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Mr. Philip Barlow
Chair, Life Risk Based Capital Working Group
Deputy Commissioner
Dept of Insurance Securities & Banking
810 First Street NE Suite 701
Washington, DC 20002

Re: Scope limitation and materiality test for C-3 Phase III

Dear Philip:

On behalf of our member companies, the American Council of Life Insurers (ACLI) is pleased to submit the following comments on certain aspects of the proposed C-3 Phase III (C3P3) methodology. The American Council of Life Insurers represents more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies represent over 90% of the assets and premiums of the U.S. life insurance and annuity industry.

In this letter, we will:

(a) Explain the need for a "proof of concept" and why both a scope limitation and materiality threshold are necessary to satisfy this need;
(b) Explain why a secondary guarantee threshold greater than five years is appropriate;
(c) Propose a clarifying amendment to the exposed scope limitation;
(d) Reiterate a comment we made in our January RBC instructions letter about the need for a more rigid definition of Business Segment; and
(e) Propose a specific, two-part materiality test based on a survey of ACLI member companies.

A. The need for a "proof of concept"

Our member companies support adoption of C-3 Phase III on a "proof of concept" basis. We have noted that the C3P3 proposal has not been field tested outside the very limited testing involved with the September 2009 Society of Actuaries study. More notably, over the past year a handful of interested parties—including some members of ACLI—have expressed concerns about certain Phase III concepts, some of which are carried over from C-3 Phase II and Actuarial Guideline 43. Although we are continuing to study these issues within ACLI and have not reached full consensus on the validity of any concerns, we believe that all parties—including regulators—would benefit from a thoughtful "field test" of the proposed C-3 Phase III methodology.

At the same time, multiple interested parties—including ACLI—have commented over the past three-plus years about the significant resource investments the proposed modeling would require. This is acknowledged in the proposal itself, which justifiably allows for as much as six months of advance modeling work. Although C3P3 allows for certain simplifications, they are based on the core stochastic methodology and appear to amount to tradeoffs involving higher capital requirements for less work. With core concepts still in question, it would seem to be unwise to mandate potentially hundreds of millions of dollars of actuarial modeling and analysis. What is needed, we believe, is a wisely chosen limited implementation that allows for deliberate assessment and analysis of the proposed methodology. To that end, our proposed scope limitation and materiality threshold attempt to identify a **meaningful and cost-effective set of policies to test**.

Our proposed **scope limitation** is intended to identify a group of policies in which mismatch risk may be significant. Although in theory any product line can contain significant asset-liability mismatches, it is our impression that regulators are particularly concerned about potential mismatch risk that may exist in policies that contain long-term secondary guarantees. This is why we have targeted these policies for our proposed field testing. In addition, focusing the testing on fixed interest policies should facilitate understanding and interpretation of results by avoiding complications involving equity market movements. In short, the scope limitation is intended to help regulators and industry determine whether the methodology is appropriately quantifying C-3 risk.

Consistent with this philosophy, our proposed **materiality test** is intended to avoid unnecessary work and cost. For field testing purposes, we believe that it is appropriate to exclude smaller blocks of ULSG business, as implementation would require very significant expense and effort, but the results would contribute little to the analysis. As we will later demonstrate, it is not our objective to limit the scope in such a manner that would exclude all companies.

Thus, ACLI is proposing the scope limitation and materiality test in order to devise, in effect, a helpful, cost-effective, mandated field test that will facilitate the development of sound risk quantification methodologies. Once the results are assessed, it should be possible for regulators and industry to determine the appropriate next steps for further reforms involving life insurance C-3 risk. This assessment should include a cost-benefit analysis and any direction that may result from the NAIC's Solvency Modernization Initiative.

B. Why the secondary guarantee threshold should be later than the 5th policy year

We hope that our explanation of the need for "proof of concept" testing will help the Working Group understand why a secondary guarantee threshold that is longer than the fifth policy year is appropriate. We are attempting to develop a testing scope that is meaningful and cost-effective, and we are concerned that a very short secondary guarantee threshold will not serve these objectives.

For fixed interest universal life contracts, the existence of early-duration secondary guarantees—as we propose to define them—presents minimal additional risk and cost to the company. For a fixed interest contract, it is unlikely that the combination of interest credits and charges would exhaust the fund value in the early policy years. Accordingly, on a short-term basis, such secondary guarantees present minimal additional risk. On the other hand, the very long-term secondary guarantees present the greatest possibility for mismatch risk. The risk increases with the length of the guarantee because it is increasingly difficult to construct a matching asset portfolio. We believe that these policies offer the greatest potential for an insightful "field test" of the proposed methodology.

Moreover, if a company is permitted, as we propose, to optionally include policies that it manages together with "in scope" ULSG business, we expect that many companies would strongly consider taking advantage of this optionality in order to avoid the practical problems involved with artificially dividing in-force asset and liability portfolios. This would make it less critical to make a division between "risky" and "not risky." What is needed is a simple minimum threshold for inclusion, and it is likely that a number of "lower risk" policies would ultimately be included in the testing as well. In conclusion, we continue to believe that a longer-term threshold such as the 15th year is appropriate.

