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Life Actuarial (A) Task Force
NAIC

Re: Reinsurance Asset Adequacy Testing Concepts - <https://content.naic.org/sites/default/files/inline-files/Reinsurance%20AAT%20LATF%20062024%20%281%29.pdf>

Dear Members of the LATF:

I am a retiree and am writing to comment as a consumer and annuity contract owner with skin in the game. My wife and I depend on Guaranteed Lifetime Withdrawal Benefits from Roth IRA variable annuities for a considerable portion of our retirement income. We did not purchase annuities as speculative investments.

As an annuity owner, the insurer's obligations to me are spelled out in my contracts. However, there are no provisions in my contracts that protect me or provide me rights to prevent my insurer from becoming insolvent or unable to meet their contractual obligations to me. **Consumers rely entirely on state regulators** to adopt and enforce regulations that **proactively and effectively** prevent: impairment of insurers' solvency, inability of insurers to honor their contractual obligations to policyowners and failures of insurers.

Reinsurance and asset adequacy is not a new problem. In the press release announcing their 2012 report on Shadow Insurance, the New York State Department of Financial Services stated: (see https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1305211)

In July 2012, the New York State Department of Financial Services initiated a serious investigation into this somewhat obscure area that – we believe – could put insurance policyholders and taxpayers at greater risk.

“Insurance companies use these captives to shift blocks of insurance policy claims to special entities – often in states outside where the companies are based, or else offshore (e.g., the Cayman Islands) – in order to take advantage of looser reserve and oversight requirements. (Reserves are funds that insurers set aside to pay policyholder claims.)

“In a typical transaction, an insurance company creates a “captive” insurance subsidiary, which is essentially a shell company owned by the insurer’s parent. The company then “reinsures” a block of existing policy claims through the shell company – and diverts the reserves that it had previously set aside to pay policyholders to other purposes, since the reserve requirements for the captive shell company are typically lower. (Sometimes the parent company even effectively pays a commission to itself from the shell company when the transaction is complete.)

“However, this financial alchemy, let’s call it ‘shadow insurance,’ does not actually transfer the risk for those insurance policies off the parent company’s books, because in many instances, the parent company is ultimately still on the hook for paying claims if the shell company’s weaker reserves are exhausted (“a parental guarantee”).

“That means that when the time finally comes for a policyholder to collect their promised benefits after years of paying premiums – such as when there is a death in their family – there is a smaller reserve buffer available at the insurance company to ensure that the policyholders receive the benefits to which they are legally entitled.

“We believe that shadow insurance also puts the stability of the broader financial system at greater risk. Indeed, in a number of ways, shadow insurance is reminiscent of certain practices used in the run-up to the financial crisis, such as issuing subprime mortgage-backed securities (MBS) through structured investment vehicles (“SIVs”) and writing credit default swaps on higher-risk MBS. Those practices were used to water down capital buffers, as well as temporarily boost quarterly profits and stock prices at numerous financial institutions. And ultimately, those practices left those very same companies on the hook for hundreds of billions of dollars in losses from risks hidden in the shadows, and led to a multi-trillion dollar taxpayer bailout.

“Similarly, shadow insurance could leave insurance companies less able to deal with losses. The events at AIG’s Financial Products unit in the lead up to the financial crisis demonstrate that regulators must remain vigilant about potential threats lurking in unexpected business lines and at more weakly capitalized subsidiaries within a holding company system.

“We are hard at work on our continuing investigation into shadow insurance. And we hope to shed light on and further stimulate a national debate on this important issue to our financial system.”

As reported at the time (see <https://www.thinkadvisor.com/2013/06/12/new-york-eyes-probe-of-captives/>), Benjamin Lawsky (then Superintendent of NYDFS) said "The Federal Insurance Office, the Office of Financial Research, the National Association of Insurance Commissioners, and other state insurance commissioners should conduct investigations similar to DFS’s to document a more complete picture of the full extent of shadow insurance written nationwide."

As reported, at a Federal Advisory Committee on Insurance meeting, FIO director Michael McRaith called for a task force operating out of the FACI to look into the issue. In response, Ben Nelson, NAIC CEO, told McRaith to “stay in its lane,” and Connecticut insurance commissioner Tom Leonardi said that McRaith and the FIO through its probe were unnecessarily overlapping state turf.

Over a decade later, the problems outlined in the NYDFS report have borne fruit - PHL Variable Life, Columbian Mutual, 777 Re and the list goes on. The failure of regulators to effectively regulate and enforce reinsurance manipulation, has resulted in millions of policy owners facing uncertainty over their financial well-being - the very opposite of the reason for which they purchased the policies in the first place.

