Report of Rector & Associates, Inc.

to the

Principle-Based Reserving Implementation (EX) Task Force

February 17, 2014

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I. Introduction and Executive Summary

A. *Task Force's Charge and Prior Report*

The NAIC's Principle-Based Reserving (PBR) Implementation (EX) Task Force (the "Task Force") serves as the coordinating body for all NAIC technical groups involved with projects related to the PBR initiative for life and health policies. The Task Force is also charged with further assessing the solvency implications of life insurer-owned captive insurers and alternative mechanisms. The following charge was given to the Task Force by the Executive Committee:

> *Upon completion of the Captives and Special Purpose Vehicle Use (E) Subgroup's Report and subsequent referral by the Financial Condition (E) Committee, consider the Report's recommendations in the context of the proposed PBR system and make further recommendations, if any, to the Executive (EX) Committee.*

On September 13, 2013, we issued our Initial Report to the Task Force. That report, and this one, are to assist the Task Force with its work relative to the charge described above.

In our Initial Report, we described what led to the Task Force's charge, described the types of reserve financing transactions[1] at issue, discussed a Threshold Decision the Task Force would need to make, and set out a Framework for the Task Force's consideration in the event the Task Force responded to the Threshold Decision by allowing such financing transactions to continue.

To summarize, the use of financing transactions arises from the belief of some insurers that current reserving and statutory accounting requirements force them to carry traditional insurance admitted assets in larger amounts than is necessary, thereby increasing costs to insurers and policyholders. Those insurers want to fund reserve liabilities using assets, including traditionally non-admitted assets, that in their view better correlate to the probability the assets will be needed to pay claims. However, statutory accounting rules require insurers to support 100% of statutory reserves with admitted assets, even if the probability that the last dollar of the reserve will be needed is much lower than the probability that the first dollar will be needed. In response, some insurers have entered into reinsurance transactions to "finance" different portions of the statutory reserve differently—i.e., to fund different portions of the reserve using different kinds of assets—based on what the insurers believe is a better correlation between the kind of asset used and the probability that it will be needed.

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[1] Throughout this report, we refer to transactions in which an insurer seeks to reduce its effective net retention of XXX and AXXX reserves by directly or indirectly supporting a portion of those reserves, or a portion of a credit for reinsurance pertaining to those reserves, with other than traditional admitted assets as "reserve financing transactions" or "financing transactions," regardless of the form or manner such transactions take.

The Threshold Decision we asked the Task Force to make was whether to accept the general logic of those insurers—i.e., the logic that atypical, non-admitted assets should be allowed to support portions of the reserve that have a low probability of being needed to pay claims—or whether, instead, to seek to prohibit transactions that result in an economic effect different than the current statutory accounting requirement that admitted assets be used to support 100% of statutory reserves. The direction we received from the Task Force relative to that Threshold Decision, in general terms, was that financing transactions should be allowed to continue until Principle-Based Reserving ("PBR") is effective, but not thereafter, and only if in the interim such transactions meet the requirements of the Framework (page 8 of our Initial Report, and attached as Exhibit A).

B. *Our Recommendations Pertain to Assets Allowed to Support Reserves, Not to Reserve Level*

It is important to start by reminding the Task Force and the readers of this report that our recommendations, if adopted, would not impact any insurer's level of reserves. Insurers are legally required to establish reserves in amounts determined pursuant to the NAIC's Standard Valuation Law and related regulations and actuarial guidelines. Our recommendations do not affect this obligation in any way. Our recommendations pertain only to the types of assets permitted to support those reserves—for example, whether the reserves must be completely supported by assets that are traditionally allowed under insurance statutory accounting or whether, instead, other assets may be used to support a portion of the reserves (and, if so, the extent to which such other assets may be used). Regardless of what assets are allowed to support the reserves, however, the full statutory policy reserve must be established and must be supported in full by assets of one type or other.

C. *Our Recommendations are Not an Attempt to "Regulate Captives"*

Our recommendations also are not an attempt to "regulate captives." In our opinion, addressing the regulatory concerns regarding reserve financing transactions by focusing on the regulation of assuming insurers will ultimately fail and will lead to financing transactions moving off-shore or otherwise out of the reach of US regulators. Instead of focusing on regulation of the assuming insurer, our recommendations focus almost exclusively on regulation of the direct/ceding insurer and on trying to ensure that high quality assets in an appropriate amount will be available to the direct/ceding insurer to allow it to pay policyholder claims as they come due.

D. *Our Recommendations are Not Dependent on PBR Becoming Effective*

As readers of this report will note, our recommendations incorporate various aspects of PBR. For example, we recommend that the "Actuarial Method" used to determine the "Primary Asset Level" in connection with financing transactions be a modified version of "VM-20," the valuation manual that is at the heart of PBR. Readers will also note that, for ease of discussion, in places we have used definitive statements such as "once PBR becomes effective" that could lead to the mistaken conclusion that our recommendations are based on an assumption that PBR will in fact become effective, with the only open question pertaining to timing. Because of these references, it is important to point out that our recommendations are not dependent on PBR becoming effective, either in current or modified form. To describe our approach generally, we borrowed various elements developed in connection with PBR for use here in connection with financing transactions instead of creating similar elements out of whole cloth. We chose to borrow PBR-related elements for multiple reasons, including the efficiencies that can be gained by using something already developed rather than developing something new, the desire to recommend an approach that would be compatible with PBR if it becomes effective, and the direction from the Task Force that our proposals not serve as a roadblock to the adoption of PBR or to full compliance with PBR if it is adopted. We believe our recommendations are appropriate even if PBR does not ultimately become effective or even if it is only adopted after being altered significantly. Of course, in either of those events, the Task Force should take another look at our recommendations to see whether any should be modified, but we anticipate that, at most, a few minor adjustments to what we have recommended would be needed rather than wholesale changes.

E. ***Further Direction from the Task Force***

In the months following the issuance of our Initial Report, we received further direction from the Task Force regarding our work. As noted above, the general direction we received is that financing transactions should be allowed to continue until PBR is effective, but not thereafter, and only if in the interim such transactions meet the requirements of the Framework. In accordance with that direction, our work focused on the following:

1. Further evaluating the Framework, both as to Alternative A (via Reinsurance) and Alternative B (at the Direct Insurer Level); and

2. Evaluating possible Actuarial Methods[2] in light of whether they would effectively eliminate the financial incentive for financing transactions once PBR becomes effective (i.e., for business covered by PBR).

As part of our engagement, we were also asked to evaluate the conclusions and recommendations set out in the NAIC White Paper "Captives and Special Purpose Vehicles," dated June 6, 2013 (the "Captives White Paper").

Consistent with the tasks assigned to us and the direction we received, this report consists of the following items:

[2] In our Initial Report, the defined term used in the Framework was "Actuarial Standard." However in its comment letter dated January 15, 2014, the American Academy of Actuaries (the "Academy") noted that the term "Actuarial Standard" might cause confusion, prompting some to think it is referencing a formal *Actuarial Standard of Practice* (ASOP) promulgated by the Actuarial Standards Board. To avoid any such confusion, and at the Academy's suggestion, we use here the term "Actuarial Method."

- Our recommendations regarding each of the defined terms in the Framework
- Our recommendations regarding Alternative B (at the Direct Insurer Level)
- Our analysis of each of the "Issues to be Addressed" set out in our Initial Report
- Our evaluation of the conclusions and recommendations set out in the Captives White Paper

Each of those items is discussed below. At the conclusion of those discussions is a summary of key regulatory protections built into our recommendations followed by a summary list of our recommendations and then a summary of action items.

F. ***Executive Summary***

1. In substance, we recommend that the direct/ceding insurer only get credit for reinsurance if it retains (on a funds withheld or trust basis) "Primary Assets" in an amount approximately equal to what the statutory reserve would be under PBR.

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

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

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

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

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

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

8. The proposed effective dates for the new requirements are:
   - 7/1/14 for newly created financing structures
   - 12/31/14 for the new "Disclosure Requirements"
   - 1/1/15 for business ceded to existing financing structures
   - 12/31/15 for the new RBC rules

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

II. Terms Used in the Framework

The Framework outlined in our Initial Report is attached as Exhibit A. To accomplish the goal of making sure that a sufficient amount of high quality assets will be available to the direct/ceding insurer, the Framework proposes that the reserves of direct/ceding insurers must be fully supported by Primary Assets in an amount determined using the Actuarial Method. Other Assets may only be used to support portions of the statutory reserve exceeding that amount. The Framework also contemplates that key aspects regarding any financing transaction must be disclosed.

The Framework incorporates five defined terms: "Actuarial Method" [see footnote 2], "Primary Asset Level,"[3] "Primary Assets," "Other Assets," and "Disclosure Requirements." Our recommendations regarding those terms are discussed below.

A. ***Actuarial Method***

As described in our Initial Report, the most important aspect of implementing the Framework, and the most difficult to accomplish, is selecting the "Actuarial Method." The primary goal of the Actuarial Method is to set criteria such that, if presented with the same fact pattern, all insurers/regulators would reach substantially the same result regarding what portion of an insurer's statutory reserve must be supported by Primary Assets and, therefore, what portion may be supported by Other Assets. The Actuarial Method need not be a rigid "one size fits all" approach to achieve the desired consistency. Rather, the goal is to select an Actuarial Method that appropriately reflects differences in business mix and characteristics from one insurer to another, but one that also would lead to substantially the same result for any given insurer no matter who performs or oversees the actuarial analysis.

A second goal we described in our Initial Report was to select an Actuarial Method that achieves consensus acceptance by all (or at least most) regulators and insurers. As we noted, if regulators and insurers agree with the Actuarial Method selected, all other aspects of the Framework should fall into place and there should not be significant compliance issues in the years ahead. However, if either group is not comfortable with the method selected, the group not comfortable with the method may seek to achieve its objective through other aspects of the Framework and/or may attempt to achieve its objective through other means while still remaining technically compliant.

We have learned that it is easier to meet the first goal described above than it is to meet the second.

We have also been guided by the direction we received from the Task Force that the Actuarial Method selected should effectively eliminate the financial incentive for further

[3] In our Initial Report, the defined term used in the Framework was "Primary Asset Requirement." We changed the last word of the term to "Level" to avoid the awkwardness of saying "insurers are required to meet the …. Requirement."

financing transactions once PBR becomes effective. With these things in mind, **<u>we recommend that the Task Force select a modified version of VM-20[4] as the Actuarial Method</u>.** Such an Actuarial Method would meet the primary goal, in that it would lead to substantially the same result for any given insurer no matter who performs or oversees the actuarial analysis. It also would effectively eliminate the financial incentive for further financing transactions post PBR. Although such an Actuarial Method would not fully meet the second goal described above because a number of insurers believe it is too conservative, it appears likely that a modified version of VM-20 would be acceptable to most regulators, and to some insurers, and we believe it is the best and most viable option.

1. *Approaches we considered*

Our Initial Report identified a number of possible Actuarial Methods for consideration:

- The Primary Reserve Methodology set out in Actuarial Guideline XXXVIII ("AG 38"), Section 8D.a.
- VM-20
- A "synthesized insurer approach"
- A possible hybrid approach
- The International Financial Reporting Standards (IFRS) (not yet adopted)
- Standards used to calculate reserves pursuant to Generally Accepted Accounting Principles (GAAP)
- Cash flow testing approaches developed specifically for purposes of the Framework

Arguments could be made in support of each of those possibilities. However, the field of potential candidates narrowed considerably once we received direction from the Task Force that the Actuarial Method selected needs to effectively eliminate the financial incentive for further financing transactions once PBR becomes effective.

If the Actuarial Method leads to a Primary Asset Level that is significantly less than what the reserve would be once PBR becomes effective, then the financial incentive to engage in financing transactions will continue to exist even under PBR. Because the PBR reserve will be determined using VM-20, the only way to effectively eliminate the financial incentive for further financing transactions post PBR is to select an Actuarial Method that leads to a Primary Asset Level that is approximately equal to or greater than what VM-20 will be as of the date PBR is effective.

Only three of the possibilities listed above would satisfy that test: (1) the Primary Reserve Methodology set out in AG 38, Section 8D.a., (2) VM-20, and (3) (possibly) cash flow testing approaches developed specifically for purposes of the Framework.

[4] NAIC Valuation Manual, VM-20, Requirements for Principle-Based Reserves for Life Products.

2. *Cash flow testing approach ("total capital" approach)*

The American Council of Life Insurers (the "ACLI") has begun developing a cash flow testing approach that seeks to measure the adequacy of the assuming entity's "total capital" (reserves plus capital) to support the business ceded. Although we recognize and appreciate the work performed by the ACLI, we do not believe such an approach is viable here, especially not in the form envisioned by the ACLI.

