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CLIENT UPDATE

RECTOR-MODIFIED RECOMMENDATIONS TO NAIC TASK FORCE ON FINANCING OF XXX AND AXXX RESERVES

NEW YORK
Ethan T. James
etjames@debevoise.com

Thomas M. Kelly
tmkelly@debevoise.com

Marilyn A. Lion
malion@debevoise.com

Nicholas F. Potter
nfpotter@debevoise.com

John Dembeck
jdembeck@debevoise.com

Alexander R. Cochran
arcochran@debevoise.com

Sean P. Neenan
spneenan@debevoise.com

Sarah Thorndike Kelly
stkelly@debevoise.com

On June 4, 2014, Rector & Associates, Inc. presented modified recommendations (the "Modified Recommendations") to the Principle-Based Reserving Implementation (EX) Task Force of the NAIC (the "Task Force") to its February 17, 2014 report (the "Rector Report") 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 set 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. The Rector Report is the subject of our Client Update dated March 5, 2014.

While the framework application and security requirements have not materially changed, the manner in which they are proposed to be implemented by the NAIC has changed. We describe the framework application and security requirements, the proposed NAIC implementation steps and the key changes from the Rector Report.

FRAMEWORK APPLICATION AND SECURITY REQUIREMENTS

Application to XXX/AXXX Ceded Risks

The framework would apply only to reinsurance involving certain types of XXX and AXXX policies, namely, those required to be valued under NAIC Valuation of Life Insurance Policies Model Regulation Sections 6 or 7.

Reinsurers Subject to the Framework Security Requirements

The framework security requirements apply to XXX and AXXX cessions to (i) reinsurers that are not certified reinsurers, (ii) licensed or accredited reinsurers that materially depart from statutory accounting or fail to follow the NAIC RBC rules, and (iii) unauthorized reinsurers that provide security in the form of "Any other security acceptable to the Commissioner." As such, the framework security requirements do not apply to XXX or AXXX cessions to (i) certified reinsurers, (ii) licensed or accredited reinsurers that follow statutory accounting without material departure and the NAIC RBC rules, and (iii) unauthorized reinsurers that provide security in a permitted form other than "Any other security acceptable to the Commissioner" (so-called "exempt transactions").

Framework Security Requirements

As to cessions to reinsurers to which the framework security requirements apply, the ceding insurer may receive credit for reinsurance only if:

- The ceding insurer establishes gross reserves, in full, using applicable reserving guidance (currently, the "formulaic" approach).
- The ceding insurer satisfies the Primary Security Requirement (*i.e.*, the ceding insurer receives as collateral Primary Security in at least the amount determined pursuant to the Actuarial Method).
  - Primary Security would consist of the types of assets listed in the NAIC Credit for Reinsurance Model Law Sections 3.A. (cash) and 3.B. (SVO-listed securities meeting certain characteristics). An open question is to what extent (if any) clean, irrevocable, unconditional "evergreen" letters of credit would be allowed as Primary Security.
  - The Actuarial Method would consist of VM-20, modified to incorporate changes to mortality tables as developed by the American Academy of Actuaries and any

other modifications suggested by NAIC Life Actuarial (A) Task Force. An open question is whether to alter or eliminate the "net premium reserve" component.

- Portions of the statutory reserve exceeding the Primary Security Requirement may be collateralized by Other Security.
  - Other Security would consist of any other security as to which the NAIC has developed an RBC "asset charge."
- At least one party to the financing transaction holds an appropriate RBC "cushion".
- The reinsurance arrangement is approved by the ceding insurer's domestic state insurance regulator.

