

Memo

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

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

Date: May 10, 2024

Subject: RRC Comments Regarding LATF's March 17th AAT Reinsurance Exposure

Background

The Life Actuarial Task Force (LATF) is requesting comments on the AAT Reinsurance Exposure that was released on March 17, 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.

RRC Comments

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 draft. We have also included commentary regarding disadvantages associated with certain alternative approaches that have been discussed in the industry.

Terminology

The Valuation Manual currently requires that “[t]he statement of actuarial opinion must apply to all in-force business on the annual statement date, whether directly issued or assumed, regardless of when or where issued.” In providing this opinion, the appointed actuary is required to opine on whether “[t]he reserves and related actuarial items, when considered in light of the assets held by the company with respect to such reserves and related actuarial items including, but not limited to, the investment earnings on the assets, and the considerations anticipated to be received and retained under the policies and contracts, make adequate provision, according to presently accepted ASOPs, for the anticipated cash flows required by the contractual obligations and related expenses of the company.” Based on this, Appointed Actuaries should already be performing AAT on all direct business whether reinsured or not.

In the case of business for which cash flows vary under different economic scenarios (“economically sensitive business”), we believe that cash flow testing is appropriate, and this aligns well with ASOP 22 which states “Cash flow testing is generally appropriate where cash flows vary under different economic scenarios.” We support a proposal that would require Appointed Actuaries to use cash flow testing (CFT) for economically sensitive business that is reinsured, and also suggest the following additional conditions under which CFT would be required:

1. 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.
2. 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).
3. Alternatives could be allowed, subject to regulatory approval, for treaties that were already in force 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.

Materiality

We would suggest use of an exemption process similar to item 3 above for immaterial treaties. Alternatively, perhaps ceded reserves below some percentage of surplus, such as 5%, could be exempted from the cash flow testing requirement.

Aggregation

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.

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.

Retroactivity and Applicability

We believe that the proposed 1/1/2020 start date is reasonable, but we suggest including an exemption process as described in item 3 under Terminology above. There may be situations in which an Appointed Actuary simply cannot obtain the necessary data to comply, so an exemption process for those situations would allow for such circumstances without requiring an Appointed Actuary to issue a qualified opinion.

Methodology

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.

A possible alternative, even for economically sensitive business, may be use of a gross premium valuation (GPV). However, if a GPV is used for economically sensitive business, we believe that it would be important for the Appointed Actuary to consider a range of scenarios, including alternative discount rate assumptions, to appropriately capture moderately adverse conditions. Since asset risks cannot be directly modeled in a GPV, we would also recommend that additional margins be required, in particular if the underlying asset mix includes material high yielding assets with risks such as illiquidity, credit, and cash flow delay or prepayment risks.

Other Comments

We have the following additional comments based on our participation in the ongoing public debate and alternative solutions that are being discussed.

We understand that some stakeholders believe that review of counterparty risk alone is sufficient to address concerns regarding material reductions in TAR. We disagree that this is sufficient. 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 do not believe a state-by-state review of individual reinsurance transactions is a sufficient approach to address the issue of significant TAR reductions. We are aware that regulators perform reviews of new reinsurance treaties through existing regulatory review procedures, and part of that process may involve evaluating the impact on policyholders. Conditions may be placed on the cedant as part of the approval process, including conditions related to minimum required reserves and capital. However, there is currently limited uniformity in how individual states implement appropriate policyholder protections, and therefore it can create an unlevel playing field for insurers. A consistent requirement across companies to ensure that TAR is adequate to fund future obligations is preferable, in our opinion.

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.