I would hope that after the afore-mentioned failures, state regulators and NAIC will not be distracted by preserving turf and focus solely on their *raison d'être* - protecting consumers.

I respectfully submit the following comments on the exposure draft of Reinsurance Asset Adequacy Testing Concepts:

1. Time is of the essence - given the recent proliferation of actions to place insurers in rehabilitation, many of which are the result of reinsurance problems, these regulations need to be issued ASAP. To facilitate rapid deployment, I'd suggest that NAIC staff begin **now** to test the reporting proposals (NAIC proposal, as well as alternate approaches to cash flow testing as suggested by stakeholders) on insurers currently or previously in rehabilitation and/or liquidation. Since the purpose of these proposed changes is to prevent insurer impairment and failure, it's important that they be effective predictors of problems, that allow time for correction before insurer failure..

For example, if you apply the proposed methodology to PHL Variable Life, at what point would the reinsurer data be predictive of the decline in RBC ratio from 268% (at the end of 2022) to NEGATIVE 847% (at the end of 2023). If the data is not predictive or not predictive in time for regulator action to prevent failure, what would be needed to make it predictive to prevent insurer failure?

2. Improve analysis - utilize holistic analysis - so that reinsurance data is analyzed in conjunction with other regularly reported information (or with additional data that will need to be required), rather than as a stand-alone measure.

Utilize analysis over time (5 or 10 year lookback) to spot trends in the components (types and quality of assets, reinsurance arrangements, premium revenue by product, etc.). This analysis would highlight unexpected trends that could compromise solvency. For example, "hot products" where increases in sales are greater than industry averages for that type of product or improvements in surplus that exceed industry averages. These results should trigger a quick and deep examination of the insurer, as they are predictive of manipulations that lead to financial deterioration.

Using a macro analysis lens, examine concentration risks of reinsurers. To do so, you will need the company-level data to see who's ceding to who, how and why. This might shine a light on a "hot" reinsurer whose business growth is abnormally greater than the industry average.

3. Require additional data to effectively regulate and enforce - all data is warehoused electronically. If you need more detailed or better data for analysis, mandate it and don't be covered by whining of industry trade groups. Without timely data, it's impossible for you to regulate and enforce to protect consumers.
4. Add transparency - the insurance industry embraces opacity, it's impossible for consumers and insurance professionals to accurately assess financial strength and actual claims-paying abilities. You should assume that policy owners are "orphans" - without benefit of a knowledgeable agent.

For most consumers, the purchase of a life insurance policy or an annuity is a one-time exercise. The purchase is made to protect the consumer from a financial risk (death, longevity, etc.) and once the purchase is made, it is not often revisited. Someone who purchased an Executive Life policy in 1986 would have been assured by company's S&P rating of AAA - with no clue that the company would fail 5 years later. Due to changes in an insured's health and age, market conditions and product offerings over time, years in the future a consumer may be unable to duplicate or even secure comparable coverage from another insurer. For a consumer with a failed insurer, this is a financial disaster.

In shopping for a product, an informed insurance consumer might look to the rating agencies (AM Best, Fitch, etc.) for assurance that an insurer is financially strong and will be there to honor contractual obligations. Most consumers and many insurance "professionals" do not understand that the agency ratings are based on the aggregate (holding company level) and that only the company named in the policy document is responsible for meeting the contractual obligations and paying claims on the consumer's policy.

To counteract the industry's opacity, a consumer or insurance professional should be able to **easily** access information about their insurer's asset adequacy, including reinsurance information. All statutory reports should be posted on the NAIC website along with a consumer guide to help them understand the statements and find information (like reinsurance data) that they're looking for.

5. Materiality threshold - given the rise in insurer failures due to reinsurance manipulations, until regulators have a good understanding of the problem and sufficient data to document the extent of the problem, free passes for no additional disclosure, should not be awarded. Without good and complete data, you're regulating with blinders on. All of the data is there, don't be fooled by the whining.

6. Appointed Actuary's Statement - that the total reserve amount held being a reasonable estimate of liabilities under moderately adverse conditions.

This should be required annually as part of the insurer's annual sworn statement.

Aggregation should not be permitted, since aggregation does not improve a consumer's ability to enforce their insurer to honor its contractual obligations or pay claims. Consider the PHL policy owners - they're guaranteed a haircut - make that a buzz-cut. Yet when PHL was aggregated with Nassau, who would've thunk it?

The Appointed Actuary should have skin in the game - financial responsibility, fines and prohibition from serving US insurers or their offshore counterparts would be great tools to achieve this.

Thanks for your consideration of my comments and the work that you do to protect consumers.

Yours truly,

Peter Gould