One of the concerns we heard most frequently regarding financing transactions was the need for greater uniformity and consistency, so any approach acceptable to the Task Force would likely be stripped of much of the "flexibility" that the ACLI believes is one of the biggest strengths of its total capital approach. Further, to meet the Task Force's direction that the Actuarial Method effectively eliminate the financial incentive for further financing transactions once PBR becomes effective, any such total capital approach would have to be calibrated to a degree of conservatism that is approximately equal to that of VM-20 (for the reserve component) plus RBC (for the capital component). Although it may be possible to develop a total capital approach that approximates VM-20 plus RBC, it would not be easy to do so. That relative equivalency would also need to be proven to the Task Force and to the wider regulatory community—a difficult and time consuming task. Moreover, the new total capital approach, as it is being developed, focuses on the assuming entity's assets and capital, not on those of the direct/ceding entity, so the Task Force would need to be convinced that the approach would apply even if the assuming entity was domiciled off-shore or was otherwise outside the reach of US regulators and that it would appropriately adjust for differences between jurisdictions in matters such as accounting standards and allowable assets. The new total capital approach would also have to be developed in such a way that it could work at the direct insurer level (Alternative B of the Framework) as well as in connection with reinsurance transactions (Alternative A), adding an additional layer of complexity. Those advocating a new total capital approach would also have to respond to questions regarding why a new approach is needed, particularly since the new approach would be designed to result in a level of conservatism approximately equal to the already-developed VM-20/RBC approaches.

For these reasons, although we appreciate the work performed by the ACLI relative to its "total capital" approach, we do not believe it is the best approach here given the real world constraints that must be considered.

3. *AG 38 and VM-20 Approaches*

The two remaining possibilities—(1) the Primary Reserve Methodology set out in AG 38, Section 8D.a. and (2) VM-20—are related, in that the AG 38 approach is a modified version of the deterministic reserve component of VM-20 (as adopted by the NAIC Life and Annuities (A) Committee on August 17, 2012).

4. *Modifications to VM-20*

Rather than merely select the same modifications to VM-20 that were selected in 2012 as part of the AG 38 process, however, we concluded that it would be better to take a new look at VM-20 in light of new information available since 2012 and its different application here. Further, given the need for the Actuarial Method to result in a Primary Asset Level approximately equal to or greater than what the PBR reserves will be (calculated using all components of VM-20, and not just the deterministic reserve component), we also concluded that all of VM-20 needs to be factored into the selection of the Actuarial Method, rather than just one component of it.

The first two of our suggested possible modifications (relating to mortality tables and the interest rate generator) are based on our understanding that the version of VM-20 that will exist at the time PBR is effective will be different from the version that exists today. Our proposed modifications take the fluid nature of VM-20 into account. For example, VM-20 as it exists today references outdated mortality tables that will be replaced before PBR becomes effective. However, the new mortality tables will likely not be adopted until late 2014 or 2015. Accordingly, we propose an adjustment to bring the currently-referenced mortality tables closer to where the new mortality tables will likely be. Although no one today knows exactly how the new mortality tables will differ from the tables currently referenced by VM-20, some simple adjustments to the currently-referenced mortality tables are likely to bring them to "approximately" where regulators and insurers believe the new mortality tables will end up. We also believe that, to maintain the appropriate incentives per the Task Force's direction, it is better to err on the side of being more rather than less conservative in anticipating where VM-20 will likely end up under PBR.

The remaining possible modifications reflect our view that some adjustments may also be warranted given that VM-20 was developed for a different purpose than anticipated here.

Consistent with this logic, **we make the following recommendations regarding possible modifications to VM-20 for use as the Actuarial Method**:

- Mortality Tables

  As noted above, VM-20 as it exists today references mortality tables that are outdated and that will be replaced before PBR becomes effective; however, the new mortality tables will not be ready until after the date we recommend these new requirements become effective. To address this issue, **we recommend that the Task Force refer to the NAIC's Life Actuarial (A) Task Force ("LATF") a charge to work with the Society of Actuaries and the American Academy of Actuaries to develop factors or ratios that can be applied to the currently-referenced mortality tables to bring them closer to where the new mortality tables will likely be**.

- Interest Rate Generator

  We understand that the interest rate generator currently referenced in VM-20 may change in two respects before PBR becomes effective. First, it might be revised to have a faster reversion to the mean. Second, the mean reversion point itself might be modified to make the mean point more stable and less volatile. If these changes are made, they will likely not be ready until after the date we recommend these new requirements become effective. To address this issue, **<u>we recommend that the Task Force refer to LATF a charge to consider whether interim adjustments should be made relative to these items and, if so, to develop such adjustments for use in connection with the Actuarial Method</u>**.

- Net Premium Reserve

  Because it is important that the Actuarial Method lead to a Primary Asset Level that is approximately equal to or greater than what the reserve would be under PBR, and because the version of VM-20 used to determine the PBR reserve will include a net premium reserve component, it is important that the net premium reserve component be a part of the Actuarial Method. However, there are two elements of the net premium reserve component that perhaps should be modified before it is used here. First, unlike other components of VM-20, the assumptions used for the net premium reserve calculation are "locked in" at the inception of the calculation. Although that may be appropriate when VM-20 is used under PBR to determine an insurer's reserves—since the insurer will be continually adding new business, and each new addition will incorporate current assumptions—it may not be appropriate when used for a somewhat different purpose here relative to a closed block of business. For closed blocks, the assumptions used at inception would be "locked in" for the duration of the block of business without any new business being added using newer assumptions, thereby potentially leading to the calculation being inappropriately understated or overstated over time as reality differs from what was assumed at inception. Second, the net premium reserve calculation is calibrated to the stochastic and deterministic reserve calculations in current VM-20. As those calculations change (by referencing different mortality tables, for example), the net premium reserve calculation may also need to change to make sure the various calculations remain appropriately calibrated. To address these issues, **<u>we recommend that the Task Force refer to LATF a charge to consider whether adjustments should be made relative to these items and, if so, to develop such adjustments for use in connection with the Actuarial Method</u>**.

- Various wording and technical adjustments

  VM-20 was developed for the purpose of providing a method insurers would use to calculate a reserve. We are recommending it be used here for a related, but different, purpose: to determine an amount (a portion of an existing reserve) that must be supported by Primary Assets. Because we are recommending it be used for a somewhat different purpose than for what it was originally developed, there will likely be the need to interpret some aspects of VM-20 so they do not result in nonsensical or inappropriate results. Rather than engage in the extensive effort of re-writing VM-20 to modify it for use here, **we recommend that the Task Force allow insurers to use their actuarial judgment to make interpretations in these areas so long as insurers prepare a memorandum documenting the judgments made and the reasoning behind such judgments. We further recommend that the NAIC's Emerging Actuarial Issues Working Group, formed to deal with similar questions arising out of AG 38, be charged with issuing interpretative guidance regarding key implementation matters**.

Some or all of the modifications made may be less refined than the adjustments that will ultimately be included in VM-20. However, we believe even crude modifications can be moves in the right direction. As a general rule, we also believe simplicity in these areas is important and is to be preferred to something that is perhaps more refined, but also significantly more complicated.

B. *Primary Asset Level*

We recommend that the Task Force adopt the following definition of the required "Primary Asset Level": A level as to which the ceding insurer must hold Primary Assets—on either a funds withheld or trust basis—determined by applying the Actuarial Method to the policies at issue.

C. *Primary Assets*

We began by considering whether any "admitted asset" (as determined by the regulator of the direct/ceding insurer) should be considered a "Primary Asset" for purposes of the Framework. The primary argument in favor of this position is that "admitted assets" are allowed to support reserves at the direct insurer level.

We decided against recommending this position for several reasons. First, based on our discussions with regulators and insurers, we learned that there is a strong desire for uniformity and consistency in the treatment of financing transactions, yet states have different rules as to what constitutes an "admitted asset." In this regard, we especially noted that a number of states admit some non-traditional assets pursuant to "basket clause" provisions in their investment laws or otherwise. Given that a primary concern pertains to the assets used in financing transactions, we concluded that minimizing asset inconsistencies among states should be a goal. Second, since the "Other Assets" being allowed here to support a portion of the reserves may be less liquid and/or pose a greater credit risk than typical admitted assets, a more conservative approach to "Primary Assets" seems prudent. For these reasons, among others, we decided against recommending that "Primary Assets" consist of any asset deemed to be an "admitted asset" by the regulator for the direct/ceding insurer.

We then considered the various asset categories referred to in the *NAIC Model Credit for Reinsurance Regulation* (Model 786), Section 10. Based on discussions with regulators and insurers, there seemed to be a consensus that at least the following two categories of assets referred to in Section 10 should be allowed as "Primary Assets:" (1) cash and (2) Securities listed by the Securities Valuation Office of the NAIC (the "SVO"), including those deemed exempt from filing as defined by the Purposes and Procedures Manual of the SVO, and qualifying as admitted assets. There was not consensus, however, as to whether a third category of assets referred to in Model 786, Section 10, should be allowed as "Primary Assets": clean, irrevocable, unconditional and "evergreen" letters of credit meeting the requirements of Model 786, Section 10.A.(3).

Many insurers believe such letters of credit should be allowed as Primary Assets. Their primary argument is that Model 786, as it has existed for many years, allows an insurer to receive 100% credit for reinsurance ceded even if the only collateral backing the reinsurance recoverable is such a letter of credit. Those insurers argue that current law allows such letters of credit and that such letters of credit have been successfully used to back reinsurance for decades, so it would be consistent to allow them to constitute Primary Assets here.

In contrast, some regulators believe such letters of credit should not be allowed as Primary Assets, or that (at a minimum) any such letters of credit should be allowed to back only a minor part of the Primary Asset Level. The arguments for this position differ somewhat from regulator to regulator, but they appear to coalesce around the following. First, although current law might allow such letters of credit, what is being considered here is allowing insurers to use "Other Assets" (that are potentially less liquid and/or pose a greater credit risk than such letters of credit) to support a portion of the reserve. Regulators feel comfortable allowing such Other Assets only if the Primary Asset Level is supported fully (or primarily) by more traditional assets. Second, other regulators believe that allowing such letters of credit without restriction as to amount was a mistake in the first instance, and they would prefer that they never be used as a primary asset supporting reinsurance.

In addition to the reasons cited by regulators, we also note that the direction given to us by the Task Force is to try to make Alternative B (at the Direct Insurer Level) as workable from a practical perspective as Alternative A (via Reinsurance). Therefore, if such letters of credit would be allowed as a Primary Asset under Alternative A, then, for the sake of consistency, logic would say they should be allowed as admitted assets of the direct insurer under Alternative B. However, our sense is that most regulators do not want to grant admitted asset status at the direct insurer level to letters of credit—even to clean, irrevocable, unconditional and "evergreen" ones.

After balancing these various points of view, we recommend that such letters of credit generally be excluded from the definition of Primary Assets, except in one circumstance illustrated by the following example. Assume that, as part of a financing transaction, the direct insurer cedes XXX/AXXX business with a reserve equal to $100 million. Assume further that, using the Actuarial Method, the transaction results in a Primary Asset Level of $60 million. Accordingly, assume the transaction is supported at its inception by $60 million of Primary Assets (not including a letter of credit) and $40 million of Other Assets. All is fine as of the date the transaction commences.

Assume, however, that at the end of year two, due to claim payments, etc., the statutory reserve has dropped to $95 million and the Actuarial Method calculation leads to a Primary Asset Level of $55 million. However, assume that due to declines in the market value of the Primary Assets and payment of claims, the value of the Primary Assets has now dropped to $50 million. Under this scenario, even though the transaction was appropriately supported by Primary Assets at the date of inception, and even though no Primary Assets have been removed other than those needed to pay claims, the transaction is now not appropriately supported by Primary Assets.

The fluid nature of the modified VM-20 Actuarial Method, coupled with the fact that assets supporting the Primary Asset Level will fluctuate in value due to market changes, could periodically result in these types of "gaps" that would need to be filled. Obviously, one way to fill them would be to require the insurer to put more cash or SVO-listed admitted asset securities into the funds withheld or trust pool. Another way, however, would be to allow the use of letters of credit for the limited purpose of plugging these gaps. Letters of credit would probably be the better choice for this purpose because these types of gaps will come and go from year to year, based on what happens in the financial markets and in the Primary Asset Level. It may be easier and less expensive for an insurer to fill a gap—which may exist in year 1, but not in year 2, and then again in year 3, etc.—using an elastic letter of credit than adding more hard assets, which would also change in value with the market much like the other Primary Assets.

