CLIENT UPDATE

RECTOR REPORT TO NAIC TASK FORCE ON FINANCING OF XXX AND AXXX RESERVES

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On February 17, 2014, Rector & Associates, Inc. issued a report (the "Rector Report") to the Principle-Based Reserving Implementation (EX) Task Force of the NAIC (the "Task Force") on the use of transactions designed to finance reserves associated with level premium term life insurance policies and universal life insurance policies with secondary guarantees, which are commonly referred to as XXX reserves and AXXX reserves, respectively. The Rector Report was made publicly available on the NAIC website on February 27, 2014. The Rector Report sets forth recommendations for the criteria to be satisfied by ceding insurers when financing XXX or AXXX reserves, including the types of assets permitted to support such reserves.

Rector & Associates submitted an initial report to the Task Force on September 13, 2013. This initial report described the type of reserve financing transactions at issue and the charge from the Executive (EX) Committee to the Task Force to make recommendations relating to these transactions. The initial report presented the Task Force with a "threshold decision" as to whether to (i) accept the general logic of insurers that use reserve financing transactions, and seek to promote changes to the existing regulatory framework to promote consistency and appropriate conservatism or (ii) reject such logic and seek to prohibit such transactions.

According to the Rector Report, the general feedback received from the Task Force suggested that reserve financing transactions should be permitted until Principle-Based Reserving ("PBR") is effective (but not thereafter) as long as they meet certain requirements set forth in the initial report, which are further developed in the Rector Report.

While there is a current discussion within the NAIC about whether U.S.-based captive reinsurers of AXXX/XXX reserves are already (or should be) subject to NAIC accreditation standards, the Rector Report opines that regulating the reinsurer will ultimately fail and will lead to financing transactions moving offshore or otherwise out of reach of U.S. state insurance regulators.

"PRIMARY ASSETS" VS. "OTHER ASSETS"

At the core of the Rector Report is a recommendation that a direct/ceding insurer should only be permitted to finance XXX and AXXX reserves if it holds "Primary Assets" on a funds withheld or reinsurance trust basis in an amount approximately equal to what applicable statutory reserves would be under PBR. The Rector Report recommends that a modified version of the VM-20 PBR approach found in the NAIC Valuation Manual be used to calculate the level of Primary Assets (the "Actuarial Method").

The Rector Report proposes that the following two asset categories be deemed Primary Assets: (i) cash and (ii) securities that are listed by the Securities Valuation Office of the NAIC (the "SVO") (including those deemed exempt from filing as defined by the Purposes and Procedures Manual of the SVO) and qualify as admitted assets. This standard is taken from Section 3.B of the NAIC Credit for Reinsurance Model Act, representing existing permitted collateral for reinsurance ceded to an unauthorized reinsurer. A third asset category consisting of clean, irrevocable, unconditional and "evergreen" letters of credit that meet requirements in existing credit for reinsurance regulation are permitted as Primary Assets only in the case of a gap due to market fluctuations between the market value of the Primary Assets and the amount of the reserve calculation under the Actuarial Method. This third category is only permitted if such letters of credit comprise no more than 10% in the aggregate of the insurer's total Primary Asset level and is not permitted in the year of inception.

The Rector Report recommends that a broader category of "Other Assets," which could include admitted assets which are not Primary Assets, letters of credit (including conditional letters of credit), affiliate guarantees and excess of loss reinsurance arrangements, be permitted to support the amount by which XXX or AXXX reserves exceed the reserving calculation under the Actuarial Method. The Rector Report suggests that the determination of the precise assets which would qualify as Other Assets be left to the discretion of the state insurance regulators of the ceding insurer and the reinsurer, with oversight by the NAIC Financial Analysis (E) Working Group ("FAWG") for certain types of Other Assets.

RBC STANDARDS

The Rector Report suggests that Other Assets should be subject to yet to be determined RBC asset charges to ensure that, in addition to reserves, the ceding insurer has sufficient capital and surplus to satisfy policyholder claims. Furthermore, the Rector Report also recommends that full RBC calculations using the traditional NAIC methodology be required by at least one party to the reserve financing transaction for the Primary Assets and Other Assets. Since most reinsurers involved in these reserve financing transactions are U.S. captive reinsurers that are not subject to NAIC RBC, this would mean that the ceding insurer would generally be expected to be subject to full RBC calculations using the traditional NAIC methodology for Primary Assets and Other Assets, a deviation from the existing RBC instructions that do not subject the ceding insurer to RBC with respect to reinsurer assets that support the ceded reinsurance in reinsurance arrangements using funds withheld or assets deposited in a reinsurance trust.

