To: Hon. John M. Huff (MO), Chair, Reinsurance (E) Task Force

From: Doug Stolte (VA), Chair, XXX/AXXX Captive Reinsurance Regulation Drafting Group

Date: July 28, 2015

Re: Drafting of the XXX/AXXX Credit for Reinsurance Model Regulation: Key Discussion Topics

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Executive Summary

The Reinsurance (E) Task Force was charged to create a new model regulation to establish requirements regarding the reinsurance of XXX/AXXX life insurance policies, and further to amend the NAIC *Credit for Reinsurance Model Law* (#785) to provide for specific authority to implement this new model regulation. Specifically, the model regulation will implement new *Actuarial Guideline XLVIII—Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued Under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation* (AG 48), which will then be recommended to become an accreditation standard. The Task Force created the XXX/AXXX Captive Reinsurance Regulation Drafting Group to prepare the draft regulation (Attachment Five) and revisions to the Model #785 (Attachment Six) for review by the Task Force.

On a conference call of the Task Force dated Oct. 29, 2014, Director Huff advised that if the Task Force is of the opinion that any substantive modifications should be made to the AG 48 approach as it finalizes the model regulation, it should submit these proposed changes back to the Principle-Based Reserving Implementation (EX) Task Force for further guidance. NAIC staff was then directed to take suggested revisions and incorporate them into the draft document and to keep track of any substantive issues that were encountered by the Group in the Drafting process. NAIC staff has identified the following key discussion topics that were addressed by the Drafting Group during this process, and provided a brief summary of the discussion held and actions taken:

1. Consequence Options

The Drafting Group members proposed several potential credit for reinsurance "consequences" for ceding insurers that have a shortfall in either Primary Security or Other Security. NAIC staff was instructed to provide, for the Drafting Group's review and consideration, illustrations of these "consequence" options. The consequence options considered by the Drafting Group are described in detail within Appendix A of this memorandum. Within the discussion of the potential "consequence" options, several regulators questioned whether certain "consequence" options fell within the charges assigned to the Drafting Group by the Reinsurance (E) Task Force.

After a thorough discussion, the Drafting Group decided to draft Sections 7(A)(3) and 7(A)(4) such that the entire reserve credit is lost if there is a shortfall in either Primary Security or Other Security (i.e. Option 1"All or Nothing" in Appendix A). However, support for this option was not unanimous. The majority of the Drafting Group concluded that companies that seek to finance part of their reserves are being granted a "privilege," and that such a privilege should only be granted if the company fully complies with the applicable requirements, including the requirement that it hold Primary Security in an amount equal to or in excess of the Required Level of Primary Security. Further, the Drafting Group concluded that the retention of Commissioner discretion in determining what assets qualify as Other Security provided adequate options to enable companies to avoid any shortfall in Other Security.

Additionally, regardless of the option ultimately used, it would likely be in addition to a RBC charge consisting of an adjustment (increase) to the ceding insurer's Authorized Control Level RBC, as recently adopted by the NAIC in response to the recommendation of the Life Risk-Based Capital (E) Working Group (see section below).

2. <u>Life Risk-Based Capital Charges and Sunsetting of AG 48</u>

On an April 22 conference call, Life RBC adopted a structural change that incorporates a RBC charge, which increases the authorized control level RBC by the amount of any shortfall of Primary Security per Actuarial Guideline XLVIII (AG 48). It was stated on the call, that AG 48 would sunset upon adoption of the model. However, the RBC charge will be explicitly stated within the RBC calculation instructions and the intent of Life RBC is to have the changes remain in effect regardless of the model being adopted in a state. Some regulators voiced an opinion that, the drafting group's decision on a credit for reinsurance consequence option (as discussed above) should be made independently of whether the RBC charge continues after the sunset of AG 48.

3. <u>Dynamic Definitions</u>

Section 8 of AG 48 is a Sunset Provision, and provides that AG 48 "shall cease to apply as to ceding insurers domiciled in a jurisdiction that has in effect, as of Jan. 1st of the calendar year immediately preceding the year in which the actuarial opinion is to be filed, a law and regulation substantially similar to the amendment to the Credit for Reinsurance Model Law and new Model Regulation adopted by the NAIC pursuant to Recommendation #5 of the June 2014 Rector Report." This means there will be a period of time in which some insurers are subject to AG 48, while others are subject to the Model Regulation.

