SOCIETY OF ACTUARIES

Article from:

Reinsurance News

August 2014 – Issue 79

Regulatory Update

By Jeremy Starr

Jeremy Starr, FSA, is a consulting actuary. He can be reached at Jeremy.starr.fsa@gmail.com.

Ever since the financial crisis, the rate of change and the impact of the international regulatory community on insurers have been on the increase. Accounting standards for insurance contracts are under review by both the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board (IASB) internationally. Another major development is that the International Association of Insurance Supervisors (IAIS) is developing a framework for how internationally active insurance groups (IAIG) should be regulated.

If that were not enough, there are also U.S. specific regulations being proposed that will have great importance to both direct writers and reinsurers alike. High on the list of controversial items is the methods companies are using to help finance redundant reserves on level term and universal life with secondary guarantees. States are starting to pass the 2011 version of the Credit for Reinsurance law and regulation that provides a way for non-U.S. companies to hold lower collateral to back reinsured reserves. Just as states were starting to adopt these changes, regulators have reopened their review of these collateral rules. In another review of collateral requirements, an old proposal relating to RBC, collateral and reinsurance has been put back on the NAIC's agenda. Another source of concern relates to the Social Security Master Death File (SSMDF). On the one hand, insurers in 11 states (with another six in various stages of potentially adopting the same requirement) are mandated to use SSMDF, but on the other, part of the Bipartisan Budget Act of 2013 places severe limitations on the access and use of SSMDF.

INTERNATIONAL

In 2004, IASB issued the current standard for insurance accounting (IFRS 4) which in substance says that your home country's GAAP was acceptable for international purposes too. This has led to great confusion by analysts trying to compare two similar companies that are located in different jurisdictions. To remedy that situation, in 2007 IASB issued a discussion paper on preliminary views of a set of uniform insurance accounting rules. In that same year, FASB issued an invitation to comment on preliminary ideas about revisions to insurance GAAP. In June of 2013 both the FASB and the IASB exposed their own versions of an Insurance Contracts proposal.

The comment period for both documents ended in October 2013. After reading through the comment letters, the boards held hearings with both users and preparers of insurance contract statements. Subsequent to understanding the comments received, the two boards arrived at very different conclusions. The IASB felt that since there is no common international standard, they must finish the project with adjustments based upon comments they received. FASB reasoned that the United States already had a good system of GAAP accounting and that only targeted improvements were necessary. FASB announced in April 2014 it would seek enhanced disclosures for short duration contracts such as: incurred and paid loss development tables, claim reserve duration in time bands, information about the frequency and severity of claims, plus a few other requirements. FASB has decided to take a different tact with long duration contracts. At that same April meeting, FASB said they would begin a process to review such items as: liabilities for future events (e.g., how often to change assumptions and how to book those changes), deferred acquisition costs (e.g., basis of amortization), premium deficiency and loss recognition (e.g., potential disclosures surrounding amount and assumptions used in calculating premium deficiencies), and revenue recognition (e.g., disclosure of amount of funds that may be returned to policyholders).

The IAIS has been working on a project to develop a common framework for the regulation of IAIGs (usually referred to as ComFrame). To be considered an IAIG, a company must have $50 billion in assets, $10 billion in premiums, write in at least three different countries and have at least 10 percent of premiums written outside their home jurisdiction. IAIS feels that these companies need a tailored and coordinated regulatory approach. ComFrame aims to make the regulation of IAIGs more comprehensive by developing effective coordination of the regulation of all facets and all jurisdictions in which IAIGs operate. The project has been broken up into three pieces. The first is to identify which companies are IAIG's and who the group super-

CONTINUED ON **PAGE 34**

visor should be. Next, the IAIS has developed a set of standards for what should be expected from IAIGs in terms of governance, risk management, etc. These standards are now entering the testing phase where IAIGs would implement ComFrame proposed standards. This process will last over several years, with an adoption of the final ComFrame, as modified by lessons learned during the testing. The final regulations would be issued in 2018. The last piece, commenced in 2011 and is targeted to be completed in 2015, looks at reviews of the group supervisor, establishment of regulatory colleges (e.g., group of regulators who all supervise a portion of the IAIG), enhance regulator capabilities to be more uniform world wide and possibly borrow from Dodd-Frank the idea of a "living will."

DOMESTIC

Ever since the *New York Times* (NYT) article that discussed life insurers use of captives to finance redundant reserves as shadow insurance companies, the NAIC has been working feverishly to develop a response. The NYT article expressed concerns that there were billions of dollars of reserves that, through some sleight of hand, whereby either the true amount of liabilities were not being held or that portions of the liabilities were not being backed by solid assets. To those in the industry, it was clear that the reserves under attack were those for level-term products and universal life with a no lapse guarantee (often referred to as XXX and AXXX reserves). The NAIC has released a white paper on the use of captives. More recently the NAIC hired Rector and Associates (the same group that helped develop the AXXX compromise—hereinafter referred to as Rector) to review the issue and make recommendations on potential solutions to the issue.