DISCLOSURE REQUIREMENTS

Consistent with the recommendations for enhanced disclosure set forth in the White Paper on Captives and Special Purpose Vehicles adopted by the NAIC Financial Condition (E) Committee on July 17, 2013, the Rector Report recommends that disclosures should be made by ceding insurers to state insurance regulators and the public, via a supplemental reinsurance exhibit to the ceding insurer's annual statutory financial statement.

The disclosure requirements include the dollar amount of XXX or AXXX statutory policy reserves ceded and information about the reinsurer, including whether it is a related party captive or special purpose vehicle and whether it is a licensed, accredited or certified reinsurer. If the reinsurer is not a licensed, accredited or certified reinsurer, details about Primary Assets, Other Assets and the amount of reserve credit taken are required.

"ALTERNATIVE B" – RESERVE FINANCINGS AT THE DIRECT INSURER LEVEL

The Rector Report continues to support the "Alternative B" set forth in the Rector & Associates initial report, namely allowing insurers the option of achieving the same economic effect of a reinsurance reserve financing transaction but without the use of reinsurance. The PBR reserve, Primary Asset, Other Asset and RBC for Other Assets standards would apply equally to Alternative B. The Rector Report opines that this remains a viable alternative, although there may be structural issues to first be addressed including (i) separation of financed reserves from non-financed reserves and (ii) financing party comfort that Other Assets will only be used to fund financed reserves, both before and after a ceding insurer is placed into receivership. The Rector Report suggests that effective separation might be achieved through the use of a protected cell structure or a separate account. Such a solution would require state legislative action to allow segregation of assets and liabilities associated with financed reserves. Recognizing that few if any life insurers may be interested in this approach at present, the Rector Report recommends that the NAIC seek out life insurers that are interested in using Alternative B and then pursue developing the regulatory infrastructure to accommodate it.

NEXT STEPS

The Rector Report recommends that the Task Force propose a new "XXX and AXXX Reinsurance Model Regulation," a draft of which is attached as Exhibit D to the Rector Report, to be made an NAIC Accreditation Standard, which embodies all the above reserve financing standards using a reinsurance arrangement. The Rector Report also suggests a number of referrals to NAIC committees to flesh out details of the Rector Report's proposed standards, including the Life Actuarial Task Force (development of a "modified" VM-20 actuarial standard), the Life Risk-Based Capital Working Group (list of Other Assets, RBC charges for Other Assets and RBC being applied to at least one party to the reinsurance transaction), the Blanks Working Group (new AXXX/XXX disclosure requirements), the Statutory Accounting Principles Working Group (new note to the audited financial statements on reserve financings) and FAWG (review disclosure requirements).

The proposed effective dates for the requirements set forth in the Rector Report are as follows:

- 7/1/2014 for newly created financing structures. The Rector Report takes the view that ceding company state regulators could begin applying some of the new standards without any change in law or regulation, simply as a condition of determining whether to approve reinsurance security as acceptable. However, no state would be bound to apply the new standards without a change in the credit for reinsurance regulations.
- 12/31/2014 for the new disclosure requirements.

- 1/1/2015 for business ceded to existing financing structures. Section 12 of the new XXX and AXXX Reinsurance Model Regulation attached as Exhibit D to the Rector Report makes it clear that the new standards would only apply to (i) business written by the ceding insurer on or after January 1, 2015, regardless of when the reinsurance arrangement was entered into (i.e., new business under existing reserve financing reinsurance arrangements) and (ii) business written under any reinsurance arrangement that is entered into *or amended* on or after January 1, 2015 (i.e., new reinsurance arrangements or prior reinsurance arrangements that are subsequently amended).
- 12/31/2015 for the new RBC rules.

Although concepts from PBR are utilized in the Rector Report, in part to encourage compatibility with PBR if it becomes effective in the future, the Rector Report emphasizes that the recommendations are not dependent upon PBR becoming effective.

The Task Force has released the Rector Report for comment. Written comments are due by Friday, March 21, 2014 to the NAIC's Kris DeFrain at kdefrain@naic.org. We expect that the contents of the Rector Report as well as the comments received will be key topics for discussion at the NAIC Spring 2014 National Meeting to be held in Orlando, Florida from March 29–April 1, 2014. We will report on any such developments in our next NAIC Client Update.

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Please do not hesitate to contact us with any questions.

March 5, 2014