To address this issue, the Actuarial Method discussed under Section 6 of the model regulation is based on AG 48, and is intended to mirror AG 48 so that insurers in states with AG 48 and insurers in states with the model regulation apply the same Actuarial Method. Section 6 of the model regulation then requires the use of VM-20 of the Valuation Manual, which is defined under Section 5.F as the "Valuation Manual adopted by the NAIC as described in Section 11B(1) of the Standard Valuation Law, with all amendments through the effective date of this regulation and as subsequently amended by the NAIC." Section 2 of the proposed revisions to the Credit for Reinsurance Model Law (#785) is amended to specifically permit a commissioner to use the Valuation Manual adopted by the NAIC. Consistent with AG 48, this is intended to be a dynamic definition of the Valuation Manual; automatically incorporating amendments adopted which may be amended from time to time by the NAIC after the model regulation becomes effective in a state. This approach is similar to the approach taken in many states with respect to amendments to the NAIC *Accounting Practices and Procedures Manual*. A Drafting note has been added to Section 5 discussing how a state may adopt the Valuation Manual during this time.

Another issue that the Drafting Group discussed is the need to develop a process for updating VM-20 that can be used (before the PBR Operative Date) in states that do not permit state laws to incorporate by reference any documents that are subject to ongoing changes without legislative approval. Drafting notes acknowledging this issue has been added to the Model Regulation, and additional guidance to these states may be warranted.

4. <u>Net Premium Reserve (NPR) Tables</u>

Section 5.A. of AG 48 incorporated (through two Tables) a percentage of Net Premium Reserve (NPR) into the Actuarial Method to allow time for necessary calibrations to NPR to be made. The Life Actuarial (A) Task Force (LATF) is presently working on the NPR calibrations and expects that AG 48 will be amended to use 100% of the "recalibrated" NPR by no later than mid-2016. Accordingly, Sections 6A1 & 2 of the Model Regulation have been drafted to assume that the NPR "recalibration" has taken place. If amendments to the Valuation Manual to "recalibrate" the NPR have not been adopted by the NAIC on or prior to the date this Model Regulation is enacted by a state, the references to NPR in Sections 6A1& 2 may need to be modified.

5. <u>Actuarial Method Revisions</u>

Section 6 of the Model Regulation ("The Actuarial Method") is intended to be consistent with Section 5 of AG 48 (except with respect to the removal of the NPR Tables, discussed above), During the drafting process, some regulators suggested various revisions to the Actuarial Method to ensure 1) that the Drafting Group does not inadvertently make a substantive change to the Actuarial Method and 2) changes applicable to both AG 48 and the Model Regulation are identified and updated within both documents. NAIC staff recommended that Drafting Group member comments regarding the Actuarial Method be discussed with representatives of the Life Actuarial (A) Task Force so that, if appropriate, revisions to the Actuarial Method could be offered to the Model during the exposure period. It is anticipated that NAIC staff, members of the Life Actuarial (A) Task Force and members of the Drafting Group will further discuss this matter in the weeks leading up to and subsequent to the Summer National Meeting.

6. Materiality

Consistent with AG 48, Section 4C1 of the Model Regulation provides an exemption for ceded risks if, among other things, the assuming insurer prepares statutory financial statements in accordance with SAP, without certain permitted practices "that are material enough that they need to be disclosed in the financial statement of the assuming insurer pursuant to Statement of Statutory Accounting Principles No. 1 ("SSAP 1")." The drafting group discussed whether the materiality standard is clear enough. One regulator advised that several traditional licensed reinsurers regulated under traditional accreditation standards have asked how to interpret "materiality." For example, if the same company has multiple permitted practices, some of which increase surplus and some of which decrease surplus, should the increases and decreases be "netted" out in determining materiality? Additionally, a regulator identified a concern that financially strong companies are being questioned by their ceding insurers as a result of what is disclosed in financials, when it is clear that the companies are financially strong and regulated appropriately.

