AMERICAN ACADEMY of ACTUARIES

American Academy of Actuaries' C3 Life and Annuity Capital Work Group
Comments Regarding Proposed C3 Phase 3 Scope Limitation

Presented to the National Association of Insurance Commissioners'
Life Risk Based Capital Working Group

February 2010

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C3 Life and Annuity Capital Work Group

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The C3WG would also like to acknowledge the work of Susan Christy and Jason Alleyne F.S.A., F.C.I.A., F.I.A.

This document has been prepared by the American Academies of Actuaries C3 Life and Annuities Capital Work Group (C3WG) in response to the American Council of Life Insurers (ACLI) C-3 Phase 3 scope proposal modified by the Life Risk Based Capital (E) Working Group and released for comment on the Jan. 13, 2010, conference call of the Working Group.

As proposed by the ACLI, the C-3 Phase 3 (C3P3) methodology would apply only to fixed interest universal life insurance policies that contain secondary guarantees (ULSG) that extend beyond the fifth policy anniversary.

The C3WG strongly believes that a risk-based determination of C-3 capital requirements that includes all life insurance products is far superior to a product-based inclusion/exclusion approach. The issue of the practicality of comprehensive stochastic modeling is addressed by the Stochastic Exclusion Test and the Alternative Amount option.

Fundamentally, minimum C-3 capital requirements should be based on the risk exposures created for the company by the product and its management, not solely based on product type. The risks for the company depend not only on the nature of the liability, but also on the supporting assets, and the investment and risk management strategies. In that context, using the length of secondary guarantee period to qualify for exclusion from the C3P3 requirements ignores many more critical items that place a company's capital at risk.

In developing our proposal, the C3WG formulated a process that is commensurate with the degree of risk. In that context, the Stochastic Exclusion Test serves as a filter, identifying blocks of business with material tail risk and that need to be measured by stochastic modeling. The C-3 required capital for those blocks identified as not having material tail risk would continue to be determined according to the existing C-3 factor basis. Further, to lessen the burden where stochastic modeling might be required, the Alternative Amount option is provided as a possible simplification tool, facilitating the use of existing risk management processes.

Any methodology for establishing C-3 capital requirements should be based on the company's aggregate portfolio of retained risks, where the methodology establishes capital requirements based on the combined effect of a company's business decisions – product, investment, and risk management strategies. Any methodology based on a portion of a company's risks has the potential for manipulation and unintended results.

Limitation of scope to a product or group of products creates a number of issues.

- Allocation Issues

  As stated in the ACLI proposal, scope limitation depends upon practitioners determining whether each specific contract satisfies the defined product scope and then artificially dividing the supporting asset portfolio in order to carry out the modeling. Other cash flows, including but not limited to reinsurance treaties, hedging, and asset investment strategy implementation, may also need to be divided or allocated.

To address these allocation issues the ACLI proposes that the company be provided with the option to apply the C3P3 methodology to other policies or funds in the same Business Segment as the policies to which the C3P3 methodology applies.

The definition of Business Segment used in the ACLI proposal is not the definition used in the C3WG draft RBC Instructions changes. The draft RBC Instructions define Business Segment as "a group of assets associated with a group of policies that are modeled to project future Accumulated Deficiencies." The ACLI adds the additional description that "this grouping will generally follow the company's asset segmentation plan, investment strategies, or approach used to allocate investment income for statutory purposes." This additional description was removed from the draft RBC Instructions definition as it is was not a requirement nor intended to be a defining requirement of Business Segment.

The phrase "generally" is not clear in a definitional format nor is it appropriate to attach the phrase "used to allocate investment income for statutory purposes." Each company may (or may not) create segments in their business to manage and analyze results. Such segments are not a level of granularity required by C3P3. C-3 is a company-based calculation with no requirements for more granular calculations.

We support the proposed option for companies to expand their C3P3 calculation to policies that are managed together with in-scope ULSG business; however, the company's approach as to what is and is not modeled for C3P3 purposes should be consistent from year-to-year, with any changes from the prior year disclosed and documented.

- Single Premium Life Exclusion

  In addition to the proposed optionality, the ACLI proposes that single premium life business be excluded from C3 Phase 3 requirements and remain within the existing C-3 Phase I framework. It's not clear how single premium is different from periodic premium in the context of scope and why a single premium universal life policy with secondary guarantee that extends beyond the fifth policy anniversary would be excluded whereas a periodic premium policy with similar length secondary guarantee would be included in scope. It is also not clear how a company would address the proposed optionality in the case where in-scope ULSG policies are managed with single premium life policies.

The scope limitation needlessly introduces complexities and may result in a distorted picture of the risks for the block as a whole. To the extent that regulators are sympathetic to industry concerns with the time and effort involved to set up a risk-based model for C3 capital requirements, the C3WG suggests that the scope limitation apply for one year with no scope limitation thereafter.

In summary, C3WG strongly believes that a risk-based determination of C-3 capital requirements that includes all life insurance products is far superior to a product-based inclusion/exclusion approach for the above reasons. The issue of the practicality of comprehensive stochastic modeling is addressed by the Stochastic Exclusion Test and the Alternative Amount option.