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AG 48: Reserve Financing's Modest Revolution

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After three full years of regulators compiling data, reading legal documents, studying actuarial models and consulting with outside advisors related to the life insurance industry's use of captive reinsurers for so-called AXXX and XXX reserve financing transactions, the year-end of 2014 was punctuated on Nov. 17, 2014, when the Principle-Based Reserving Implementation (EX) Task Force of the National Association of Insurance Commissioners (the "PBR Task Force") adopted a draft of Actuarial Guideline 48, dated Nov. 14, 2014, which defines the rules to be followed for new life reserve financing transactions after Jan. 1, 2015 (subject to certain grandfathering rules described below). These rules were finally adopted by the Executive Committee and Plenary of the NAIC on Dec. 16, 2014, and are in the process of being implemented. While the version of AG 48 that was so adopted is clearly still a work in progress, it should give regulators, industry participants and financing parties more clarity for financings in the life sector for 2015 than they have seen at anytime since these structures came under intense scrutiny in 2011.

For the first time in over three years, the life insurance industry was reassured by prominent members of the NAIC that the organization's three-year, multifaceted project related to the use of life insurer-owned captives and special purpose vehicles would not result in any moratorium or other draconian prohibitions or restrictions on structured finance as a tool for reserve financing for life insurance companies. Instead, during the fourth quarter of 2014, insurance regulators tasked with the project finally overcame their differences and arrived at a long-awaited compromise now known as Actuarial Guideline 48.

The genesis of AG 48 and its pending implementation were, and will continue to be, guided by the reports and ongoing advice of Rector & Associates Inc., an outside consulting firm engaged by the NAIC's PBR Task Force to study the propriety of reserve financing. AG 48 and the Rector reports provide a framework for reserve financings that is intended to: (i) permit life companies to continue to pursue capital relief opportunities through third-party financings; (ii) establish some uniformity among jurisdictions and regulators for the review and approval of such financings; (iii) facilitate transparency regarding such financings and (iv) add enhanced policyholder protection to such financings by way of increased liquidity and solvency margins.

Ever since the NAIC first undertook its investigation into certain types of life insurer-owned captive reserve financings in 2012, the inevitability of a new regulatory regime was widely accepted by the life insurance industry. Uncertainties and speculation about the exact nature of that new regime were widespread during 2014 (as reflected in the anemic deal flow). One of the most prevalent concerns for the life sector during the negotiation of AG 48 was retroactivity. Given the time, resource commitment and expense that are required to implement a reserve financing, life insurers were reluctant to propose new transactions that could potentially need to be unwound within the next 12 months. At a special meeting of the PBR Task Force in November 2014, after a heated debate, the issue of retroactivity was finally laid to rest. The substantive provisions of AG 48 do not and will not apply to any life insurance policies that were included in a reserve financing as of Dec. 31, 2014. This final rule (the "Grandfathering Test") is a bright-line test that applies to all such reinsured policies. The adoption of the Grandfathering Test was a significant victory for the life industry, since the proposed alternative would have required immediate compliance with AG 48 for any transaction that is amended in any way subsequent to Jan. 1, 2015, effective as of the date of such amendment. Due to the unavoidability of amendments to structured reinsurance deals, this alternative would have resulted in constructive retroactivity. One aspect of the Grandfathering Test that interested parties need to keep in mind is that amendments to existing transactions that add new business to blocks that were previously financed would jeopardize eligibility for grandfathering.

Currently, AG 48 only applies to financing arrangements involving term life insurance business subject to Regulation XXX (Regulation 147 in New York) and universal life insurance business subject to Actuarial Guideline 38 (more commonly known as Regulation AXXX or AG 38). While these are the business lines that have been identified by the life insurance industry as having the most self-evident reserve redundancies and are, therefore, currently the most commonly financed lines, there are other lines of business outside of the scope of AG 48 for which life insurers could demonstrate reserve redundancies and/or benefit from outside financing. For example, so-called embedded value financings, which provide capital relief for the surplus strain associated with issuing and selling life insurance products, appear to be very interesting to the industry at the moment. One cautionary note is that regulators have indicated that they intend to explore expanding the applicability of AG 48 to other product lines, specifically annuities and long-term care insurance policies.

In addition to the foregoing, AG 48 provides a brief list of exemptions from its application. These include: (i) transactions related to certain types of yearly renewable term reinsurance, (ii) certain reinsurance cessions to appropriately licensed, accredited or certified reinsurers and (iii) transactions that are not intended to be covered, are covered only technically and need not be covered for the protection of policyholders. The foregoing exemptions are subject to the approval of a life insurance company's domiciliary regulator (after consultation with an appropriate committee within the NAIC — currently the Financial Analysis Working Group, or "FAWG"). We understand from discussions at PBR Task Force meetings that the intent of these exemptions, particularly that described in (iii) above, is to provide a mechanism to shield "conventional" reinsurance transactions involving "professional" reinsurers from the application of the rules. Nevertheless, the applicability, practical mechanics and scope of AG 48 exemptions continues to stimulate debate among regulators, insurers and potential financiers.

