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Regulatory Update

By Jeremy Starr

The NAIC is in the midst of an all-out revision of the reinsurance of level term and secondary guarantee universal life policies. Activities include: creation of a new Actuarial Guideline (AG48—passed December 16, 2014), creating a new regulation that implements Rector recommendations (to be developed this year), Risk Based Capital (RBC) changes, a new supplement to the annual statement, financial handbook changes and changes in the treatment of certain captives. Finally, to make sense of these changes, the American Academy of Actuaries (AAA) is planning to develop a practice note on these changes.

A major point of the new guideline is that current statutory reserves must still be held by either the cedent or the reinsurer. AG 48 requires the calculation of reserves using the Actuarial Method. This method is largely the same as the Valuation Manual Minimum Standard 20 (VM 20) requirements (i.e., principle based reserves) with certain modifications. The key modification is to use factors applied to the 2001 VBT net level term premiums to approximate what the net level premiums will be using for 2014 VBT. These reserves need to be backed by Primary Securities. Acceptable assets for Primary Securities include: cash, and Securities Valuations Office (SVO) listed instruments (excluding: synthetic letters of credit, credit linked notes, etc.). In addition, for Modified Coinsurance or Funds Withheld reinsurance agreements, acceptable assets would also include: a) Commercial Loans rated CM3 and better, b) Policy Loans, and c) hedges purchased in the normal course of business covering "actual" risks. Other Securities can be used to back the excess of the currently required statutory reserves and AG 48 reserves. Other Securities include instruments that qualify for Primary Securities and assets approved by the commissioner. If between the cedent and the reinsurer there are insufficient Primary and Other Securities, the actuarial opinion will need to be qualified. This can be avoided if the deficiency is remedied prior to March 1 of the year when the filing of the annual statement occurs. AG 48 became effective Jan. 1, 2015 for all new issues.

New York Department of Financial Services (NYDFS) was one of the states that voted against the AG 48 framework. They are also not in favor of PBR. Instead, NYDFS has issued a revision to its XXX/AXXX statutory reserve calculation regulation, for 2015 issues and later, to allow the use of mortality improvement factors for the first segment. Subsequent segments cannot use improvement factors. The improvement factors are 1 percent for the first 40 years and 0.5 percent thereafter. Starting at attained age 81 the mortality rates shall grade back to the base table by attained age 90.

With these changes there are a few RBC issues. One issue relates to the assignment of RBC factors for those Other Securities that do not have an RBC factor. The NAIC has decided that assets that do not currently have an RBC factor will use the bond factor based on the ratings of the issuer. Another issue surrounds the additional RBC required when a qualified opinion is determined by the valuation actuary. Regulators decided that a qualified opinion solely based on AG 48 will not be subject to these additional RBC requirements. Furthermore, in instances where the reinsurer is not holding RBC associated with the risks they have assumed, the cedent must hold all of the calculated RBC. Currently there are two proposals as to how a short fall in Primary Securities effects RBC. One method would reduce Total Adjusted Capital and the other would reduce the Authorized Control Level directly.

A key concern of regulators was the lack of transparency of captive transactions. To remedy this situation, there will be a new supplement to the annual statement that will provide detailed information associated with meeting the AG 48 requirements. The new supplement is to be filed by April 1 of the year following the year studied (e.g., 2014 results filed in 2015). The supplement is divided into four sections:

- Part 1 - All XXX and AXXX Cessions;
- Part 2 - All "Covered Policies" as defined in AG 48. Covered policies are all XXX/AXXX policies reinsured except for those transactions associated with certain reinsurers, such as licensed reinsurers;
- Part 3 - Collateral for all XXX/AXXX Reinsurance Transactions Reported in Part 2; and
- Part 4- Non-Collateral Assets Supporting Reserves for All Affiliate XXX/AXXX Reinsurance Transactions Reported on Part 2.

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"LARGER INSURERS MAY BE MORE LIKELY TO POSE A SYSTEMIC RISK."

Another area that changed due to AG 48 is the Financial Analyst Handbook. The changes give guidance on the type of documentation an analyst should review to understand a company's use of captives. These documents include: Form D filing for the Captive, overall review of company's use of reinsurance captives and review of the new AG 48 supplement to the annual statement.

Early in 2014 a proposal was made by a regulator to have all captives that assume business from three or more states to be subject to all NAIC accreditation standards. Up until now captives have not been subject to these standards and thus individual states have created their own standards for captives. After a deluge of negative comments from industry, there is a new proposal made that would limit this requirement to transactions involving XXX, AXXX, AG 43 variable annuities and long-term care.