For these reasons, **<u>we recommend that the Task Force select the following as "Primary Assets":</u>**

- cash; and
- securities listed by the SVO, including those deemed exempt from filing as defined by the Purposes and Procedures Manual of the SVO, and qualifying as admitted assets.

<u>We also recommend that the Task Force allow the following to be used as a "Primary Asset" under limited circumstances, as described below:</u>

- clean, irrevocable, unconditional and "evergreen" letters of credit that meet the requirements of the NAIC Model Credit for Reinsurance Regulation (Model 786), Section 10.A.(3). However, such letters of credit should be used only for years subsequent to the year of inception of the financing transaction and only so long as such letters of credit in the aggregate comprise no more than 10% of the insurer's total Primary Asset Level.

D. ***Other Assets***

As noted in our Initial Report, we believe the decision regarding the types of assets permitted as "Other Assets" should be tied to what is selected as the Actuarial Method. If the Actuarial Method results in a Primary Asset Level high enough to cover the vast majority of realistic possible claims scenarios, significant flexibility is warranted as to Other Assets since there should be a low probability that such assets will be needed to pay policyholder claims.

As noted above, we recommend an Actuarial Method consisting of VM-20, as modified to bring it to approximately where it will be at the time PBR is effective. If the Task Force accepts our recommendation, the Actuarial Method will produce a Primary Asset Level approximately equal to what the total statutory reserve would be under PBR. As such, all insurers would be holding Primary Assets on a funds withheld or trust basis in an amount approximately equal to 100% of the PBR reserve. Since the portion of the current statutory reserve supported by Other Assets would not even need to be carried as a reserve if the business at issue were covered by PBR, imposing significant restrictions on Other Assets seems inconsistent and unnecessary. As such, **if the Task Force accepts our recommended Actuarial Method, we recommend that judgments as to what is appropriate to use as Other Assets should generally be left to the discretion of the regulators for the direct/ceding insurer and the assuming insurer—both of which are required to approve the transaction—with some additional oversight to be provided by the NAIC's Financial Analysis (E) Working Group ("FAWG")**. As procedures regarding these various items are being developed, the Task Force may also want to give consideration to how, and at what point in the process, regulators of insurers affiliated with the parties to a proposed transaction should be notified of the proposal. Appropriate RBC asset charges would also need to be developed relative to Other Assets to ensure that the direct/ceding insurer has sufficient capital/surplus, in addition to reserves, to pay policyholder claims.[5]

With this in mind, attached as Exhibit B is an illustrative template of possible categories to which RBC asset charges could be developed. Please note that we are not recommending the specific categories listed on Exhibit B. The list needs to be revised and refined. Exhibit B is provided merely as a template or starting point to help guide the NAIC Life Risk-Based Capital (E) Working Group (the "RBC Working Group") as it develops categories of Other Assets and relevant RBC asset charges.

For the reasons provided above, **we recommend that the Task Force refer to the RBC Working Group a charge to develop a list of assets that regulators, insurers and financiers believe will be commonly used as Other Assets and to determine RBC asset charges relative to each such asset** (including RBC charges for assets not specifically described and thus falling within a "miscellaneous" or "other" category).

[5] Our recommendations relating to RBC are set forth in greater detail in Part IV ("Issues to be Addressed"), Issue 4, of this report.

We further recommend that, once the Other Asset list is developed, the Task Force make decisions regarding which of the listed assets should warrant additional oversight by FAWG if used in financing transactions. In this regard, we believe that if the Task Force adopts our recommendation regarding the Actuarial Method, the primary purpose of FAWG's oversight should be to review particularly unusual or complex assets with the goal of minimizing the chance that such assets do more harm than good by introducing additional levels of risk to the insurer and/or the holding company system.

E. *Disclosure Requirements*

As noted in our Initial Report, appropriate disclosure regarding reserve financing transactions is critical so regulators and others will know that the rules are being followed and so they can more effectively measure the levels of risk presented by financing transactions. Appropriate disclosure can go a long way toward promoting the desired uniformity and consistency from insurer to insurer and regulator to regulator. Disclosure, alone, will not address the issues raised, but the Framework recognizes that appropriate disclosure is an important part of regulatory oversight.

The New York Department of Financial Services (the "New York Department") and the ACLI have each put extensive effort into identifying what they believe are appropriate disclosures regarding financing transactions. The NAIC has also recently adopted changes to various parts of Schedule S (reinsurance schedules) to identify and segregate transactions involving captive insurers. Our efforts in this area were significantly aided by all of this prior work.

Consistent with our general approach, we believe the Disclosure Requirements should be directed at the direct/ceding party to the transaction rather than at the assuming entity. Any attempt to require disclosure by assuming entities would likely run into obstacles, including the existence of confidentiality laws in some captive jurisdictions and the inability of the NAIC and US regulators to enforce disclosure requirements in off-shore jurisdictions. Moreover, our view is that the primary role of regulators here pertains to the impact of financing transactions on the financial health of the direct/ceding insurer. Imposing disclosure requirements on the direct/ceding insurer and in connection with the direct/ceding insurer's financial statements is consistent with that view.

Although the recommended level of disclosure is somewhat different for future reserve financing transactions than for existing transactions, we believe some disclosure of all reserve financing transactions is important. In that regard, we note that disclosure requirements initiated by the New York Department and those incorporated by the NAIC into the recent changes to Schedule S also cover existing financing transactions. Accordingly, we do not believe our disclosure recommendations pertaining to existing transactions will impose much of a new burden on insurers.

We have also been guided by the belief that disclosures should be made not only to regulators, but also to the public, so that policyholders, rating agencies, creditors, and others can understand the extent to which a particular direct/ceding insurer uses reserve financing transactions. We recognize the desire by some insurers to keep aspects of financing transactions confidential. However, unless key information about the direct/ceding insurer's use of reserve financing transactions is made public, at approximately the same level of detail as contained in existing public documents such as statutory financial statements, the financial condition of the insurer reported in such public documents may be incomplete or misleading. Public disclosure is needed at a level of detail sufficient to allow policyholders, rating agencies and others to assess the financial strength of one insurer as compared to another. We believe there should be a regulatory presumption in favor of public disclosure and that any decision to allow the presumption to be overcome should be made reluctantly and in a narrow, limited fashion.

For the reasons described above, **we recommend that the Task Force adopt provisions analogous to those outlined in Exhibit C as the "Disclosure Requirements" and that these items be disclosed publicly**. Please note that the attached exhibit is necessarily incomplete at this point. It will need to be modified to reflect final decisions regarding other aspects of the Framework, such as the list of Other Assets referred to above. Consideration should also be given to how information regarding multiple transactions involving different companies in a holding company system can be most efficiently captured to show the impact of financing transactions on the entire holding company group.

We further recommend that the Task Force refer a charge to the NAIC's Blanks (E) Working Group to finalize the Disclosure Requirements and add them to the Life Annual Statement Blanks.

III. <u>Alternative B</u>

The Framework included two alternatives: Alternative A (via Reinsurance) and Alternative B (at the Direct Insurer Level). Alternative B would give insurers the option of achieving substantially the same economic effect as Alternative A, but without using reinsurance. The Framework contemplates that a direct writing insurer using Alternative B would be subject to the same requirements as it would if it were a ceding insurer under Alternative A. In other words, the direct insurer would be required to establish its statutory (gross) reserves in full using applicable reserving guidance and to perform a review of those reserves using the "Actuarial Method," just as it would if it were a ceding insurer under Alternative A. Additionally, the direct insurer would be required to hold "Primary Assets" and "Other Assets" in the same amounts and subject to the same restrictions as if reinsurance were used. However, rather than holding those various assets pursuant to a reinsurance arrangement, the direct insurer would retain the assets and liabilities and would report them on its statutory financial statements.

Since the issuance of our Initial Report, we have learned that most insurers interested in financing transactions have continued to focus on transactions involving reinsurance—i.e., what we described in the Framework as Alternative A. We continue to believe, however, that reaching the same economic effect at the direct insurer level—Alternative B—is viable, and we anticipate there will be greater interest in further developing Alternative B once insurers understand the full scope of the new requirements applicable to Alternative A.

The biggest question insurers have regarding Alternative B is whether it is possible to sufficiently separate the reserves being financed from the rest of the direct insurer's reserves so third party financiers will continue to provide financing on a cost-effective basis. For example, suppose a third party financier is willing to issue a letter of credit that can be drawn down if the claims arising from a covered block of business exceed certain specified assets supporting that block of business. If the covered business and assets are ceded to a separate legal entity (such as a captive), then the third party can provide the letter of credit to that separate legal entity, can be quite confident that only that entity can draw on it, and can be confident that a draw will occur only if the claims arising out of that specified covered block of business exceed the specified assets supporting that block. The question being asked about Alternative B is whether a third party financier would have similar confidence that the letter of credit would only be drawn as intended if the letter of credit is issued to the direct insurer to cover reserves and assets that are retained by the direct insurer. The question posed is how to convince the third party financier that a rehabilitator or liquidator would not attempt to make a draw on the letter of credit if the direct insurer got into financial trouble for reasons unrelated to the covered block of business. It will be important to structure Alternative B to address this concern.

Based on preliminary explorations, we believe there are several ways that a sufficient separation of business and assets could be accomplished at the direct insurer level. For example, in some states it may be possible for an insurer to create a "protected cell" at the direct insurer level that would provide clear legal separation between the covered reserves and assets and the direct insurer's other reserves and assets. In other states, it may be possible to place the covered reserves and assets in a "separate account," again providing clear legal separation. There also may be ways to structure the asset being provided by the third party to eliminate (or at least minimize) the chance it could be called on to support business other than the business intended to be financed. For example, it might be possible to create an asset structured as a derivatives contract that operates much like financing assets in use today, and yet to do so in a way whereby it both constitutes an "admitted asset" at the direct insurer level and has preferential treatment in any insolvency proceeding.

In addition to the concerns cited by insurers, several of the regulators with whom we spoke were hesitant regarding Alternative B, because they believe incorporating "Other Assets" into the direct insurer's statutory financial statements might complicate the financial analysis pertaining to the insurer, might prompt the need to rethink certain Statutory Accounting concepts, might necessitate the need to make changes to RBC, might require changes to the rehabilitation and liquidation mechanisms, and might cause difficulties in measuring cash flows when performing Asset Adequacy Analysis at the direct insurer level. We anticipate that most of those concerns could be addressed—particularly in a "protected cell" or "separate account" context, since the "Other Assets" would be clearly separated from the general assets of the insurer, enabling a fairly easy distinction during regulatory review—although more work is needed.

To summarize, then, we continue to believe that Alternative B is a viable concept, and we believe it can be developed in ways that address the concerns described above. However, we are reluctant to move too quickly and specifically in fleshing out Alternative B without first identifying several insurers that might actually wish to use it. In an ideal world, it would be best to work with several insurers and financing partners to see if—together—we can craft something that is workable for the insurer and its financing partners and yet that still addresses the regulatory concerns discussed in this report. If we move forward too quickly without that input, we run the risk of inadvertently including or excluding some aspect that, while not critical from a regulatory point of view, results in preventing or discouraging insurers from using Alternative B. It is better to work through the details of Alternative B by using a real-world example than doing so in the abstract.

For the reasons described above, **we recommend that the Task Force seek out insurers that are potentially interested in using Alternative B and then task us or others with working with those insurers to further develop the concept**.

In this context, we also wish to point out that the overwhelming consensus—among regulators and insurers alike—is that establishing the direct insurer's reserves at the "right" level to begin with so insurers do not feel the need to engage in financing transactions would be the best way to address the issues presented here. Virtually everyone with whom we spoke would prefer that such issues be dealt with at the direct insurer level, if possible, without the expense and complication of using reinsurance finance transactions. With that in mind, another option that could be explored is whether states that feel comfortable with PBR should consider granting a narrowly defined "permitted practice" to insurers that wish to begin using PBR early, even before PBR is legally effective nationally, with respect to the XXX/AXXX business written by such insurers prospectively (on or after some future date). The permitted practice could be based on VM-20 as it exists today, or on VM-20 as modified in some way.

Granting a direct insurer the ability to set its direct XXX/AXXX reserves at the PBR level would result in approximately the same net financial effect as if the insurer had engaged in a financing transaction in compliance with the new requirements described in this report, but that effect would be achieved in a less expensive and less complicated way. Further, since the existence of the permitted practice and the magnitude of its financial impact would need to be disclosed in the direct insurer's statutory financial statement, that information would be available to regulators, policyholders, creditors, rating agencies and others. Such a permitted practice would also allow insurers and regulators to start using PBR in a narrow way, allowing them to see in what areas adjustments to it should be made before it becomes used more widely.