PROPOSED NAIC IMPLEMENTATION STEPS

The Modified Recommendations propose the following implementation steps:

- XXX/AXXX Reinsurance Supplement to the annual statement to be added for 2014. This would apply to all XXX and AXXX reinsurance transactions, including those subject to the framework security requirements as well as exempt transactions.
- Add XXX/AXXX reinsurance transaction review procedures to the NAIC Financial Analysis Handbook for 2014.
- Develop the Actuarial Method that is key to the framework security requirements.
- Adopt the framework in concept.
- Develop an Actuarial Guideline (AG) to provide interim guidance for the Actuarial Opinion Memorandum Regulation (AOMR) as it relates to XXX/AXXX reinsurance transactions. The AG should specify that, in order to comply with the AOMR, the opining actuary must issue a qualified opinion as to the ceding insurer's reserves if the ceding insurer or any insurer in its holding company system has engaged in a XXX/AXXX reserve financing transaction that does not adhere to the Actuarial Method and Primary Security forms adopted by the NAIC. The AG is intended to induce near-term, nationwide compliance immediately (since it's a new AG to be applied under an existing NAIC model regulation – the AOMR – that is an NAIC accreditation standard) pending NAIC action on a model law amendment and new model regulation that will take several years to become new NAIC accreditation standards (see next two bullets).
- Amend the NAIC Credit for Reinsurance Model Regulation Sections 2.A, 2.B and 2.C to allow the Commissioner to specify, by regulation, any other requirements a reinsurer involved with reserve financing transactions must meet in order for it to

qualify as a reinsurer within the meaning of those sections. The other requirements would be that the reinsurer follow statutory accounting without material departure and the NAIC RBC rules (see next bullet).

- Adopt a new model regulation that (i) applies only to domestic ceding life insurers that cede XXX/AXXX risks, (ii) sets out the other requirements for cessions to reinsurers under NAIC Credit for Reinsurance Model Regulation Sections 2.A, 2.B and 2.C (see prior bullet), and (iii) sets out the conditions for credit for reinsurance ceded to an unauthorized reinsurer that provides security in the form of "Any other security acceptable to the Commissioner."
- Develop the component parts of the framework security requirements – define Primary Security, develop an RBC "cushion," develop RBC charges for Other Security and determine whether the RBC C-3 treatment of qualified actuarial opinions is adequate for purposes of XXX/AXXX reinsurance transactions that receive qualified actuarial opinions.
- Develop a Note to the audited financial statement regarding compliance with the new model regulation.
- Evaluate the life reinsurance risk-transfer rules applicable to XXX/AXXX reserve financing transactions to make sure they appropriately apply to situations such as those where parental/affiliate guarantees are used, resulting in the risk effectively being kept within the holding company system even though the reinsurance arrangement involves a cession to an unaffiliated reinsurer.

KEY CHANGES FROM THE RECTOR REPORT

The Modified Recommendations make the following key departures from the Rector Report:

- The Rector Report would have applied the framework security requirements to a domestic life insurer and a licensed non-domestic life insurer not subject to substantially similar regulation in its domestic state. The Modified Recommendations apply only to a domestic life insurer. However, since the new model regulation is designed to become an NAIC accreditation standard, it would have to be eventually promulgated by each state in order to remain NAIC accredited.
- Failure to satisfy the framework security requirements under the Rector Report would have resulted in the ceding insurer being presumed to be in a hazardous financial condition and be subject to review by the NAIC Financial Analysis Working Group (the NAIC group that reviews potentially troubled insurers). Under the Modified

Recommendations, failure to satisfy the framework security requirements would result in denial of reinsurance credit.

JUNE 12, 2014 PBRI TASK FORCE CONFERENCE CALL

The NAIC Principle-Based Reserving Implementation (EX) Task Force held a conference call on June 12, 2014 in which Mr. Rector gave a presentation regarding the Modified Recommendations, the Task Force discussed the Modified Recommendations and the Task Force exposed the Modified Recommendations for comment with written comments due Wednesday, June 25, 2014. Given the short exposure time, the Task Force requested comments on the cover memo and Exhibits 1 and 2. The Task Force has a conference call scheduled for June 30, 2014 where comments will be considered and the framework could be adopted in concept.

While the Modified Recommendations do not set forth a proposed effective date for the new proposed AG, Mr. Rector, in response to a question by Paul Graham of the ACLI, suggested that it could be completed by the NAIC by year-end 2014 to be effective January 1, 2015 for actuarial opinions to be rendered for annual statements as of December 31, 2015. If so, the new AG could apply to risks ceded under new XXX/AXXX reinsurance transactions entered into after a specified date in 2015, and new risks ceded after a specified date under existing XXX/AXXX reinsurance transactions.

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Please do not hesitate to contact us with any questions.

June 16, 2014