FINANCIAL STABILITY BOARD (FSB)

The FSB (an international group) is developing standards for determining whether a company is a Globally Systemically Important Financial Institution (GSIFI). FSB has issued a discussion draft of their criteria for determining a GSIFI insurer. In this discussion draft they indicate that reinsurers are unlikely to be systemically significant:

"The insurance market may become more concentrated, reducing competition and choice offered to customers. Larger insurers may be more likely to pose a systemic risk. However, there is no strong historic evidence that the interconnectedness arising from reinsurance business contributes materially to a reinsurer being systemic in distress or failure under normal circumstances. There is evidence that significant substitutability exists for reinsurance coverage amongst existing market participants and that following large losses new capital flows into the market as underwriting rates adjust. Authorities may place reliance on such evidence, but should bear in mind that uncertainty exists regarding interconnectedness and what may contribute to systemic risk in circumstances of significant distress."

While this statement is encouraging to many reinsurers, it in no way prevents FSB from declaring individual reinsurers systemically important.

The United States non-banking financial industry has complained about some facets of Financial Stability Oversight Council's (FSOC) Systemically Important Financial Institution (SIFI) review process. To begin to remedy this problem, FSOC announced on Feb. 4, 2015:

- Will allow a company to become involved in the review process once an investigatory team is established during Stage 2, rather than waiting until Stage 3;
- Investigatory team will have meeting with company on concerns that drove decision to move to Stage 3;
- Will consult with company's regulators and will provide them a non-public explanation of Council's decision;
- If a company publicly acknowledges it is under review, the Council, if asked, will confirm the announcement;
- The Council will issue a report to the public outlining their decision, but leaving out all confidential information;
- The Council will publish guidelines on how a company gets to Stage 1;
- A SIFI's status will be reviewed at least annually. Oral presentations by the company will be allowed once every five years, but written submissions will be allowed for all reviews; and
- The Council will announce in its annual report the number of companies, during that year, that: a) made it to Stage 3, b) were dropped after Stage 2, c) proposed final decisions and will report on the number of companies, in the aggregate, that were subject to a final decision.

INTERNATIONAL

International Accounting Standards Board (IASB) Insurance Contracts Project

During 2014, there were two changes made to the IASB proposed accounting for reinsurance transactions. For portfolio transfers, the Board clarified that the acquired policies should be treated as if they were newly issued policies. Those policies that were in payout at time of closing would be treated as either a discovery of a past loss or as an adverse development. The second change relates to renewal periods in which the direct portfolio results are running through the profit and loss statement. A primary example of this is when the portfolio becomes onerous. An onerous portfolio is one in which the present value of economic benefits (e.g., premium income) are less than the present value of liabilities. Once a portfolio is considered onerous, the change in reinsurance cash flows would run through the company's statement of profit and loss. The statement would thus show the mitigation of some of the onerous portfolio's risk due to reinsurance.

FINANCIAL INSTRUMENTS PROJECT

The Financial Instruments Project (IFRS 9) revises the accounting for financial instruments so that they are more in line with the true economic performance of the covered products. In the Insurance Contract Standard the method of calculating the impaired value of a reinsurance contact is specified in the Financial Instruments Standard. IASB describes the method as:

"Specifically, IFRS 9 requires an entity to base its measurement of expected credit losses on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information."

FASB TARGETED IMPROVEMENT TO US GAAP

In 2014, FASB decided that the difference between their version of the Insurance Contracts Project and the IASB version were irreconcilable. Since one of the primary purposes of the projects was to have one worldwide standard, FASB decided to drop the project. Instead, FASB will look to do targeted improvements to

current GAAP standards. While it is clear that overall changes will affect reinsurance accounting, they have elected to not make changes to FAS 113 – Reinsurance.

COVERED AGREEMENTS

The Dodd-Frank Act allowed for covered agreements in situations where foreign competitors are treated less favorably than domestic companies. Dodd-Frank defines a covered agreement as:

"(2) COVERED AGREEMENT.—The term 'covered agreement' means a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that—

''(A) is entered into between the United States and one or more foreign governments, authorities, or regulatory entities; and

''(B) relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation."

Currently under discussion is a covered agreement for credit for reinsurance between a United States cedent and a non-United States licensed reinsurer (i.e., reinsurer is not licensed, accredited or certified). The impetus for this is that not all states have adopted the revised Credit for Reinsurance Law and Regulation. Further, there is inconsistent enforcement of the models in those states that have adopted the models. To promote uniformity in regulating the amount of collateral that a reinsurer must hold, a covered agreement using the

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language of the NAIC Models would create uniformity. If such covered agreements are signed, for the countries involved, they could rely on the covered agreement as the final say in how collateral is to be posted. Dodd-Frank Act states:

"(f) PREEMPTION OF STATE INSURANCE MEASURES.—

"(1) STANDARD.—A State insurance measure shall be preempted pursuant to this section or section 314 if, and only to the extent that the Director determines, in accordance with this subsection, that the measure—

"(A) results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a United States insurer domiciled, licensed, or otherwise admitted in that State; and

"(B) is inconsistent with a covered agreement."

Finally, just as a note of interest, this year is the 30th anniversary of the original NAIC Life and Health Reinsurance Agreements Model Regulation. To celebrate the anniversary, it appears that the NAIC is planning to create some similar type regulation for property and casualty agreements. ■