Of course, there are many reasons why allowing such "early adoption" of PBR might not make sense. For example, a number of regulators are unsure whether PBR as set out today is sufficiently conservative and whether the resources exist at the NAIC and state level to appropriately monitor insurers' use of PBR. In addition, key aspects of PBR—such as the applicability of PBR relative to smaller insurers and technical questions such as the selection of a statistical agent—still need to be determined. There also would likely be concerns about the lack of a "level playing field" if some states allow insurers domiciled there to early adopt and others do not. However, we note that the use of financing transactions has effectively resulted in a similar non-level playing field today. We further note that an early adoption of PBR reserve levels for XXX/AXXX business, with those reserves supported fully by admitted assets, would be generally consistent with our recommended Framework approach and would be more conservative (and no more difficult to monitor) than many financing transactions in effect today. Limiting the early adoption to XXX and AXXX business only, and for prospective use only, might further address concerns about early adoption.

Please note that we are not recommending that the Task Force advocate the early adoption of PBR through "permitted practices" as described above. There are too many issues outside the scope of our work that would need to be considered before any such recommendation could be made. However, the concept is a logical outgrowth of what we heard when discussing these matters with regulators and insurers, so we decided to bring it to the attention of the Task Force.

IV. “Issues to be Addressed”

On pages 10-20 of our Initial Report, we set out a number of issues that need to be addressed for the Framework to be successfully implemented. Following are our thoughts and recommendations regarding each issue.

1. *Determine what constitutes the “Actuarial Method” and how it is to be used to determine the “Primary Asset Level.”*

   Our recommendations regarding what should constitute the “Actuarial Method” and how it should be used to determine the “Primary Asset Level” are discussed above in Part II (“Terms Used in the Framework”), Section B (Primary Asset Level).

2. *Determine what constitutes “Primary Assets.”*

   Our recommendations regarding what should constitute “Primary Assets” are discussed above, in Part II (“Terms Used in the Framework”), Section C (Primary Assets).

3. *Determine what constitutes “Other Assets.”*

   Our recommendations regarding what should constitute “Other Assets” are discussed above, in Part II (“Terms Used in the Framework”), Section D (Other Assets).

4. *Determine how to ensure that an appropriate amount of capital/surplus exists in the event policyholder claims exceed the reserves established to pay them.*

   As discussed in our Initial Report, insurance regulation contemplates that the primary source for payment of policyholder claims is money that the insurer has set aside in “reserves” for that purpose. A secondary source for payment of policyholder claims is the insurer’s capital/surplus. Insurance regulators require an insurer to carry an appropriate level of capital/surplus that would allow it to pay claims in the event the monies held in the “reserves” are not sufficient to do so. The traditional way insurance regulators measure the adequacy of available capital/surplus is RBC. In other words, an insurer is required not only to hold appropriate levels of “reserves,” but also to hold capital/surplus in amounts sufficient to allow the insurer to sustain an appropriate RBC ratio.

   However, that traditional way of measuring the adequacy of available capital/surplus breaks down somewhat in connection with reserve financing transactions. For various technical reasons, the direct/ceding insurers’ RBC calculations do not fully consider the business ceded, yet in many instances the entities to which the business is ceded are not required to calculate RBC ratios and/or are allowed to calculate such ratios in a modified fashion. The assuming entities also often hold non-traditional assets and/or use GAAP or other non-statutory accounting methods. Accordingly, full RBC consideration using traditional NAIC methodology is often not given to the business subject to financing transactions.

We recommend that this gap be remedied by requiring full RBC calculations using traditional NAIC methodology by at least one party to the reserve financing transaction.

- With respect to Alternative A (via Reinsurance): If the assuming entity performs RBC calculations in full compliance with standard NAIC insurance statutory accounting, then that would suffice. On the other hand, if the business is ceded to an entity that is not required to perform RBC calculations, or an entity that uses non-statutory accounting methodology, or an entity that is allowed to perform RBC calculations on a modified basis, then the business and assets supporting it would be pulled back into the direct/ceding insurer for RBC-calculation purposes.

- With respect to Alternative B (at the Direct Insurer Level): The precise method of performing RBC calculations should await further details regarding how Alternative B is to be accomplished.

Regardless of whether the RBC calculations are performed at the direct/ceding insurer level or the assuming entity level, a decision will need to be made as to how to treat any non-traditional assets (such as "Other Assets") for RBC purposes. In that regard, in Part II ("Terms Used in the Framework"), Section D. (Other Assets) of this report, we recommend that the Task Force refer to the RBC Working Group a charge to develop a list of Other Assets and to determine RBC asset charges relative to each such asset.

An alternative we considered, but ultimately rejected, is a "total capital" approach such as the one proposed by the ACLI. Such an approach entails modeling the assuming entity's total assets (reserves plus capital) to evaluate their sufficiency to pay the policyholder claims associated with the business ceded. As described in more detail in Part II ("Terms Used in the Framework"), Section A. (Actuarial Method) of this report, we do not believe such a "total capital" approach is the best approach here given the real world constraints that must be considered.

5. *Determine the effective date of the new requirements.*

As noted throughout this report, more work needs to be done to flesh out various aspects of the Framework. For example, some time will be needed to develop appropriate "modifications" to VM-20. However, implementation of the new requirements need not await this more detailed work. Rather, we believe there is enough detail in this report that, if our recommendations are adopted by the Task Force, insurers and regulators will have a fairly good understanding of the following basic components of the new requirements:

- An Actuarial Method of VM-20 (as modified to take into account the new mortality tables being developed and possibly other matters, as determined by LATF);

- Primary Assets of (1) cash, (2) SVO-listed securities qualifying as admitted assets, and (3) (to a limited extent) clean, irrevocable, unconditional and "evergreen" letters of credit issued or confirmed by a qualified United States institution; and

- Other Assets as approved by the regulators of the ceding and assuming insurers.

In most instances, regulators could begin to use these concepts immediately without needing to modify any statute or regulation. Most financing transactions already need regulatory review and approval because the ceding insurer seeks to obtain credit for reinsurance collateralized by assets not listed in the *NAIC Model Credit for Reinsurance Regulation* (Model 786), Section 10.A(1), (2) or (3). Rather, the insurer seeks permission pursuant to Model 786, Section 10.A.(4) to use "[another] form of security acceptable to the commissioner." In other words, each insurance regulator already has discretion under Section 10.A.(4) to accept, or not to accept, the type of asset proposed by the insurer in connection with most financing transactions. The new requirements described in this report could be used immediately without any change to statute or regulation since all that is needed is for a commissioner to decide that, in his or her discretion, he or she will only accept the forms of security (assets) proposed if the transaction is structured in accordance with the new requirements described in this report. In other words, if the transaction does not meet the new requirements, the commissioner would not accept the proposed alternative form of collateral pursuant to Model 786, Section 10.A.(4), thereby forcing the insurer to fully collateralize the reinsurance with one of the assets set out in Section 10.A.(1), (2) and (3): i.e., with cash; SVO-listed securities; or clean, unconditional, "evergreen" letters of credit.

Even though these concepts could be used immediately, interpretive variations among insurers and regulators will continue, particularly until further details regarding the new requirements are fleshed out. However, that degree of variation would be much less than the variation that exists today (and that will continue to exist until regulators begin to use the new requirements).

For the above reasons, **we recommend that insurers and regulators begin to use the new requirements pertaining to the Actuarial Method, Primary Asset Level, Primary Assets and Other Assets as follows:**

- In concept (i.e., using as much detail about the new requirements as is available and applying regulator judgment to the extent details are not available), with respect to any financing transaction structures that are newly created on or after July 1, 2014 (pertaining to XXX and AXXX business);

- In greater detail to be developed over the next several months, with respect to any XXX or AXXX business written by the direct insurer on or after January 1, 2015, regardless of when the financing structure/vehicle was created.

We recommend that other aspects of the new requirements become effective as follows:

- The remaining details pertaining to the new requirements be finalized so the proposed "XXX and AXXX Reinsurance Model Regulation"[6] can be adopted by the NAIC no later than the NAIC's Fall National Meeting (November, 2014).

- The Disclosure Requirements be implemented no later than in connection with the financial statements filed by direct/ceding insurers as of December 31, 2014. (The Task Force may wish to consider requiring insurers to file an initial disclosure statement sooner than December 31, 2014 in order to provide timely disclosure of existing reserve financing transactions.)

- RBC changes as described above be implemented in connection with the financial statements filed by direct/ceding insurers as of December 31, 2015.

6. *Determine the "Disclosure Requirements."*

   Our recommendations regarding what should constitute the "Disclosure Requirements" are discussed above, in Part II ("Terms Used in the Framework"), Section D (Disclosure Requirements).

7. *Determine how the new framework will be "codified."*

   We recommend that the new framework be "codified" as follows:

   - Alternative A (via Reinsurance)

     We recommend that the Task Force propose the adoption of a new "XXX and AXXX Reinsurance Model Regulation," similar to that attached as Exhibit D. We further recommend that this new regulation be made an NAIC Accreditation Standard.

     Consistent with what we described above, **we further recommend that the Task Force refer to the RBC Working Group a charge to amend the NAIC's RBC requirements to make sure that full RBC calculations are performed by at least one party to the financing transaction and that RBC charges be developed relative to non-traditional assets such as Other Assets**.

[6] We discuss this proposed Model Regulation below in Part IV ("Issues to be Addressed"), Issue 7.

- Alternative B (at the Direct Insurer Level) The precise method of "codifying" Alternative B should await further details regarding how it is to be accomplished.

In addition to the above, **we also recommend that the Task Force refer to the NAIC's Statutory Accounting Principles (E) Working Group a charge to revise the disclosure requirements of SSAP No. 61R – Life, Deposit Type and Accident and Health Reinsurance – to include a Note to the Financial Statement (for Annual Statement and Annual Audited Financial Statement disclosure) that would set forth the relevant aspects of financing transactions**. Making the proposed Note a requirement of the Annual Audited Financial Statements would subject it to annual audit procedures. Guidance for the content of the proposed Note might be as follows:

> "The Company has entered into xxxx [number of contracts] contracts to cede reserves pursuant to transactions subject to the requirements of Section 7 of the *NAIC XXX and AXXX Reinsurance Model Regulation* (Model ___). For each such contract, the Company has "Primary Assets" in an amount at least equal to the "Primary Asset Level," as those terms are defined in Model ___. Further, for each such contract, the entire statutory policy reserve is supported by either "Primary Assets" or "Other Assets," as those terms are defined in Model ___. The total amount of statutory policy reserves ceded under all such contracts is [$.....]. The amount of "Primary Assets" supporting those statutory policy reserves is [$.....]. The amount of "Other Assets" supporting those statutory policy reserves is [$.....]."

8. *Determine the legal and statutory accounting treatment needed to implement Alternative B (at the Direct Insurer Level).*

   The determination of the legal and statutory accounting treatment needed to implement Alternative B should await further details regarding how Alternative B is to be accomplished.

9. *Determine framework applicability to reinsurance ceded to accredited/admitted, certified, and unaffiliated reinsurers.*

   Our guiding principle has been that the new requirements should apply to related party transactions that are entered into for the primary purpose of using non-traditional (non-admitted) assets to support part of the statutory reserve or reserve credit taken. In general, we believe the new requirements should not apply to "traditional" reinsurance arrangements with well capitalized unaffiliated third party reinsurers.

   The difficulty, of course, is that defining the types of transactions to be covered by the new requirements opens up the potential for abuse: financing transactions that are in substance the type regulators want to cover might be altered so they do not meet the technical definitions under the new requirements. Accordingly, we concluded that it would be inappropriate to apply the new requirements only to "affiliated" or "related party" transactions, or to transactions involving "captives" or "special purposes vehicles," etc., because creative minds would find ways around those definitions—for example, by interposing a non-affiliate third party between the direct/ceding insurer and the entity that ultimately holds some or all of the risk (with the purpose of claiming that the transaction is no longer an "affiliated" or "related party" transaction), or by creating assuming entities that have many of the characteristics of what we might consider to be "captives" or "special purpose vehicles" yet that do not meet the technical definition of those types of entities.

We ultimately concluded that it is best to start by including within the initial scope any reinsurance of XXX or AXXX reserves, and then exempting financing transactions with certain specified assuming reinsurance entities from the bulk of the new requirements. In other words, we have attempted to create a situation where any reinsurance of XXX or AXXX reserves must comply with the new requirements unless specifically exempt rather than only applying the new requirements if certain criteria are met. We believe this approach reduces the possibility that someone might invent a new structure or type of entity as a way around the new requirements.

