentive to push for adoption of PBR, since under PBR the NPR will serve as a floor on company discretion. As alluded to above, removing the NPR from PBR itself is likely to be a non-starter for many regulators and companies. For the same reasons that the NPR is included within PBR, a formulaic floor should be retained in the Primary Security Requirement and regulatory actuaries should be given a strict time frame to make the NPR workable.

Finally, the Modified Recommendations leave open the question of whether unconditional letters of credit should be allowed as “primary security.” We see no reason that letters of credit should be exempted, particularly where affiliate guarantees and letter of credit reimbursement obligations defeat risk transfer.

*   *   *

Again, we appreciate the efforts of Rector & Associates and the NAIC to move toward a swift and effective solution to address the issues surrounding captives. We also appreciate your consideration of this comment letter. We believe the appropriate regulation of life insurers’ use of XXX/AXXX reserve financing structures is crucial to protect insurer solvency. As we have stated previously, we see this issue as a major threat to the future of the state-based insurance regulatory system. Unfortunately, because the Modified Recommendations substantially weaken the proposals in the Original Report, we do not believe that they mitigate this threat. Please let us know if you would like to discuss this letter with us or require any additional information.
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)

June 25, 2014

The Honorable Julie Mix McPeak
Commissioner
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The Honorable Joseph Torti, III
Superintendent
Rhode Island Department of Business Regulation, Insurance Division
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Re: USAA’s Comments Regarding the Modified Recommendations of Rector & Associates, Inc. to the Principle-based Reserving Implementation (EX) Task Force, June 4th, 2014 (the “Recommendations”)

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 comments on the Recommendations, which act as a roadmap for implementing the framework that Rector & Associates had proposed in its report dated February 17, 2014. We continue to support the general direction of Rector’s proposed framework and Recommendations.

We believe that the implementation of these Recommendations should promote adoption of Principle-based Reserves (PBR) and enhance regulatory consistency between companies that use XXX/AXXX captives and those that do not. We therefore offer the following comments on Exhibit 1 of the Recommendations:

**Actuarial Method:** We agree that the Actuarial Method should consist of VM-20, modified to incorporate changes to mortality tables as developed by the American Academy of Actuaries and any other modifications suggested by LATF. We are not in favor of altering or eliminating the “net premium reserve” component of VM-20. The net premium reserve facilitates the adoption of PBR by the states as it provides a minimum regulatory reserving standard which is the same across all companies. As noted by Neil Rector in these Recommendations, the net premium reserve helps ensure consistency between transactions and would help prevent the Primary Security Requirement from deviating substantially from what the reserve would be under PBR. Any alterations to the net premium reserve should only be made in the context of the Valuation Manual, so that the same PBR applies to companies that have captive arrangements in place and to those who do not.
Primary Security: We are not in favor of allowing letters of credit as Primary Securities within the framework envisaged in these Recommendations. As we stated in our earlier comment letter dated March 21, 2014, traditional insurance accounting rules have never allowed LOCs to be treated as admitted assets and 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.

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

Sincerely yours,

[Signatures]

Steven Alan Bennett
Executive Vice President
General Counsel & Corporate Secretary

William H. McCartney
Senior Vice President
Assistant to the General Counsel
For Special Projects