rrc risk®ulatory CONSULTING

Memo

To: Rachel Hemphill, FSA, MAAA, FCAS, Life Actuarial Task Force

From: Patricia Matson, FSA, MAAA, Partner, RRC

Date: July 18, 2024

Subject: RRC Comments Regarding LATF's June 20th AAT Reinsurance Exposure

Background

The Life Actuarial Task Force (LATF) is requesting comments on the AAT Reinsurance Exposures (one on AAT concepts and one on AAT attribution) that were released on June 20, 2024.

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. Below we outline our suggestions as they relate to each item in the exposure drafts. We have also included commentary regarding disadvantages associated with certain alternative approaches that have been discussed in the industry.

RRC Comments on AAT Concepts

Need for Review Beyond Counterparty Risk/Collectability

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), 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.

Materiality

We are in favor of exempting treaties that do not have a material impact on the cedant's financial statements. For example, ceded reserves below some percentage of surplus, such as 5%, could be exempted from a cash flow testing requirement. We also suggest including guidance for situations in which there are multiple similar treaties that are below the materiality threshold that, when combined, exceed materiality to avoid potential "gaming" of the materiality threshold.

In our experience, the types of treaties that give risk to material TAR reductions are coinsurance or variations thereof (such as modified coinsurance). Therefore, we believe that non-proportional treaties, such as yearly renewable term or excess of loss, could potentially be excluded.

We are not in favor of a more "generous" requirement in the first year, since we believe this may result in a "race" to get treaties in place before the tougher requirements are implemented. As a possible alternative, we would suggest including some sort of exemption or limited requirements that could be followed in the event that the new requirements are viewed as onerous for existing treaties only, and only if approved by the domiciliary regulator.

Risk-Based Rigor and Frequency

We believe that adjusting the degree of rigor based on the degree of risk is reasonable. Regarding the specific scenarios outlined in the exposure, we have the following comments:

1. We agree that more rigor may be needed if the assuming company does not provide a VM-30 memorandum to their regulator
2. We agree that more rigor may be needed if there is a significant reserve decrease, and would also suggest that this criteria be applied both at the time of the transaction as well as prospectively, to avoid a situation in which reserves are maintained to avoid the additional analysis and subsequently released
3. We agree that more rigor may be needed if there is a significant collectability risk associated with the reinsurer, and would also suggest that this criteria be applied prospectively since the collectability risk may increase over time. Collectability risk should also be based on robust analysis, and not just a review of credit rating.
4. We agree that more rigor may be needed if assets are not held in trust or a funds withheld account. However, this should be considered in conjunction with item 2 above. If there is a trust or funds withheld, but the reserve decrease is significant, more rigor may still be appropriate.
5. We suggest applying the requirements to both affiliated and non-affiliated reinsurers.

While we agree that aggressive assumptions used by the reinsurer are concerning, this may not be a practical criterion for determining degree of rigor since it is subjective, and if the cedant's appointed actuary (AA) is not already required to perform an assessment of the adequacy of the invested assets (i.e. the AA is simply assessing counterparty risk), it may be hard to determine whether assumptions are aggressive. Review of the assumptions used would be something the AA and US regulator could do once a requirement to perform testing of the invested assets for adequacy is in place. If the AA determines the reinsurer's assumptions are aggressive, the AA could use more moderate assumptions in their own assessment of adequacy.

Analysis Considerations

We suggest requiring cash flow testing (CFT) under the following criteria:

1. The reinsurance agreement (or combination of similar agreements) has a material impact on the cedant's balance sheet.
2. The reinsurance agreement transfers investment risk to the reinsurer, so for example coinsurance, modified coinsurance, and coinsurance with funds withheld. If the agreement does not transfer investment risk, then CFT of the reinsured business may not be necessary.
3. The reinsurer is not already subject to VM-30 (since in such cases, material reductions in TAR are less likely and the reinsurer is likely already performing CFT on the reinsured business).
4. Alternatives could be allowed, subject to regulatory approval, for treaties that were already inforce at the time of adoption of a CFT standard if there are significant data availability issues. We note that most treaties include provisions allowing for changes due to changes in law, and therefore it seems that most companies could therefore obtain necessary data to perform cash flow testing. However, we recognize this may not always be the case, and therefore some allowance for an exemption may be needed.

In the case of business for which cash flows do not vary under different economic scenarios, we do not believe that cash flow testing should be mandated. If significant TAR reductions are occurring for any such business, an alternative requirement such as a gross premium valuation may be appropriate. However, we have not seen specific cases involving non-economically sensitive business.