As a result of this review, it was suggested by one regulator that for a licensed reinsurer, if the permitted practice impacted surplus positively by a defined percentage or would cause RBC to decrease to below 450%; the permitted practice would be considered "material" for purposes of Section 4C1. Further, another regulator was supportive of trying to craft language that distinguishes between companies that merely have permitted practices and companies that need them. In essence this language would assist in identifying companies that would be financially strong without the permitted practice.

7. Title of Regulation

The Drafting Group considered two titles for naming of this regulation: 1) *Term Life and Universal Life With Secondary Guarantees (XXX/AXXX) Credit for Reinsurance Model Regulation* and 2) *Non-Universal Life And Universal Life With Secondary Guarantees Credit for Reinsurance Model Regulation* (Current Title Per Attachment Five).

CC: Members of the Reinsurance (E) Task Force
Members of the XXX/AXXX Captive Reinsurance Regulation Drafting Group
Josh Arpin, Statutory Accounting and Reinsurance Policy Advisor
Dan Schelp, Managing Counsel

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To: Hon. John M. Huff (MO), Chair, Reinsurance (E) Task Force
Doug Stolte (VA), Chair, XXX/AXXX Captive Reinsurance Regulation Drafting Group
Members of the Reinsurance (E) Task Force
Members of the XXX/AXXX Captive Reinsurance Regulation Drafting Group

From: Josh Arpin, NAIC Statutory Accounting and Reinsurance Policy Advisor

Date: July 25, 2015

Re: Background Information on Credit for Reinsurance Consequence Options

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NAIC staff was instructed to provide, for the Drafting Group's review and consideration, illustrations of the credit for reinsurance "consequences" options discussed in conjunction with the *Term Life and Universal Life With Secondary Guarantees (XXX/AXXX) Credit for Reinsurance Model Regulation*. This memorandum contains discussion of the four "consequence" options.

Through discussions, the Drafting Group determined that to be consistent with AG 48, the new model regulation, at a minimum, will need to provide that, in order to get full credit for reinsurance, the ceding insurer will need to hold Primary Security equal to the Required Level of Primary Security and Other Security up to the balance of the ceded AG 48 reserves. <u>If there is a shortfall relative to either component—Primary Security or Other Security—then the credit for reinsurance would be reduced, with the amount of the reduction determined pursuant to one of the options identified below. As noted below, the Drafting Group ultimately selected Option 1 (All or Nothing), although the selection was not unanimous</u>. Although a reduction could in theory be triggered by a shortfall in either Primary Security or Other Security, as a practical matter any shortfall is most likely to be a shortfall of Primary Security. Therefore, this was the scenario presented in the consequence option descriptions and illustrations, which assume the entity is holding the appropriate level of Other Security.

<u>Option 1: All or Nothing</u>

- Under this option, credit for reinsurance is <u>only</u> allowed if the entity maintains primary security holdings equal to the principal based reserve (required level of primary security). If the entity maintains the required level of primary security, the credit for reinsurance allowed is equal to the ceded AG 48 reserves (full credit for reinsurance). If the entity does not maintain the required level of primary security, no credit for reinsurance is allowed.

<u>Option 2: Dollar for Dollar Reduction</u>

- Under this option, the credit for reinsurance allowed is reduced dollar for dollar by the shortfall (if applicable) between the entity's primary security holdings and the required level per the PBR. This shortfall leads to a dollar for dollar reduction in the credit for reinsurance and requires the entity to establish a liability equal to the difference between the ceded AG 48 reserve and credit for reinsurance allowed.

<u>Option 3: Percentage Reduction</u>

- Under this option, the credit for reinsurance allowed is reduced by a proportional percentage of the shortfall (if applicable) between the entity's primary security holdings and the required level per the PBR. This shortfall leads to a proportional percentage reduction in the credit for reinsurance and requires the entity to establish a liability equal to the difference between the ceded AG 48 reserve and credit for reinsurance allowed.

Option 4: Primary Security Limitation

- Under this option, the credit for reinsurance allowed is based on the amount of the entity's primary security holdings. If the primary security holdings equal to the required level (PBR), full credit for reinsurance is allowed. However, if there is a shortfall between the primary security holdings and the required level, credit for reinsurance is limited to the primary security holdings. This limitation requires the entity to establish a liability equal to the difference between the ceded AG 48 reserve and the entity's primary security holdings.

