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Memo

To:	Rachel Hemphill, FSA, MAAA, FCAS, Life Actuarial Task Force
From:	Patricia Matson, FSA, MAAA, Partner, RRC Ben Leiser, FSA, MAAA, Director, RRC
Date:	October 11, 2024
Subject:	RRC Comments Regarding LATF's Reinsurance AAT Actuarial Guideline Draft Exposure

Background

The Life Actuarial Task Force (LATF) is requesting comments on the AAT for Reinsurance Actuarial Guideline (AG) Draft ("the Exposure"). Per LATF's request for earlier comments regarding the Scope and Aggregation sections of the Exposure, RRC provided prior comment letters on September 19th.and October 3rd. For ease of reference, we have included in this comment letter our previously submitted comments as well as comments on the remaining sections. Note that we have two additional comments on the Scope section that were not previously provided, and those are in bold font.

RRC appreciates the opportunity to offer our comments. Should you have any questions, we would be glad to discuss our comments with you and Task Force members.

We appreciate the work LATF has undertaken to address what we believe is a critical industry issue, namely the significant use of reinsurance, including offshore reinsurance, to provide US insurers with material reserve and capital relief.

RRC has assisted regulators in reviewing a variety of reinsurance transactions that result in material reductions in the total asset requirement (TAR) backing the policyholder obligations. We understand that while these transactions are executed for a variety of appropriate business and financial strategies, we also believe that in some cases they can result in reserves or capital that are reduced to a level that raises questions about their appropriateness from a policyholder protection perspective.

General Comments

We believe that when an insurer makes a promise to its direct policyholders, it is critical for the insurer to set operational and financial standards that will enable it to meet that promise. One such standard would be to ensure there are sufficient assets to pay future claims. This does not change when the insurer chooses to reinsure the business.

Based on this important promise, in a case in which an insurer uses reinsurance to reduce reserve and capital requirements that it views as overly conservative, we believe it would be reasonable to expect the insurer to continue to hold *adequate* reserves and capital, based on US statutory requirements. Based on the overall statutory framework, reserve adequacy has tended to be viewed as the level that would be sufficient under moderately adverse conditions (which may equate to an 85% confidence level). Capital would then cover conditions beyond moderately adverse, up to a higher confidence level (such as 95%).

Therefore, we believe that a goal of the Exposure (which we recognize is focused on reserves) should be

to set guardrails so that reserve financing transactions do not result in those reserves declining below a level that would be sufficient to cover policyholder obligations with approximately 85% confidence (or under moderately adverse conditions) based on the US statutory framework. This seems to be a fundamental minimum, under US statutory guidance, to meet policyholder protection while still allowing for the use of reinsurance to finance reserves.

Comments on Effective Date

We believe that additional guidance is needed as soon as feasible, and therefore we support a December 31, 2025 effective date (since sooner implementation does not appear feasible). We also support ultimately incorporating the AG into the Valuation Manual.

Comments on Scope

With respect to the two options laid out in the Exposure, RRC is in favor of "Option 1: Narrow scope, some analysis expected for all treaties in the scope." Our rationale for this is to address the areas of concern while avoiding creating significant work for Appointed Actuaries and regulators that does not materially address the areas of concern.

Based on our experience, it appears to be a relatively small subset of all reinsurance transactions that result in a material reduction in TAR. Therefore, we are in favor of limiting the scope of the new guidance to reinsurance transactions that result in such material reduction (or may result in such reduction in the future).

We are in favor of using a size threshold as laid out in the Exposure.

We agree with exempting treaties in situations in which the reinsurer is required by law to provide a VM-30 memorandum, since such treaties are unlikely to result in a significant reduction in TAR. **The VM-30 report exclusion is valuable primarily because a counterparty reporting under VM-30 is highly unlikely to have a materially lower reserve requirement, and not because the report itself would address the areas of concern. Therefore, we disagree with excluding transactions solely on the basis that the reinsurer provides a VM-30-like report without actually being subject to VM-30.**

We agree with including any treaty that presents significant collectability risk. Potential approaches to defining such risk are:

1. Credit rating (however, we don't believe that this alone is sufficient)
2. Solvency position (e.g. the reinsurer's capital exceeds the regulatory intervention threshold in its jurisdiction)
3. Delays in payment on the reinsurance agreement that exceed a defined period such as 180 days

We also note that in the case of significant collectability risk, an appropriate reserve would need to take into account the potential need for the cedant to re-establish the full U.S. Statutory reserve if the reinsurer were to default. For example, if the U.S. Statutory reserve is materially higher than an 85th percentile reserve set solely based on the projected underlying asset and liability cash flows, and the reinsurer defaults, the cedant would have to hold the full statutory reserve. This should be considered by the cedant's Appointed Actuary in their asset adequacy assessment.