In formulating our approach, we were cognizant of the different categories specified in the *NAIC Model Credit for Reinsurance Model Law* (Model 785) and *NAIC Model Credit for Reinsurance Regulation* (Model 786). As noted above, most financing transactions need regulatory review and approval because the ceding insurer seeks to obtain credit for reinsurance collateralized by assets (security) not listed in Model 786, Section 10.A(1), (2) or (3). It was a relatively easy task to think of grafting the new requirements onto the existing requirement that forms of security not listed in those provisions must be acceptable to the commissioner.

Transactions involving other categories of Models 785/786 were not as easy to bring within the initial scope. For example, neither regulatory review/approval of specific transactions nor collateral requirements automatically exist for reinsurance ceded to "licensed" or "accredited" reinsurers (Model 786, Sections 4 and 5 respectively). Because regulatory approval is needed for an entity to be granted "licensed" or "accredited" status, regulators could require compliance with requirements such as those set out here as a condition of licensure/accreditation. However regulators would not have that option in situations where "licensed" or "accredited" status has already been granted.

We dealt with this issue in two ways. First, there is a real regulatory concern that financing transactions entered into without complying with these new requirements are—or have the potential to be—financially hazardous to the direct/ceding insurer. For example, suppose that an insurer domiciled in State X cedes business to an assuming entity that is licensed or accredited in State X. Suppose, further, that in accordance with Model 786 (Section 4 or 5) the direct/ceding insurer does not obtain any collateral supporting the reinsurance. If the assuming entity does not have sufficient wherewithal to perform on the reinsurance, and/or if that entity retrocedes the business to an offshore entity that does not have the ability to perform, the reinsurance poses a regulatory concern relative to the direct/ceding insurer even though the reinsurance transaction complies with Model 786. Accordingly, **we added provisions to our proposed "XXX and AXXX Reinsurance Model Regulation" whereby if a direct insurer cedes XXX or AXXX business without falling within one of the specified exemptions and without complying with the new requirements, such transaction creates a presumption that the direct/ceding insurer is in a financially hazardous condition pursuant to the *NAIC Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition* (Model 385)**. Accordingly, even in instances where collateral is not required by Models 785/786, unless the transaction is in compliance with the new requirements (or exempt from those requirements), the direct/ceding insurer would have the burden of proving that the reinsurance is supported by assets that are the functional/substantive equivalent of the Primary Asset Level or otherwise that the transaction is not potentially hazardous to the direct/ceding insurer's financial condition. To bring potentially hazardous transactions to the attention of the wider regulatory community, our proposed new regulation also provides that any non-exempt, non-compliant cession of XXX/AXXX business would be subject to review by FAWG. To help ensure that non-compliant, non-exempt financing transactions come to FAWG's attention, **we recommend that the Task Force refer to FAWG a charge to add review of disclosures made by direct/ceding insurers pursuant to the Disclosure Requirements to FAWG's standard monitoring criteria for life insurers**.

Second, **the Disclosure Requirements are drafted in such a way that any insurer ceding XXX or AXXX business will be required to complete the disclosure schedule. The disclosures proposed with respect to exempt transactions are minimal**: the name of the assuming entity, the date of the transaction, the amount of reserves ceded, a confirmation that the transaction is exempt and information pertaining to the type of exemption relied upon. Nevertheless, the exhibit would need to be included in the direct/ceding insurer's financial statements in connection with all XXX/AXXX cessions, even those involving exempt transactions, thereby bringing all XXX/AXXX cessions into the mix initially and making clear which cessions are in compliance with the new requirements and which are not. Any non-exempt, non-compliant cessions would be publicly disclosed.

We next turned our attention to the consideration of possible exemptions, focusing our efforts on the following three categories set out in Model 786: licensed reinsurers (Section 4), accredited reinsurers (Section 5), and certified reinsurers (Section 8).

We quickly felt comfortable with an exemption pertaining to certified reinsurers, since such reinsurers must maintain $250 million of surplus and must satisfy other requirements. It seemed to us quite unlikely that a direct/ceding insurer would create an entity that met those requirements merely for the purpose of avoiding the new requirements.

We were not comfortable, initially, with exemptions pertaining to licensed or accredited reinsurers (as those entities are defined in Model 786) because the Model does not impose extensive capital or other requirements on such entities. We were concerned, for example, that if exemptions were allowed for such entities, a direct insurer domiciled in State X could avoid the new requirements by having the assuming entity become licensed or accredited in State X and having it obtain a "permitted practice" to allow it to carry non-traditional assets as admitted assets. We concluded, however, that the exemption is warranted if the licensed and accredited entity complies with full NAIC statutory accounting requirements (without any permitted practices) and with risk-based capital rules. Licensed and accredited entities meeting those requirements would be holding traditional admitted assets to fully support reserves as calculated on a traditional NAIC basis, and the entities would also be required by RBC rules to maintain sufficient capital and surplus, in addition to reserves, to support the reinsurance assumed.

It is important to note that transactions involving assuming entities that do not fit within one of the exempt categories are not prohibited. For example, there is nothing preventing a direct insurer from ceding XXX/AXXX business to a licensed or accredited insurer that uses GAAP accounting or to a licensed or accredited insurer that has been granted a permitted practice. Such a transaction would be allowed. It is just that the transaction would not be exempt from the requirements set out in the "XXX and AXXX Reinsurance Model Regulation."

For the reasons described above, **we recommend that the Task Force exempt from the new requirements reinsurance ceded to the following assuming entities:**

- "Certified" reinsurers, within the meaning of Model 786, Section 8.

- "Licensed" and "accredited" reinsurers, within the meaning of the of Model 786, Sections 4 and 5, respectively, so long as the reinsurer also (1) prepares its financial statements in full compliance with NAIC statutory accounting, without any "permitted practices," and (2) is not in one of the "action levels" of risk-based capital, with the RBC ratio calculated on a traditional (non-modified) NAIC basis.

We also recommend that the Task Force exempt from the new requirements reinsurance required by law, as set forth in Model 786, Section 9.

10. *Determine the requirements for periodically monitoring the sufficiency of the Primary Asset Level.*

The direct/ceding insurer will be required to comply with the Disclosure Requirements each year in connection with its Annual Statement. In addition, as discussed in Issue 7 above, we recommend that the direct/ceding insurer file a Note to its year-end financial statements regarding these transactions. **To be able to comply with the Disclosure Requirements and to prepare the Note to the financial statements, the direct/ceding insurer will need to annually update its testing to determine whether it remains in compliance with the Primary Asset Level as of the date of the Disclosure Requirements and Note**.

11. *Determine appropriate levels of examination coordination.*

As noted throughout this report, our primary focus is on regulation of the direct/ceding insurer. However, we believe regulatory oversight can be enhanced by appropriate levels of coordination between regulators of the ceding and assuming insurers.

We anticipate that the domiciliary regulator of the direct/ceding insurer would conduct a review of the insurer's use of financing transactions as part of its annual financial analysis of the direct/ceding insurer. **As part of the financial analysis process, it may be appropriate for the direct/ceding insurer's domiciliary state regulator to contact the regulator of the assuming insurer to obtain information about the assuming insurer** (possibly in an Insurer Profile Summary-type document).

We also anticipate that the risks associated with reserve financing transactions would be identified as critical risks in accordance with the risk-focused examination approach set out in the *NAIC Financial Condition Examiners Handbook*, thereby ensuring that the risks will be assessed as part of the financial examination of the direct/ceding insurer. The examiners could choose to proceed with the examination of the direct/ceding insurer separately from the examination of the assuming insurer. However, **we believe that, to the extent possible, it would be appropriate for the examination of the ceding and assuming insurers to be conducted concurrently and for those examinations to be coordinated using the coordination approach outlined in the *NAIC Financial Condition Examiners Handbook***.

Finally, we note that FAWG may also play a role in facilitating examination coordination by providing analytical support to the direct/ceding insurer's domestic regulator if, as we recommend above, it expands its standard monitoring criteria to include the disclosures made by direct/ceding insurers pursuant to the Disclosure Requirements.

12. *Determine guidelines for auditor and actuarial oversight.*

We recommend that there be annual independent auditor oversight of the direct/ceding insurer's compliance with key aspects of the new requirements. As discussed above under Issue 7, we recommend there be a Note to the direct/ceding insurer's financial statements regarding XXX/AXXX financing transactions. By making the proposed Note a requirement of the Annual Audited Financial

Statements, as well as the Annual Statement, the Note and its content would be subject to annual audit procedures by the direct/ceding insurer's independent auditor.

13. *Determine tax impact.*

During our discussions, a question arose whether the new requirements would impact the tax deductions insurers are allowed to take pertaining to their reserves. It is important to emphasize that the new requirements do not change in any way the level of reserves an insurer is legally required to establish. Insurers are legally required to establish statutory policy reserves in amounts determined pursuant to the NAIC's Standard Valuation Law and related regulations and actuarial guidelines. The ONLY question being dealt with here is what assets should be allowed to support those reserves. None of our recommendations impacts in any way the level of reserves themselves. In other words, nothing being done here changes in any way each insurer's legal obligation (1) to establish statutory policy reserves to the full extent determined pursuant to the NAIC's Standard Valuation Law and related regulations and actuarial guidelines, and (2) to support those statutory policy reserves in full with permitted assets. As such, although we are not tax experts and of course render no opinion regarding the matter, **we do not anticipate that our recommendations, if adopted, would impact the tax deductions insurers are allowed to take pertaining to their reserves**.

14. *Determine whether separate solutions should be developed for XXX and AXXX.*

Although we are not opposed to the development of separate solutions for XXX and AXXX, we wish to point out that the Actuarial Method recommended above—a modified version of VM-20—would be sufficient to cover both types of products. We recognize, of course, that although the Actuarial Method for both products is the same, its application would lead to different results for XXX products than for AXXX products, just as it would lead to different results for the XXX/AXXX business written by one insurer than for the XXX/AXXX business written by another insurer. These types of variation are to be expected, and they appropriately reflect differences in characteristics between the two types of products as well as differences in the business and characteristics of one insurer compared to those of another.

V. <u>Captives White Paper</u>

The conclusions and recommendations of the Captives and Special Purpose Vehicle (SPV) Use (E) Subgroup (the "Subgroup") to the Financial Condition (E) Committee are set out in section XI of the Captives White Paper. The Subgroup offered seven recommendations to address the issues presented in the Captives White Paper. Our evaluation of those recommendations, and the conclusions underlying them, is set out below.

1. *Accounting Considerations*

The Subgroup's recommendation in this area was as follows:

> *"As noted throughout this paper, captives and SPVs have often been a means of dealing with perceived XXX and AXXX reserve redundancies. The practice of using a different entity or different structure outside of the commercial insurer to engage in a particular activity because of a perception that the regulatory framework does not accurately account for such activity should be discouraged. The Subgroup held a consensus view that captives and SPVs should not be used by commercial insurers to avoid statutory accounting prescribed by the states. The Subgroup believes that an alternative treatment of such transactions should be to deal with the accounting and reserving issues within the ceding company, thereby eliminating the need for separate transactions outside of the commercial insurer. Specifically, the Subgroup held a consensus view that the Financial Condition (E) Committee should form a separate subgroup to develop possible solutions for addressing any remaining XXX and AXXX perceived redundancies prior to the effective date of PBR. Such issues should be addressed directly, as opposed to through the use of captives and SPVs. Possible solutions could include changes similar to the AG 38 solution, or disclosed prescribed or permitted accounting practices. The NAIC should also consider modifications to the statutory accounting framework to recognize, in strictly limited situations, alternative assets, such as 'tier 2' type assets to support specific situations (e.g., less likely to develop liabilities), thereby eliminating the need for the separate transaction outside of the commercial insurer."*

We believe our recommended approach is consistent with the Subgroup's core concerns and recommendations: that captives/SPVs not be used as a way to avoid statutory accounting requirements, that any perceived reserve redundancies are best dealt with directly and in an open fashion, and that "tier 2" type assets may be appropriate to cover liabilities that are less likely to develop. Further, our recommended Alternative B is consistent with the Subgroup's preference that solutions take place at the direct insurer level, avoiding the need for separate transactions outside of the direct insurer.

The sentiment we heard throughout our interviews—that the rules should be clear and should be consistently followed—echoed the Subgroup's recommendations. We believe that our recommendations, if adopted, would accomplish that goal by requiring insurers to comply with what in effect would be a new statutory accounting paradigm pertaining to efforts to address perceived XXX and AXXX reserve redundancies.

2. *Confidentiality*

The Subgroup recommended that the NAIC study the issue of confidentiality related to commercially owned captives and SPVs more closely; that it may be appropriate to consider the type of information that should, and should not, be held confidential; and that further work should be done to ensure that the state (or other functional regulator) of a group obtains additional information from the captive regulator on a confidential basis to understand the details of captive and SPV transactions for US and non-US captives.