After a spirited discussion, the Drafting Group decided to draft Sections 7(A)(3) and 7(A)(4) such that the entire reserve credit is lost if there is a shortfall in either Primary Security or Other Security (i.e., Option 1 "All or Nothing" in Appendix A), although support for this option was not unanimous. The majority of the Drafting Group concluded that companies that seek to finance part of their reserves are being granted a "privilege," and that such a privilege should only be granted if the company fully complies with the applicable requirements, including the requirement that it hold Primary Security in an amount equal to or in excess of the Required Level of Primary Security. Further, the Drafting Group concluded that the retention of Commissioner discretion in determining what assets qualify as Other Security provided adequate options to enable companies to easily avoid any shortfall in Other Security. Consistent with these conclusions, the AG 48 option to take a reduced reserve credit in exchange for posting a balance sheet liability pertaining to any shortfall has not been incorporated into the model regulation.

Additional discussion identified that regardless of the consequence option ultimately used, it would likely be in addition to an RBC charge consisting of an adjustment (increase) to the ceding insurer's Authorized Control Level RBC, as recently adopted by the NAIC in response to the recommendation of the Life Risk-Based Capital (E) Working Group. Several regulators are of the opinion that for purposes of the Drafting Group, the charges imposed by Life RBC should not be considered in the Drafting Group's decision on a credit for reinsurance consequence option.

For purposes of Drafting Group discussion, staff provided illustrations which factored in the Life RBC charge outlined above. For these illustrations, the RBC calculation was impacted by the following items:

- Total Adjusted Capital = Consequence Imposed by the Drafting Group (decrease)
- Authorized Control Level = Charge Imposed by Life Risk-Based Capital (E) Working Group (increase by the amount of the shortfall in primary security)

Historical RBC Consideration (Exhibit A)

As part of the consequence discussion, staff summarized historical RBC data from the Life Industry RBC Results documented on the Life Risk-Based Capital (E) Working Group webpage. For the year ending 2013, there was a total of 750 life companies, for which 91% (683) had a RBC ratio > 500% and 9% (67) <500%. Additionally, 54% (404) of companies had an RBC in excess of 1,000%.

Risk-Based Capital Life Industry Historical Results

The table below summarizes historical data from the Life Industry RBC Results documented on the Life Risk-Based Capital (E) Working Group webpage (http://www.naic.org/documents/research_stats_rbc_results_life.pdf)

Staff compiled this information for the Drafting Group to consider during discussions of the credit for reinsurance consequences and the potential RBC impact to life companies.

# of Companies	2013	2012	2011	2010	2009	2008	2007	2006
Ratio > 10,000%	67	71	69	75	74	83	90	96
Ratio < 10,000%	337	331	353	352	321	301	350	366
Ratio >500 & < 1,000%	279	273	281	279	292	323	320	354
Ratio >250 & < 500%	56	76	69	84	107	115	98	95
Ratio >200 & <250%	4	4	4	3	3	4	3	3
Ratio < 200%	6	6	9	11	16	21	11	12
Ratio of Zero	1	0	1	0	1	0	2	0
Total # of Companies	750	761	786	804	814	847	874	926

# of Companies	2013	2012	2011	2010	2009	2008	2007	2006
% with RBC > 1000%	54%	53%	54%	53%	49%	45%	50%	50%
% with RBC > 500%	91%	89%	89%	88%	84%	83%	87%	88%
% with RBC < 500%	9%	11%	11%	12%	16%	17%	13%	12%

Industry	2013	2012	2011	2010	2009	2008	2007	2006
TAC (In Millions)	472,894	455,931	429,883	415,751	384,906	337,861	382,628	363,475
ACL (In Millions)	49,206	49,014	47,140	46,280	46,103	44,597	47,719	44,798
Aggregate RBC %	961%	930%	912%	898%	835%	758%	802%	811%
Median RBC %	1053%	1032%	1050%	1047%	989%	910%	1009%	996%

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Industry	2013	2012	2011	2010	2009	2008	2007	2006
Reserves (In Millions)	2,596,165	2,524,931	2,535,994	2,398,890	2,240,333	2,212,832	2,071,960	2,052,496
TAC as % of Reserves	18%	18%	17%	17%	17%	15%	18%	18%