LATF may want to consider exempting from scope treaties that meet the following criteria, since such treaties are unlikely to result in a significant reduction in TAR:

1. The treaty does not involve business with material investment risk (for example, YRT treaties)
2. The current and projected future reserves that will be held by the reinsurer are not materially less

than those required under the U.S. Statutory framework

We do not believe that scoping out modified coinsurance transactions or those that use a trust or funds withheld makes sense, because such transactions can result in a material reduction in assets available to fund future obligations.

Comments on Definitions

Regarding the definition of Attribution Analysis, we suggest including in the definition other anticipated significant contributors, beyond assumptions, to differences between the pre-reinsurance Statutory Reserve and the Total Reserve. Suggested language could be "….differences in individual key assumptions, underlying methodology, application of any floors, and allowances for risk offsets among policies" or similar.

Regarding the definitions of Deficient and Sufficient Block, we suggest clarifying that the cash-flow testing scenarios are those used under a US Statutory Framework. In other words, the assessment of sufficiency and deficiency is based on the US Statutory cash flow testing approach.

Comments on Risk Identification

We agree with the criteria outlined for determination of the relative level of risk, and with the concept that higher risk should imply more rigorous and frequent analysis by the Appointed Actuary.

Another risk that may be worth consideration is the risk profile of the assets backing the liabilities post reinsurance transaction. Suggested language could be "A significant change in the investments or investment strategy that results in higher risk or higher volatility in the current or future asset portfolio."

Comments on Analysis and Documentation in Light of Risks

We believe that cash flow testing should be mandatory in instances in which there is a Significant Reserve Decrease (as defined in the Exposure) and "where cash flows vary under different economic scenarios" (as described in Actuarial Standard of Practice No. 22, STATEMENTS OF ACTUARIAL OPINION BASED ON ASSET ADEQUACY ANALYSIS OF LIFE INSURANCE, ANNUITY, OR HEALTH INSURANCE RESERVES AND OTHER LIABILITIES (ASOP 22).

As described in our General Comments above, in a case in which an insurer uses reinsurance to reduce reserve and capital requirements that it views as overly conservative, we believe it would be reasonable to expect the insurer to continue to hold *adequate* reserves and capital, based on US statutory requirements. Use of cash flow testing would be an appropriate approach to make such an adequacy assessment for business for which the cash flows are expected to vary with variation in economic scenarios. If there is a Significant Reserve Decrease and the business does not have cash flows that are expected to vary under different economic scenarios, alternative approaches as laid out in ASOP 22 (such as a gross premium valuation) would be reasonable (although there may not be many transactions that fit these criteria, as noted in item B(1) of the Exposure).

We do not believe that the existence of a trust or funds withheld should impact whether cash flow testing is performed. If there is a Significant Reserve Decrease, an assessment of asset adequacy would be needed to determine if there are sufficient assets to cover future policyholder obligations regardless of who is holding the assets.

We do not believe that review of counterparty risk/collectability alone is sufficient to address concerns regarding material reductions in TAR. The Appointed Actuary is already required to evaluate counterparty risk per the requirements of actuarial standards of practice (both ASOP 22 and ASOP 11**,** Treatment of Reinsurance or Similar Risk Transfer Programs Involving Life Insurance, Annuities, or Health Benefit Plans in Financial Reports), and that would continue. However, review of counterparty risk alone would not address situations in which a company cedes a large proportion of its reserves to a strong counterparty that suffers a subsequent material decline in the counterparty's financial resources, resulting in the ceding company needing to recapture the business with insufficient assets available to cover TAR. In addition, if a lot of reinsured business is concentrated in a small number of reinsurers, insolvency of one or more of those reinsurers could lead to systemic risk. In light of the increasing trend to move economically sensitive business offshore, the industry could face a situation similar to the current long term care crisis, i.e., without sufficient total assets available to pay policyholder claims. We support requirements for the Appointed Actuary to directly assess the adequacy of the invested assets backing the ceded reserves.