As discussed above, our focus is on regulation of the direct/ceding insurer rather than on that of the assuming entity. Consistent with that approach, our recommended Disclosure Requirements apply to the direct/ceding insurer. Our approach minimizes the ability of captives/SPVs to use confidentiality laws in their domiciles to prevent the disclosure of key information or the ability of insurers to move transactions off-shore in an attempt to withhold information from regulators.

We also concluded that information should be disclosed not only to regulators, but also to the public more widely. We believe this is important so policyholders, rating agencies, creditors, and others can understand to what extent a particular insurer uses financing transactions.

3. *Access to Alternative Markets*

The Subgroup noted that it supported the use of solutions designed to shift risk to the capital markets or provide alternative forms of business financing. Consistent with that view, the Subgroup indicated that the NAIC should consider re-evaluating the Special Purpose Reinsurance Vehicle Model Act (Model 789), and updating it as necessary. The Subgroup further indicated that the NAIC should encourage the states to adopt Model 789 and should consider making the model an accreditation standard in those states that have an active captive and SPV market.

We agree with the views of the Subgroup regarding the desirability of reviewing and updating Model 789. We believe a decision as to whether to propose it as an accreditation standard should wait until after the model is revised.

4. *IAIS Principles, Standards and Guidance*

   The Subgroup recommended that the NAIC closely monitor the ongoing developments with respect to IAIS principles, standards and guidance, and consider, where appropriate, enhancements to the US captive and SPV regulatory framework in preparation for future FSAP reviews.

   We agree with these recommendations by the Subgroup.

5. *Credit for Reinsurance Model Enhancements*

   The Subgroup reached a consensus view that the use of conditional LOCs and parental guarantees in connection with financing transactions was inconsistent with the requirements outlined in the NAIC Credit for Reinsurance Model Law (Model 785) and Credit for Reinsurance Model Regulation (Model 786). The Subgroup recommended that "consideration be given to study … further the effects of, and potential limits on, the variability in qualified LOCs or any other security that might not provide the intended protections provided within [Model 785]."

   We believe our recommended approach is consistent with the Subgroup's recommendation. Under our recommended approach, conditional LOCs and parental guarantees could not be used to satisfy the Primary Asset Level.

6. *Disclosure and Transparency*

   The Subgroup recommended enhanced disclosure in the direct/ceding insurer's financial statements "regarding the impact of the transactions on the financial position of the ceding insurer." Further, the Subgroup concluded "Enhancement of Note to Financial Statement 10M should be made to provide for disclosure of non-trade-secret captive information and disclosure of the overall utilization of captives."

   We believe our recommended approach is consistent with the Subgroup's recommendations. Our recommendations regarding Disclosure Requirements are described above, in Part II ("Terms Used in the Framework"), Section D (Disclosure Requirements).

7. *Financial Analysis Handbook Guidance*

   The Subgroup recommended:

   > *"[A]dditional guidance should be developed by the NAIC to assist the states in a uniform review of transactions, including recommendations for minimum analysis to be performed as well as ongoing monitoring of the ceding insurer, the captive and the holding company. The guidance should be developed for perspectives of the ceding state, the captive state and the lead state. Once developed, the guidance should be considered to be added to the NAIC Financial Regulation*

> *Standards and Accreditation Program standards to ensure consistency and uniformity among the states."*

The Subgroup then described in further detail what such guidance might look like, including the recommendation:

> *"…that the Financial Analysis Handbook be amended to include a section on alternative risk-transfer arrangements. In this regard, it may be worth considering the development of ceding company procedures for alternative risk-transfer arrangements similar to other holding company procedures to help document the review and approval of these types of transactions."*

We generally agree with the Subgroup's conclusions and recommendations in these areas, although (as noted throughout this report) our recommended focus is on the regulatory review of the direct/ceding insurer rather than on that of the assuming entity. We believe the Framework approach described above, including the Disclosure Requirements, will make it significantly easier for such guidance and procedures to be developed and successfully implemented. The development of such guidance and procedures is outside the scope of our work to date, but we stand ready to assist the Task Force and other NAIC groups on these and any other matters in whatever way we can.

VI. Summary of Regulatory Protections

The following is a summary of key regulatory protections that are part of our recommendations:

1. All direct/ceding insurers entering into reserve financing transactions covered by the new requirements would need to follow the same rules, make key determinations the same way, and provide the same types of public disclosure, all of which significantly level the playing field.

2. All covered financing transactions involving reinsurance would need to be approved by two regulators: the domiciliary regulator of the direct/ceding insurer and the domiciliary regulator of the assuming insurer.

3. The direct/ceding insurer would have ready access on a funds withheld or trust basis to high quality assets in an amount approximately equal to 100% of what the full policy reserve would be under PBR.

4. Although any type of asset could be considered to support the remainder of the policy reserve, any such asset (1) could only be used to cover something that would likely not even need to be a reserve under PBR, (2) would have to be approved by the domiciliary regulators for both the ceding and assuming insurers, (3) would be disclosed publicly, (4) would be subject to review by FAWG in certain circumstances, and (5) would be subject to RBC “asset charges” to make sure it is not given undue value in connection with RBC calculations.

5. Direct/ceding insurers would need to annually update their testing and indicate that they remain in compliance with the new requirements.

6. There would be annual independent auditor oversight of the direct/ceding insurer’s compliance with key aspects of the new requirements.

7. The new requirements apply regardless of where the assuming entity is domiciled, thereby eliminating the incentive for financing transactions to move off-shore.

8. The incentives are such that reserve financing transactions should stop once PBR becomes effective (with respect to business covered by PBR).

VII. **Summary of Our Recommendations**

1. Our recommendation that the Task Force select a modified version of VM-20 as the Actuarial Method is on p. 9.

2. Our recommendations regarding possible modifications to VM-20 for use as the Actuarial Method are on pp. 11-13.

3. Our recommendation as to the definition of the required "Primary Asset Level" is on p. 13.

4. Our recommendations as to what should constitute "Primary Assets" are on on p. 15.

5. Our recommendation that if the Task Force accepts our recommended Actuarial Method, that judgments as to what is appropriate to use as "Other Assets" should generally be left to the discretion of the regulators for the direct/ceding insurer and the assuming insurer with some additional oversight to be provided by FAWG is on p. 16.

6. Our recommendation that the Task Force refer to the RBC Working Group a charge to develop a list of assets that regulators, insurers and financiers believe will be commonly used as Other Assets and to determine RBC asset charges relative to each such asset is on p. 16.

7. Our recommendation that, once the Other Asset list is developed, the Task Force make decisions regarding which of the listed assets should warrant additional oversight by FAWG if used in financing transactions is on p. 17.

8. Our recommendations regarding the "Disclosure Requirements" are on p. 18.

9. Our recommendation that the Task Force refer to the NAIC's Blanks Working Group a charge to finalize the Disclosure Requirements and add them to the Life Annual Statement Blanks is on p. 18.

10. Our recommendation that the Task Force seek out insurers that are potentially interested in using Alternative B and then task us or others with working with those insurers to further develop the concept is on p. 20.

11. Our recommendation that full RBC calculations using traditional NAIC methodology be performed by at least one party to the reserve financing transaction is on p. 23. Our related recommendations that the Task Force refer to the RBC Working Group a charge to amend the NAIC's RBC requirements to make sure that full RBC calculations are performed by at least one party to the financing transaction and that RBC asset charges be developed relative to non-traditional assets such as Other Assets are on p. 25.

12. Our recommendations regarding when insurers and regulators should begin to use the new requirements pertaining to the Actuarial Method, Primary Asset Level, Primary Assets and Other Assets are on pp. 24-25.

13. Our recommendations regarding when other aspects of the new requirements should become effective are on p. 25.

14. Our recommendations that the Task Force propose the adoption of a new "XXX and AXXX Reinsurance Model Regulation," similar to that attached as Exhibit D, and that the new regulation be made an NAIC Accreditation Standard are on p. 25.

15. Our recommendation that the Task Force refer to the NAIC's Statutory Accounting Principles (E) Working Group a charge to revise the disclosure requirements of SSAP No. 61R – Life, Deposit Type and Accident and Health Reinsurance – to include a Note to the Financial Statement (for Annual Statement and Annual Audited Financial Statement disclosure) that would set forth the relevant aspects of financing transactions is on p. 26.

16. Our recommendation that the Task Force refer to FAWG a charge to add review of disclosures made by direct/ceding insurers pursuant to the Disclosure Requirements to FAWG's standard monitoring criteria for life insurers is on p. 28.

17. Our recommendations as to financing transactions that should be exempt from the new requirements are on p. 29.

18. Our recommendation that there be annual independent auditor oversight of the direct/ceding insurer's compliance with key aspects of the new requirements is on p. 30.

VIII. **Summary of Action Items**

Note: As described above in Part IV. ("Issues to be Addressed"), Issue 5, regulators can begin to use the new requirements in concept immediately with respect to most financing transactions without modifying any law or regulation. The action items set out below are designed to "codify" the new requirements and to provide additional detail regarding how they should be implemented. We recommend that these action items be completed at or before the NAIC's Fall National Meeting (November, 2014).

1. Adopt our recommendations in concept (our general approach, definitions of defined terms, proposed effective dates, etc.)

2. Refer items to other NAIC working groups and task forces:

    - Refer to LATF a charge to develop modifications to VM-20 so it can be used as the Actuarial Method.
    - Refer to the RBC Working Group charges (1) to develop a list of anticipated Other Assets, (2) to determine RBC asset charges relative to Other Assets, and (3) to require that full RBC calculations using traditional NAIC methodology be performed by at least one party to financing transactions.
    - Refer to the Blanks Working Group a charge to finalize the Disclosure Requirements and add them to the Annual Statement Blanks.
    - Refer to the Statutory Accounting Principles Working Group a charge to include a Note to the annual audited financial statements to set forth relevant aspects of financing transactions.
    - Refer to FAWG a charge to add review of the Disclosure Requirements to the standard monitoring criteria for life insurers.

3. Make decisions as to which Other Assets should be referred to FAWG for review if used in financing transactions.

4. Identify insurers interested in exploring Alternative B (at the direct insurer level) and further develop that alternative.

5. Finalize and adopt the proposed "XXX and AXXX Model Reinsurance Regulation" and take action to make it an accreditation standard.

Exhibit A—Framework

Alternative A—via Reinsurance:

Any insurer that seeks to reduce the net retention of its XXX or AXXX reserves through a reinsurance ceding arrangement will be allowed to do so if, but only if, the following criteria are satisfied:

a. The ceding insurer's gross XXX and AXXX reserves are established, in full, using applicable reserving guidance (currently, the "formulaic" approach);

b. The transaction to reduce the net retention of those reserves is approved by the ceding insurer's domestic regulator and by the state/jurisdiction in which the assuming insurer is domiciled;

c. The ceding insurer satisfies the "Primary Asset Requirement" (i.e., the ceding insurer receives collateral consisting of "Primary Assets" in at least the amount determined pursuant to the "Actuarial Standard");

d. The ceding insurer receives collateral consisting of "Other Assets" with respect to any portion of the reserve credit that is not collateralized by "Primary Assets;" and

e. The "Disclosure Requirements" are met.

Alternative B—at the Direct Insurer Level:

In lieu of seeking to reduce its net retention of XXX or AXXX reserves through a reinsurance ceding arrangement, a direct writing insurer may choose to achieve substantially the same economic effect as the above by satisfying the following criteria:

a. The insurer's gross XXX and AXXX reserves are established, in full, using applicable reserving guidance (currently, the "formulaic" approach);

b. The arrangement is approved by the insurer's domestic regulator;

c. The insurer separately identifies on its statutory financial statement the gross reserve for the business at issue;

d. The insurer also separately identifies on its statutory financial statement the following two categories of assets supporting the gross reserve for that business: (1) "Primary Assets" in an amount at least equal to the "Primary Asset Requirement," and (2) "Other Assets" to the extent the insurer seeks to rely on such assets to support a portion of the gross reserve; and

e. The "Disclosure Requirements" are met.

<u>Not a recommendation: For Illustrative Purposes Only</u>

****

<u>Exhibit B—List of “Other Assets” and Related RBC Charges</u>

To be a permitted “Other Asset,” within the meaning of the “XXX and AXXX Reinsurance Model Regulation,” the asset (including those listed below) must be approved for use by the domiciliary regulator of the ceding insurer AND the domiciliary regulator of the assuming insurer in connection with a specific reserve financing transaction.