Requiring attribution analysis would assist regulators in understanding the drivers of a reduction in reserves or TAR; however, 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.

Requiring the AA to opine that the total reserve amount is a reasonable estimate of liabilities under moderately adverse conditions would not address the invested assets supporting the business. Therefore, we believe that an opinion from the AA regarding the adequacy of the **invested** assets to support the policyholder obligations under moderately adverse conditions would be more helpful in addressing this issue.

Aggregation Considerations

We do not believe that assets should be aggregated across different reinsurers. In the event a cedant has multiple treaties covering similar business with the same reinsurer and the Appointed Actuary determines and documents that the reinsurer supports both treaties with the same pool of assets, aggregation may be appropriate. ASOP 22 already states "the actuary should not use assets or cash flows from one block of business to discharge the reserves and other liabilities of another block of business if those assets or cash flows cannot be used for that purpose."

We do not believe that the ceded business should be aggregated with other direct written business unless the respective durations of the businesses are sufficiently similar. For example, if a company cedes long duration payout annuities and the asset backing reserves are significantly lower post-reinsurance, combining that block with short duration deferred annuities may show that aggregate reserves are sufficient. However, once the short duration block runs off, there may be a shortfall in assets without any

guarantee that there are available assets to cover that shortfall. While this potential outcome already exists for the retained business, the retained business can be monitored closely by the cedant Appointed Actuary and the domestic regulator. If the "offsetting" blocks are spread across entities and jurisdictions close monitoring may be challenging. Another potential approach to addressing such an issue could involve requirements for review of interim values for the aggregated businesses rather than focusing on ending surplus in assessing adequacy.

In some situations, aggregation may be reasonable. We would encourage a regulatory review process for this so that individual facts and circumstances could be considered. For example, aggregation may be appropriate for blocks of business with similar characteristics and reinsured to the same reinsurer.

Frequency

We agree with a risk-based approach to frequency of applying any new, more prescriptive, requirements. Asset adequacy testing in general should be performed annually. However, for more prescriptive requirements, if a cedant can demonstrate asset adequacy with material margins for the reinsured business, less robust analysis may be appropriate in subsequent years, as long as the AA is still able to opine on asset adequacy. The AA could apply judgment as to how much analysis is needed based on past results and material changes in the business, the environment, the assets, or the treaty. For example, if there are material asset adequacy margins in year one and no significant changes, the AA could use rollforward techniques to support his or her opinion in year two.

Attribution Analysis

As we noted above, 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.

Timing

We suggest adopting a requirement for cash flow testing based on the criteria described above (which would limit the requirement to a relatively small number of treaties) for year end 2024 if possible. We suggest this because an extension of one year may push companies to move as much business offshore as possible between now and year end 2025. Although this could be addressed by a retroactive start date (such as 1/1/2021 per the exposure), there is risk that companies will not structure treaties in a way that would ensure they are able to get sufficient data to perform CFT.

If the effective date is pushed to year end 2025, we believe it is important to scope in treaties starting at 1/1/2024 at a minimum, as there is clearly industry awareness of this issue at this time. If an older start date is used, such as 1/1/2021, we believe there may be situations in which the AA won't have sufficient data to perform robust CFT, and that should be taken into account in some way. Perhaps through an exemption process.

<u>RRC Comments on AAT Attribution (Excel file)</u>

While we believe that attribution analysis will be helpful in understanding the drivers of changes in reserves, an attribution from CARVM to a post-reinsurance/offshore basis (such as the approach used in Bermuda) may not be insightful due to the very significant differences between the two approaches. Removal of a cash surrender value floor alone may cause a material reduction in reserves. Every single transaction will involve major assumption differences due to the fixed, prescribed CARVM assumptions and the lack of assumptions for behavior and expenses. Investment assumption differences will involve not only the rate of return, but also assumptions regarding prepayments, defaults, recoveries, calls, asset sale prices, etc.

In other words, we would generally expect a material reserve reduction from CARVM to offshore, as that is often a key driver of entering into the transaction itself. Perhaps a more meaningful comparison would be between the reserve held for the business under the most recently performed US cash flow testing (on a standalone basis, under moderately adverse conditions) to the reserve held in the offshore jurisdiction. Such a comparison would help the regulator understand whether the post-reinsurance reserve is less than what would be required under moderately adverse conditions. In addition, attribution of each individual assumption difference would allow the US regulator to understand if the post reinsurance assumptions are aggressive relative to assumptions used in the US framework which were already subject to regulatory review.

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