After Rector had discussions with regulators it became apparent that there was agreement that there was some level of redundancy in XXX and AXXX reserves, but once Principle Based Reserves (PBR) were adopted the redundancy would disappear. Rector released a brief report in September 2013, outlining broad principles and a final report in February 2014. The latter paper makes several recommendations, but holding reserves less than what the regulations require was not one of them. Rector has developed clear ideas for a reinsurance solution, but is less clear about a solution that would allow an insurer to internally fund the redundant reserves. For the reinsurance solution, economic reserves would be calculated using a "modified" VM-20 (life PBR standard) reserve methodology called the "Actuarial Method." An example of a modification to VM20 is to use a more current mortality table. Assets backing reserves calculated using the Actuarial Method ("Primary Assets") would be cash and SVO listed securities that would be retained or held in trust by the direct writer. Reserves in excess of this level could be backed by non-traditional assets that were approved by the domiciliary regulator. Despite the reserves in excess of the Actuarial Method calculated reserves being backed by non-traditional assets, full RBC had to be held by the combination of cedant and reinsurer. The transactions would have more disclosure requirements to make it more transparent that these financing agreements were being utilized.

As a side note to this activity, the New York State Department of Financial Services (NYSDFS) has taken several actions. The Department developed a paper explaining, from their perspective, many of the problems with captive structures. As a result, it has banned these types of transactions in NYS and has tried to get other states to join their ban. They have also made it clear that they will not support the passage of PBR. The NYSDFS has combined these two concerns and have proposed a new way to reserve for level-term business. For the level-term period, NYSDFS has proposed using mortality improvement factors on the 2001 CSO of 1 percent from 2008 to 2047 and .5 percent thereafter. In addition, they have decided that the cost of putting term business on the books is much greater, proportionately, than it is for other types of business, so it will create a two year preliminary term reserve.

Another prong in the attack on captives is a new proposal to redefine a multistate insurer. Under the current rules, captives are excluded from the definition and thus do not need to meet all of the NAIC accreditation standards. The new definition would include all captives that write reinsurance covering blocks of business with policies from multiple states, with an exception for captives owned by non-insurers, and transactions entered prior to July 1, 2014 and covering contracts dated no later than Dec. 31, 2014. If a reinsurance agreement covers business on or after Jan. 1, 2015 the portion of the agreement covering these risks shall be subject to the accreditation standards. Not only would that require captives to essentially become insurers, but it would sweep into this new regulatory environment captives that are doing transactions not involving XXX and AXXX policies.

In November 2011, the NAIC passed new rules that could reduce the amount of collateral reinsurers not licensed or accredited in the United States would need to hold if they complied with certain rules. The amount of collateral ranged from 0 for AAA rated reinsurers to 100 percent collateral for low rated reinsurers. To achieve the lower collateral, first the domiciliary country would have to be approved by the NAIC as having a strong regulatory environment. To date, four countries are well down the road to approval. They are Bermuda, Germany, Great Britain, and Switzerland. The law has been enacted in 19 states. In these states, a number of reinsurers have been certified to be able to hold lower collateral. In 2011, as part of the compromise to gain approval of the NAIC for the new collateral rules, it was agreed that the impact of the reduction in collateral was to be reviewed in two years. The NAIC plans to start this process later this year.

More than a decade ago, NYSDFS proposed that collateral should be posted for the RBC credit that a cedant obtains when it reinsures business. The proposal has been raised a few times again over the years and was brought up again last year. This time, however, NYSDFS invited a Canadian regulator, to an NAIC meeting, who explained that Canada already has this type of requirement in place. It remains to be seen if this proposal will gain traction this time.

Several years ago it came to light that insurers were using the SSMDF for determining whether annuitants were still alive. At the same time, these same insurers were not using the SSMDF for life insurance. Approximately 11 states have passed laws requiring insurers to use the SSMDF for determining if life insurance policyholders have died. Many companies have paid large fines because they had not used the SSMDF for life insurance. In the December budget passed by Congress, there is a provision that severely limits who can use the file. Even some of those who can use the SSMDF under the new law, will be required to wait three years after a person dies to be able to learn of the person's death. Various industry groups and individual insurers are approaching rule setters to allow insurer's timely access to the SSMDF.

In this article a few of the various actions being taken by regulators both home and abroad have been highlighted. There are many other issues that are either in process or being planned for the future. It is important that your company find methods to stay informed and make decisions in the context of the evolving world of regulation. ■