<u>Admitted Assets</u>

<u>Category 1</u>
Assets that are considered to be “admitted assets” in the state of domicile of the ceding insurer but that are not “Primary Assets” as defined in the “XXX and AXXX Reinsurance Model Regulation.” **<u>RBC Asset Charge = ___.</u>**

<u>Letters of Credit</u>:

<u>Category 2</u>
Clean, irrevocable, unconditional and “evergreen” letters of credit issued or confirmed by a qualified United States institution and meeting the other characteristics specified in the *NAIC Model Credit for Reinsurance Regulation* (Model 786), Section 10.A.(3). **<u>RBC Asset Charge = ___.</u>**

<u>Category 3</u>
Other letters of credit, the cash flows of which are neither deferred nor limited in amount (other than by contract limits) upon the trigger of contract requirements. **<u>RBC Asset Charge = ___.</u>**

<u>Category 4</u>
Other letters of credit. **<u>RBC Asset Charge = ___.</u>**

<u>Affiliate Guarantees</u>:

<u>Category 5</u>
Affiliate guarantee supplementing arrangement where all mortality risk is unconditionally transferred to a separate, highly capitalized and rated entity that is unaffiliated with the ceding insurer. **<u>RBC Asset Charge = ___.</u>**

Category 6
Other affiliate guarantees, the cash flows of which are neither deferred nor limited in amount (other than by contract limits) upon the trigger of contract requirements. **RBC Asset Charge = ___.**

Category 7
Other affiliate guarantees. **RBC Asset Charge = ___.**

Excess of Loss Treaties:

Category 8
Excess of loss reinsurance where all mortality risk is unconditionally transferred to a separate, highly capitalized and rated entity that is unaffiliated with the ceding insurer and as to which there is no recourse to an affiliate of the ceding insurer. **RBC Asset Charge = ___.**

Category 9
Other excess of loss reinsurance, the cash flows of which are neither deferred nor limited in amount (other than by contract limits) upon the trigger of contract requirements. **RBC Asset Charge = ___.**

Category 10
Other excess of loss treaties. **RBC Asset Charge = ___.**

Miscellaneous:

Category 11
Other assets not meeting one of the categories described above and that are not "Primary Assets" as defined in the "XXX and AXXX Reinsurance Model Regulation." **RBC Asset Charge = ___.**

EXHIBIT C

SUPPLEMENT FOR THE YEAR OF THE

SUPPLEMENTAL REINSURANCE EXHIBIT

For the Year Ended December 31, [XXXX]
(To be filed by April 1)

OF THE…………………………………………………………………………….
NAIC GROUP CODE ……………………… NAIC COMPANY CODE……………………………………………….

TABLE 1 – ALL XXX AND AXXX CESSIONS

								Exempt Transactions			
	A	B	C	D	E	F	G	H	I	J	K
	Name of Company	Related Party Captive/SPV	Inception Date	Statutory Reserve	XXX statutory policy reserves ceded	AXXX statutory policy reserves ceded	Subject to Table 2 Disclosure (Y/N)	Authorized Reinsurer	Accredited Reinsurer	Certified Reinsurer	Reinsurance required by law

TABLE 1 INSTRUCTIONS

Table 1 applies to <u>all</u> cessions of XXX and/or AXXX statutory policy reserves by the reporting entity. As to each cession:

Column A – Provide the name and NAIC code of the assuming insurer

Column B – Check box if the assuming insurer identified in Column A is a related party captive or special purpose vehicle

Column C – Provide the inception date of the reinsurance ceding arrangement

Column D – Provide the dollar amount of the statutory reserve with respect to the business ceded

Column E – Provide the dollar amount of XXX statutory policy reserves ceded

Column F – Provide the dollar amount of AXXX statutory policy reserves ceded

Column G – Answer “Y” if either of the following applies:

1. The cession is with respect to insurance written by the ceding insurer on or after January 1, 2015, regardless of when the reinsurance ceding arrangement was entered into; OR

2. The cession is with respect to insurance, regardless of when written, under any reinsurance arrangement entered into or amended on or after January 1, 2015.

If neither of the options above applies, answer “N” and skip to Table 3 as to that cession (unless Column H, I, J or K is checked, in which case no further information on this Schedule is required). If answer to Column G is “Y”, complete both Tables 2 and 3 as to that cession (unless Column H, I, J, or K is checked, in which case no further information on this Schedule is required).

Column H – Check box if the reinsurance was ceded to an assuming insurer licensed to transact insurance or reinsurance in the reporting entity’s state of domicile within the meaning of Section 2.A. of the NAIC Credit for Reinsurance Model Law (Model 785), as adopted in the reporting entity’s state of domicile, <u>and</u> the assuming insurer:

1. prepares its statutory financial statements in full compliance with the NAIC Accounting Practices and Procedures Manual, without any “permitted practices”; and

2. is not in a Company Action Level Event, Regulatory Action Level Event, Authorized Control Level Event, or Mandatory Level Control Event as those terms are defined in the NAIC Risk-Based Capital (RBC) for Insurers Model Act, as adopted in the reporting entity’s state of domicile, when its RBC is calculated in accordance with the NAIC Life Risk-Based Capital Report including Overview and Instructions for Companies, as the same may be amended by the NAIC from time to time, without deviation..

Column I—Check box if reinsurance was ceded to an assuming insurer that is accredited by the commissioner of the reporting entity’s state of domicile within the meaning of Section 2.B. of the NAIC Credit for Reinsurance Model Law (Model 785), as adopted in the reporting entity’s state of domicile, <u>and</u> the accredited reinsurer:

3. prepares its statutory financial statements in full compliance with the NAIC Accounting Practices and Procedures Manual, without any “permitted practices”; and

4. is not in a Company Action Level Event, Regulatory Action Level Event, Authorized Control Level Event, or Mandatory Level Control Event as those terms are defined in the NAIC Risk-Based Capital (RBC) for Insurers Model Act, as adopted in the reporting entity’s state of domicile, when its RBC is calculated in accordance with the NAIC Life Risk-Based Capital Report including Overview and Instructions for Companies, as the same may be amended by the NAIC from time to time, without deviation.

Column J—Check box if reinsurance was ceded to an assuming insurer that has been certified by the commissioner as a reinsurer in this state within the meaning of Section 2.C. of the NAIC Credit for Reinsurance Model Law (Model 785), as adopted in the reporting entity’s state of domicile.

Column K—Check box if reinsurance was ceded to an assuming insurer as to the insurance of risks located in jurisdictions where the reinsurance is required by the applicable law or regulation of that jurisdiction within the meaning of Section 2.F. of the NAIC Credit for Reinsurance Model Law (Model 785), as adopted in the reporting entity’s state of domicile.

If Column H, I, J, or K is checked as to a cession, do not complete the remaining Tables in this Supplemental Reinsurance Schedule as to that session.

TABLE 2 – NON-EXEMPT TRANSACTIONS SUBJECT TO TABLE 2 DISCLOSURE															
	As of Inception Date or Next Preceding Annual Statement Date								As of Annual Statement Date						
	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O
	Name of Company	Inception Date or Next Preceding Annual Statement Date	Reserve Credit Taken	Primary Asset Level	Primary Assets	Primary Assets - trust	Primary Assets – funds withheld	Other Assets	Reserve Credit Taken	Primary Asset Level	Primary Assets	Primary Asset Adjustment	Primary Assets-trust	Primary Assets – funds withheld	Other Assets

TABLE 2 INSTRUCTIONS

Table 2 applies to all cessions of XXX and/or AXXX statutory policy reserves identified in Table 1 except cessions as to which (a) Column “G” contains an “N” or (b) Column H, I, J or K is checked. The terms “Primary Asset Level”, “Primary Assets” and “Other Assets” shall have the meaning given to them in the NAIC XXX and AXXX Reinsurance Model Regulation as adopted in the reporting entity’s state of domicile. As to each cession:

Column A – Provide the name and NAIC code of the assuming insurer

Column B—Provide the latter of (a) the inception date of the cession or (b) the annual statement date immediately preceding the current annual statement date

Column C – State the dollar amount of the reserve credit taken by the reporting entity as of the date reported in Column B

Column D—State the Primary Asset Level applied to the statutory policy reserves as of date reported in Column B

Column E—State the fair value as of the date reported in Column B of the Primary Assets received by the reporting entity as collateral

Column F—State the fair value as of the date reported in Column B of any part of the collateral reported in Column E that is held in trust for the benefit of the reporting entity

Column G—State the fair value as the date reported in Column B of any part of the collateral reported in Column E that is held by the reporting entity on a funds withheld basis

Column H—State the fair value as of the date reported in Column B of all collateral that is not reported in Column E

Column I— State the dollar amount of the reserve credit taken by the reporting entity as of the current annual statement date

Column J—State the Primary Asset Level applied to the statutory policy reserves as of the current annual statement date

Column K—State the fair value as of the current annual statement date of the Primary Assets received by the reporting entity as collateral

Column L—If Column J is greater than Column K, state the fair value as of the current annual statement date of any additional Primary Assets received by the reporting entity as collateral to cover the difference

Column M—State the fair value as of the current annual statement date of any part of the collateral reported in Column K or Column L that is held in trust for the benefit of the reporting entity

Column N—State the fair value as of the current annual statement date of any part of the collateral reported in Column K or Column L that is held by the reporting entity on a funds withheld basis.

Column O—State the fair value as of the current annual statement date of all collateral with respect to the transaction that is not reported in Columns K or L

TABLE 3 – COLLATERAL FOR ALL NON-EXEMPT TRANSACTIONS REPORTED IN TABLE 1								
As of Inception Date or Next Preceding Annual Statement Date					**As of Current Annual Statement Date**			
	A	B	C	D	E	F	G	H
	Name of Company	Inception Date or Next Preceding Annual Statement Date	Category	Assets	Affiliate or Parental Guarantee	Category	Assets	Affiliate or Parental Guarantee
			Cash held as Primary Asset			Cash held as Primary Asset		
			SVO-listed securities held as Primary Asset			SVO-listed securities held as Primary Asset		
			Evergreen, Unconditional LOCs held as Primary Asset			Evergreen, Unconditional LOCs held as Primary Asset		
			Other assets—Category 1			Other assets—Category 1		
			Other assets—Category 2			Other assets—Category 2		
			Other assets—Category 3			Other assets—Category 3		
			Other assets—Category 4			Other assets—Category 4		
			Other assets—Category 5			Other assets—Category 5		
			Other assets—Category 6			Other assets—Category 6		
			Other assets—Category 7			Other assets—Category 7		
			Other assets—Category 8			Other assets—Category 8		
			Other assets—Category 9			Other assets—Category 9		
			Other assets—Category 10			Other assets—Category 10		
			Other assets—Category 11			Other assets—Category 11		
			Totals			**Totals**		

			Cash held as Primary Asset			Cash held as Primary Asset		
			SVO-listed securities held as Primary Asset			SVO-listed securities held as Primary Asset		
			Evergreen, Unconditional LOCs held as Primary Asset			Evergreen, Unconditional LOCs held as Primary Asset		
			Other assets—Category 1			Other assets—Category 1		
			Other assets—Category 2			Other assets—Category 2		
			Other assets—Category 3			Other assets—Category 3		
			Other assets—Category 4			Other assets—Category 4		
			Other assets—Category 5			Other assets—Category 5		
			Other assets—Category 6			Other assets—Category 6		
			Other assets—Category 7			Other assets—Category 7		
			Other assets—Category 8			Other assets—Category 8		
			Other assets—Category 9			Other assets—Category 9		
			Other assets—Category 10			Other assets—Category 10		
			Other assets—Category 11			Other assets—Category 11		
			Totals			**Totals**		
			Cash held as Primary Asset			Cash held as Primary Asset		
			SVO-listed securities held as Primary Asset			SVO-listed securities held as Primary Asset		
			Evergreen, Unconditional LOCs held as Primary Asset			Evergreen, Unconditional LOCs held as Primary Asset		
			Other assets—Category 1			Other assets—Category 1		
			Other assets—Category 2			Other assets—Category 2		
			Other assets—Category 3			Other assets—Category 3		
			Other assets—Category 4			Other assets—Category 4		
			Other assets—Category 5			Other assets—Category 5		
			Other assets—Category 6			Other assets—Category 6		
			Other assets—Category 7			Other assets—Category 7		
			Other assets—Category 8			Other assets—Category 8		
			Other assets—Category 9			Other assets—Category 9		
			Other assets—Category 10			Other assets—Category 10		
			Other assets—Category 11			Other assets—Category 11		
			Totals			**Totals**		

TABLE 3 INSTRUCTIONS

Table 3 applies to <u>all</u> cessions of XXX and/or AXXX statutory policy reserves identified in Table 1 <u>except</u> cessions as to which Column H, I, J or K is checked. As to each cession:

Column A – Provide the name and NAIC code of the assuming insurer

Column B—Provide the latter of (a) the inception date of the cession or (b) the annual statement date immediately preceding the current annual statement date

Column C—Column C identifies categories of assets in which collateral supporting the cession may be held [[Note: the instructions will need to define or cross reference to definitions for each category of assets]]

Column D—State the fair value as of the date reported in Column B for collateral held in each category identified in Column C. For cessions subject to Table 2, report cash, SVO securities, and evergreen, unconditional LOCs held as Primary Assets separately from cash, SVO securities and evergreen, unconditional LOCs held as Primary Assets. For cessions not subject to Table 2, report all such collateral together.