We also note (as stated in the Scope section above) that in the case of significant collectability risk, an appropriate reserve would need to take into account the potential need for the cedant to re-establish the full U.S. Statutory reserve if the reinsurer were to default. For example, if the U.S. Statutory reserve is materially higher than an 85th percentile reserve set solely based on the projected underlying asset and liability cash flows, and the reinsurer defaults, the cedant would have to hold the full statutory reserve. This should be considered by the cedant's Appointed Actuary in their asset adequacy assessment.

We support inclusion of the option for the domestic insurance commissioner to require cash flow testing for individual treaties or counterparties.

<u>Comments on Attribution Analysis</u>

Attribution analysis alone would not ensure adequate assets to cover policyholder obligations. Therefore, we do not believe that requiring disclosure of attribution analysis alone is sufficient to address this important issue. We believe that any company ceding reserves for economically sensitive business to a reinsurer has an obligation to understand how the reinsurer is managing the assets and mitigating risk. Most agreements include investment guidelines. Therefore, it seems that the Appointed Actuary should be able to gain some insight into how the reinsurer is investing. While it is true that the Appointed Actuary may not be able to obtain sufficient details to model each actual asset backing the business, reasonable approximation methods could be used. Therefore, as noted above, we are in favor of prescribing cash flow testing for economically sensitive business based on specific and defined risk-based criteria. If a US insurer is willing to write business, that insurer should be willing to ensure assets are held in support of that business at a level that covers moderately adverse conditions. This is a very reasonable minimum threshold.

If attribution analysis is used as the sole basis to address asset adequacy for reinsured business, and the use of results is left to the discretion of the individual actuary and their regulator, there may be material differences in how the results impact the amount of assets held in support of reinsured business from company to company. We believe that this is an undesirable result, as we believe there is currently industry and regulator concern regarding a "non-level playing field" due to the current significant level of discretion in how AAT is performed for reinsured business.

<u>Comments on Aggregation</u>

Based on our experience, the transactions that are generating regulatory concern are those in which the insurance company achieves a significant reduction in TAR. In other words, the treaty is entered into for

the express purpose of reducing reserves and/or capital. While such a transaction may be done for good business reasons, we strongly believe that there should not be adverse impacts on policyholder protection. Therefore, we believe that the assets available to cover future policyholder obligations should remain at a level that aligns with overall statutory principles. As described above, this would imply that the reserves backing the transferred business would still be set at approximately an 85% confidence level, and capital at a 95% confidence level. Therefore, we believe that standalone testing of the adequacy of the assets backing reserves for the transferred business is appropriate. Such testing would be used to ensure that the assets backing the reserves post-transaction are still adequate to cover policyholder obligations under moderately adverse conditions. This seems like an appropriate minimum standard, and would still allow companies to free up capital in situations in which formulaic statutory reserves are viewed as excessive (i.e. materially greater than an 85% confidence level). In other words, we do not support aggregation across treaties, counterparties, or with retained blocks of business.

While we recognize that current asset adequacy testing (AAT) allows for aggregation of business, the purpose of AAT is as a backstop test to ensure that the formulaic statutory reserves (which are intended to be conservative) continue to be sufficient. Therefore, the testing allows for aggregation of deficient blocks (i.e. blocks that have booked statutory reserves that are below the 85% confidence level) with sufficient ones as long as "the assets or cash flows from the blocks are available to support the reserves" (per ASOP 22, *Statements of Actuarial Opinion Based on Asset Adequacy Analysis for Life Insurance, Annuity, or Health Insurance Reserves and Other Liabilities*). We believe that in a situation in which an insurance company is proactively seeking surplus relief through a reinsurance treaty (typically because reserves are believed to be overly conservative), it is reasonable to expect that the post-transaction reserves continue to be sufficient on a standalone basis.

Comments on Documentation

We believe this section contains reasonable documentation expectations, and do not have any specific comments.

Thank you for the opportunity to provide comments on this important topic. We can be reached at 860-305-0701/tricia.matson@riskreg.com or 201-870-7713/ben.leiser@riskreg.com if you or other members have any questions.