C. A clarifying amendment to ACLI's scope limitation proposal

As our member companies contemplated our scope limitation proposal, which was exposed for comment on January 13 (with a friendly amendment changing "fixed" to "fixed interest" and a modification of the secondary guarantee threshold from 15 years to 5 years), we were concerned that the proposed language could be interpreted as including certain policies that we had intended to exclude. We were concerned that the exposed language could be interpreted to include variable contracts with secondary guarantees in which the customer had decided to invest all funds in fixed accounts. We believe that the most straightforward way to clarify this intention is to change certain references to "policies" and "contracts" to "policy forms." In sum, we propose the following amended language:

> The Phase III methodology shall apply to fixed interest[1] universal life[2] insurance ~~policies~~ policy forms that contain secondary guarantees[3] that extend beyond the fifth policy anniversary, as defined by the following:
>
> 1. Fixed interest: ~~Contracts~~ Policy forms in which all policyholder funds receive interest credits that are determined by the company, possibly subject to legal and contractual limitations.
> 2. Universal life: A life insurance policy in which the policyholder pays into a fund (or account value) from which explicit expense and mortality charges are deducted and to which explicit interest credits are added. The policy remains in force as long as the fund is sufficient to pay the periodic mortality and expense charges.
> 3. Secondary guarantee: A guarantee that a policy will remain in force even if its fund value is exhausted, subject to one or more conditions.

D. The need for an expansive definition of Business Segment

Our proposed limited optional application of the Phase III modeling is intended to facilitate meaningful and efficient testing by avoiding the need to artificially divide asset and liability portfolios. In November we began to develop this proposal on the basis of the Academy's September 2009 report, which contained the following definition of Business Segment.

- Business Segment (September 2009 definition): "A group of assets associated with a group of policies that are modeled together to project future Accumulated Deficiencies. *This grouping will generally follow the company's asset segmentation plan, investment strategies, or approach used to allocate investment income for statutory purposes."* (emphasis ours)

When the proposed Phase III instructions were exposed for comment in December, the definition of Business Segment had been amended.

- Business Segment (December 2009 definition): "A group of assets associated with a group of policies that are modeled together to project future Accumulated Deficiencies."

Unfortunately we did not identify and focus on this change until after we had submitted our proposal to the Working Group in January. Because we are attempting to construct a practical accommodation, not an opportunity for companies to "cherry pick," we believe that language is needed that resembles the earlier, more rigid definition. The latest definition would seemingly allow companies to include any combination of their assets and life insurance liabilities in a Business Segment.

Accordingly, we believe that it is necessary either to amend the latest definition of Business Segment or to define a new term around the same concept.

E. Details on ACLI's proposed materiality test

Although we were disappointed that the Working Group decided not to expose our proposed materiality test on the January 13 call, we came away from the call believing that we had failed to adequately communicate the reasoning behind our proposal. Accordingly, over the past month we have conducted a survey of group of ACLI member companies that allows us to provide greater specificity about our proposal. We request reconsideration from the Working Group.

Our original proposal was:

> *The "ULSG C-3 Materiality Test" is the ratio of factor-based C-3a risk charges for fixed ULSG business over the sum of all risk charges for the company without covariance, i.e. C-0 + C-1 + C-2 + C-3 + C-4. If this ratio is greater than **X**%, the company's C-3 risk is deemed material, and it must do the Phase III modeling.*

We pointed out that, conceptually, this test is similar to the "C-3 Significance Test" that currently exists for C-3 Phase I. We also noted that the value of **X** would require additional research.

ACLI continues to support this concept. After conducting a voluntary survey of a group of member companies, we recommend that that the value of **X** should be 1%, based on our recommended 15-year definition of ULSG. In addition, we are recommending a second test that would scope in companies that have blocks of fixed premium ULSG business greater than $1 billion in reserves—regardless of the value of the ULSG C-3 Materiality Test ratio. Thus, all large blocks of fixed interest ULSG business in the industry would be included in the field test.

Combined, we propose a materiality test that would scope in companies with 15-year ULSG, where such business meets <u>either or both</u> of the following tests:

1. The ULSG C-3 Materiality Test ratio is greater than 1%.
2. Statutory reserves for the block of business are greater than $1 billion.

Among our surveyed organizations, these tests, in conjunction with our proposed ULSG scope limitation including the 15th policy year, would sweep in 5 of the 8 surveyed insurance organizations, 10 of the 22 statutory companies, and 92.5% of the "in scope" ULSG business, based on 2008 figures.

One additional concern expressed about our proposed materiality test (expressed by a regulator on the January 13 call) was that its use of factor-based C-3 risk charges may be unwise because the factors themselves may poorly represent risk. We understand this concern, and it seems that the current "C-3 Stress Test" for C-3 Phase I modeling was designed to address it. This test involves multiplying the factor-based C-3 risk charges by 6.5 and determining whether the company's RBC ratio would fall into a regulatory action level.

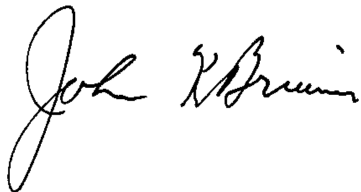
We decided against recommending the C-3 Stress Test concept for this purpose for two primary reasons:

1. The C-3 Stress Test implicitly assumes that the modeling is an accurate and appropriate representation of risk, whereas the factors are not. In this instance, we are not certain whether the proposed modeling methodology produces an accurate and appropriate representation of risk.
2. It is unlikely that a recalculation of RBC after multiplying the C-3 risk charges for fixed-premium ULSG policies by a factor of 6.5 would bring any companies into a regulatory action level.

Also, we would note that the limited modeling performed in the SOA research study suggests that C-3 risk charges for fixed premium ULSG contracts may actually decrease relative to current factors under the proposed approach.

Finally, for completeness purposes, in conjunction with the materiality test, we had also proposed allowing optional application of the proposed Phase III methodology to immaterial amounts of ULSG business. We continue to support this proposal.

We would like to thank the members of the Working Group for their consideration and reconsideration of our proposals. We look forward to continuing to work with you and the other members of the Working Group on this project.



cc: Dan Swanson, NAIC