Column E—Check box as to any asset identified in Column D as to which an affiliate of the reporting entity has issued a guarantee

Column F—Column F identifies categories of assets in which collateral supporting the cession may be held [[Note: the instructions will need to define or cross reference to definitions for each category of assets]]

Column G—State the fair value as of the date reported in Column E for collateral held in each category identified in Column F

Column H—Check box as to any asset identified in Column G as to which an affiliate of the reporting entity has issued a guarantee

EXHIBIT D

XXX and AXXX Reinsurance Model Regulation

Section 1. Authority.

This regulation is adopted and promulgated by [title of supervisory authority] pursuant to Section [applicable section] of the [name of state] Insurance Code.

Section 2. Preamble.

A. The [name of state] Insurance Department recognizes that licensed life insurers routinely enter into reinsurance arrangements that yield legitimate relief to the ceding insurer from strain to surplus.

B. However, it is improper for a licensed insurer, in the capacity of ceding insurer, to enter into reinsurance arrangements without ensuring that the liabilities reinsured are backed by appropriately high-quality assets. Such arrangements violate:

   (i) Section [insert provision of state law requiring insurer to file statutory financial reports] to relating to financial statements which do not properly reflect the financial condition of the ceding insurer;

   (ii) Section [insert provision of state law equivalent to NAIC Credit for Reinsurance Model Act (Model 785)] relating to reinsurance reserve credits, thus resulting in a ceding insurer improperly reducing liabilities or establishing assets for reinsurance ceded;

   (iii) Section [insert provision of state law equivalent to NAIC Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (Model 385)] relating to creating a situation that may be hazardous to policyholders and the people of this State.

Section 3. Purpose.

The purpose of this regulation is to facilitate the Department's surveillance of the financial condition of life insurers by establishing asset quality requirements for insurers to reduce any liability or establish any asset in any financial statement filed with the Department based on reinsurance ceded by the insurer. These requirements are to ensure that financial statements reflect risks to the financial condition of a ceding insurer resulting from reinsurance ceding transactions, and that a ceding insurer has not reduced liabilities or established assets through the improper use of reinsurance reserve credits.

Section 4. Applicability.

This regulation shall apply to:

A. Any domestic life insurance company; and

B. Any other licensed life insurance company not subject to a substantially similar regulation in its domestic state that seeks to reduce statutory policy reserves required to be held under the NAIC Valuation of Life Insurance Policies Model Regulation (#830), which is commonly referred to as Regulation XXX, or statutory policy reserves required to be held under the NAIC Actuarial Guideline XXXVIII-The Application of the Valuation of Life Insurance Policies Model Regulation (A.G. 38), commonly referred to as AXXX, through a reinsurance ceding arrangement.

Section 5. Definitions.

A. "Actuarial Method" shall mean a calculation made pursuant to the NAIC Valuation Manual, VM-20 "Requirements for Principle-Based Reserves for Life Products", [[as modified by __________]]

B. "Primary Assets" shall mean the following:

(1) Cash;

(2) Securities listed by the Securities Valuation Office of the NAIC, including those deemed exempt from filing as defined by the Purposes and Procedures Manual of the Securities Valuation Office, and qualifying as admitted assets; and

(3) Clean, irrevocable, unconditional and "evergreen" letters of credit meeting the requirements of [insert provision of state law equivalent to Section 10.A.(3) of the Credit for Reinsurance Model Act]; provided, however, that (i) such letters of credit shall constitute Primary Assets solely for the purposes of satisfying the requirements of Section 10.A.(ii) of this regulation in connection with an annual review occurring after the inception of the reinsurance ceding arrangement, and provided further that (ii) such letters of credit shall in no event constitute more than 10% of the Primary Asset Level as of the date of any such annual review.

C. "Primary Asset Level" shall mean the dollar amount resulting from applying the Actuarial Method to reserves within the scope of Section 4 of this regulation.

D. "Other Assets" shall mean any asset approved for use in a reinsurance ceding arrangement by both the ceding insurer's domestic regulator and the assuming insurer's domestic regulator.

E. An insurer shall be deemed to have met the "Disclosure Requirements" if the insurer, with respect to each transaction within the scope of Section 4 of this regulation: (i) completes all relevant portions of the [Supplemental Reinsurance Exhibit] as part of the insurer's Annual Statutory Financial Statements; and (ii) discloses each such transaction in a Note to its Annual Audited Financial Statements in accordance with the requirements of SSAP No. 61R – Life, Deposit Type and Accident and Health Reinsurance.

Section 6. Asset Requirements.

A ceding insurer seeking to reduce its statutory policy reserves for life insurance within the scope of Section 4 through a reinsurance ceding arrangement using any form of security subject to commissioner approval pursuant to [insert provisions of state law equivalent to Section 3.D. of the NAIC Credit for Reinsurance Model Law and/or Section 10.A.(4) of the NAIC Credit for Reinsurance Model Regulation] may do so if, and only if, the following criteria are satisfied:

A. The ceding insurer's statutory policy reserves with respect to such life insurance are established in full in accordance with the applicable requirements of [insert provision of state law equivalent to the NAIC Standard Valuation Law and related regulations and actuarial guidelines];

B. The ceding insurer determines the Primary Asset Level with respect to such reserves and provides support for its calculation to its domestic regulator;

C. The reinsurance ceding arrangement is approved by the ceding insurer's domestic regulator;

D. The reinsurance ceding arrangement is approved by the assuming insurer's domestic regulator;

E. The ceding insurer receives collateral on a funds withheld or trust basis consisting of Primary Assets with a fair value not less than the Primary Asset Level;

F. The ceding insurer receives collateral consisting of Other Assets with respect to any portion of the reserve credit that is not collateralized by Primary Assets;

G. If the assuming insurer is exempt from the requirements of Risk Based Capital (RBC) or otherwise calculates RBC using prescribed or permitted accounting practices, the ceding insurer includes in its RBC calculation the assets and liabilities of the assuming insurer; and

H. The ceding insurer satisfies the Disclosure Requirements.

Nothing herein shall limit the ceding insurer's domestic regulator or the assuming insurer's domestic regulator authority to impose such additional or more stringent requirements or conditions for approval as such regulator deems appropriate.

Section 7. Presumption of Hazardous Financial Condition.

Any ceding insurer that reduces its net retention of reserves for life insurance within the scope of Section 4 through a reinsurance ceding arrangement (including arrangements not subject to Section 6) shall be presumed to be in a hazardous financial condition pursuant to Section [insert provision corresponding to Section 3.D. of NAIC Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (Model 385)] unless the following criteria are satisfied:

A. The ceding insurer's statutory policy reserves with respect to such life insurance are established in full in accordance with the applicable requirements of [insert provisions of state law equivalent to the NAIC Standard Valuation Law and related regulations and actuarial guidelines];

B. The ceding insurer determines the Primary Asset Level with respect to such reserves and provides support for its calculation to the ceding insurer's domestic regulator;

C. The reinsurance ceding arrangement is approved by the ceding insurer's domestic regulator;

D. The reinsurance ceding arrangement is approved by the assuming insurer's domestic regulator;

E. The ceding insurer receives collateral on a funds withheld or trust basis consisting of Primary Assets in not less than an amount equal to the Primary Asset Level;

F. The ceding insurer receives collateral consisting of Other Assets with respect to any portion of the reserve credit that is not collateralized by Primary Assets;

G. If the assuming insurer is exempt from the requirements of Risk Based Capital (RBC) or otherwise calculates RBC using prescribed or permitted accounting practices, the ceding insurer includes in its RBC calculation the assets and liabilities of the assuming insurer; and

H. The ceding insurer satisfies the Disclosure Requirements.

Nothing herein shall limit the ceding insurer's domestic regulator or the assuming insurer's domestic regulator authority to impose such additional or more stringent requirements or conditions for approval as such regulator deems appropriate.

Section 8. Exemptions.

The presumption set forth in Section 7 shall not apply to reinsurance ceding arrangements meeting the following criteria, provided that the ceding insurer shall satisfy the Disclosure Requirements with respect to such reinsurance ceding arrangements:

A. Reinsurance ceded to an assuming insurer that is licensed to transact insurance or reinsurance in this state within the meaning of [insert provision of state law equivalent to Section 2.A. of the NAIC Credit for Reinsurance Model Law (Model 785)], provided that the assuming insurer:

1. prepares its statutory financial statements in full compliance with the NAIC Accounting Practices and Procedures Manual, without any "permitted practices"; and

2. is not in a Company Action Level Event, Regulatory Action Level Event, Authorized Control Level Event, or Mandatory Level Control Event as those terms are defined in [insert provision of state law equivalent to the NAIC Risk-Based Capital (RBC) for Insurers Model Act] when its RBC is calculated in accordance with the NAIC Life Risk-Based Capital Report including Overview and Instructions for Companies, as the same may be amended by the NAIC from time to time, without deviation.

B. Reinsurance ceded to an assuming insurer that is accredited by the commissioner as a reinsurer in this state within the meaning of [insert provision of state law equivalent to Section 2.B. of the NAIC Credit for Reinsurance Model Law (Model 785)], provided that the accredited reinsurer:

1. prepares its statutory financial statements in full compliance with the NAIC Accounting Practices and Procedures Manual, without any "permitted practices"; and

2. is not in a Company Action Level Event, Regulatory Action Level Event, Authorized Control Level Event, or Mandatory Level Control Event as those terms are defined in [insert provision of state law equivalent to the NAIC Risk-Based Capital (RBC) for Insurers Model Act] when its RBC is calculated in accordance with the NAIC Life

Risk-Based Capital Report including Overview and Instructions for Companies, as the same may be amended by the NAIC from time to time, without deviation.

C. Reinsurance ceded to an assuming insurer that has been certified by the commissioner as a reinsurer in this state within the meaning of [insert provision of state law equivalent to Section 2.C. of the NAIC Credit for Reinsurance Model Law (Model 785)].

D. Reinsurance ceded to an assuming insurer as to the insurance of risks located in jurisdictions where the reinsurance is required by the applicable law or regulation of that jurisdiction within the meaning of [insert provision of state law equivalent to Section 2.F. of the NAIC Credit for Reinsurance Model Law (Model 785)].

Section 9. FAWG Review.

Any reinsurance ceding arrangement as to which a presumption is created pursuant to Section 7 shall be subject to review by the Financial Analysis Working Group of the National Association of Insurance Commissioners.

Section 10. Annual Review.

A ceding insurer that has reduced its net retention of reserves for life insurance within the scope of Section 4 through a reinsurance ceding arrangement that is not exempt under Section 8 shall, as of the December 31st next following the inception date of the cession or the effective date of this Regulation, whichever is later, and as of every subsequent December 31st on which the cession remains in effect: (1) determine the Primary Asset Level as of the date of the annual review; and (2) determine the fair value of the collateral consisting of Primary Assets. If any such review reveals that the value of the Primary Assets is less than the Primary Asset Level, the ceding insurer shall either (i) cease to take credit for an amount equal to the difference; or (ii) obtain collateral on a funds withheld or trust basis from the assuming insurer consisting of Primary Assets in an amount equal to the difference.

Section 11. Severability.

If any provision of this regulation be held invalid, the remainder shall not be affected.

Section 12. Transactions Affected.

A. This regulation shall apply to all cessions with respect to any life insurance within the scope of Section 4 written by the ceding insurer on or after January 1, 2015, regardless of when the reinsurance arrangement was entered into.

B. This regulation shall apply to all cessions with respect to any life insurance within the scope of Section 4, regardless of when written, under any reinsurance arrangement that is entered into or amended on or after January 1, 2015.

Section 13. Prohibition against Avoidance.

No insurer shall take any action or series of actions, or enter into any transaction or arrangement or series of transactions or arrangements, involving reserves within the scope of Section 4, if the purpose of such action, transaction or arrangement or series thereof is to avoid the requirements of this Regulation.

Section 14. Effective Date

This regulation shall become effective [insert date].