Under AG 48, the risks under a block of covered businesses are divided into two layers: the "Primary Security" layer, which effectively replaces what would have been called the economic reserve layer in a traditional reserve financing, and the "Other Security" layer, which likewise replaces the excess reserve layer. The threshold dividing the two layers is now known as the "Required Level of Primary Security,"

which must be determined in accordance with an actuarial valuation model provided for in AG 48. This model is a modified version of the NAIC's "VM-20" standard, which was originally negotiated among regulators and interested parties in connection with efforts to move the current statutory accounting regime for life insurers from a rules-based to a principles-based reserving system. In the minds of many regulators, moving the life industry to a principles-based reserving system would negate any need for reserve financing; therefore, it was only logical to use the existing "principles-based" valuation model to set the threshold. However, early reports from insurers indicate that the Required Level of Primary Security under AG 48 for most books of business is substantially higher than a truly principles-based economic reserve determination would generate.

Many observers of the life insurance industry and its regulation expected a main focus of any new rules and regulations related to reserve financing to be on the nature and availability of assets used as collateral for excess reserves. Instead, AG 48 reinforces policyholder protections by regulating assets backing the Primary Security layer. Pursuant to AG 48, assets that qualify as Primary Security (i.e., that must be used as collateral for at least that portion of a company's reserves up to the Required Level of Primary Security) include only: (1) cash and (2) securities listed by the Securities Valuation Office ("SVO") of the NAIC (including securities deemed exempt from filing under the NAIC's Purposes and Procedures Manual) that are otherwise admitted assets under relevant state law, but not including: letters of credit (whether clean or conditional), synthetic letters of credit, contingent notes, credit-linked notes or other similar securities that operate in a manner similar to a letter of credit. Clearly, Rector and the regulators identified those financial instruments that were being used chiefly as collateral for excess reserves and expressly disqualified them as collateral for Primary Security. One issue that still requires clarification is the distinction between "securities listed by the SVO" (described above) and bespoke assets that are privately rated by the SVO at the request of an issuer or investor. The intent of AG 48 appears to be to exclude the latter type of assets; however, the SVO should be publishing guidance on this point in the near future.

In addition to cash and SVO-listed securities, AG 48 permits financing Primary Security with: (3) commercial loans in good standing (CM3 quality or higher), (4) policy loans and (5) derivatives acquired in the normal course and used to support and hedge liabilities pertaining to the actual risks ceded under the applicable reinsurance agreement; provided that such additional asset classes (3, 4 and 5) may only be used where collateral for Primary Security is achieved through either a funds-withheld or modified-coinsurance arrangement (i.e., where such assets are held in the general account of the sponsor life insurance company). With respect to collateral supporting Other Security, AG 48 permits any assets, including assets that could be used to support Primary Security, that are acceptable to the sponsor life insurer's domiciliary regulator. Therefore, AG 48 could be seen as an affirmation of the status quo as it relates to financing excess reserves, except that the cutoff for what defines such excess has been clearly defined (and likely increased). There were lively debates among regulators and interested parties over the appropriate consequences for any insurer that violates the provisions of AG 48. Ultimately, it was agreed that if a ceding company engages in a transaction subject to AG 48, but fails to meet the collateral requirements of AG 48, the company must file a qualified actuarial opinion with its statutory financial statements.

One of the initial allegations made in opposition to life insurance reserve financing was that these were hidden transactions consummated without any meaningful disclosure. In response, the NAIC adopted a new Supplemental XXX/AXXX Reinsurance Exhibit (Parts 1, 2 and 3), which must be filed by each regulated U.S. life insurance company with its statutory annual statement beginning in April 2015. This exhibit requires detailed disclosures of nearly all material aspects of reserve financing transactions subject to AG 48, including details about the nature of assets held as Primary Security.

In connection with the adoption of AG 48, the PBR Task Force charged another body within the NAIC, the Life Risk-Based Capital Working Group, with two other related tasks. The first was to develop an appropriate risk-based capital ("RBC") cushion for assuming reinsurers that do not file an RBC report using the NAIC RBC formula and instructions (which most captive and other reinsurers that are used for reserve financings do not); and the second was to develop appropriate asset charges for the forms of "Other Security" used by insurers under AG 48, which charges should then be considered for incorporation into such RBC cushion. Essentially, regulators are seeking to bolster policyholder protections by discounting the value of certain assets that may be employed as Other Security. Guidelines for RBC cushions and asset charges are expected to be finalized by April 2015. From a practical standpoint, most transactions that predated AG 48 already included some negotiated buffer between the economic reserve level and the excess reserve financing threshold (i.e., excess assets posted by a sponsor insurer for the protection of its creditors).

Many insurance regulators who previously opposed any form of reserve financing believed that such transactions were an impediment to the implementation of a much needed principles-based reserve system for life insurers ("PBR"), which would replace the antiquated rules-based system. If reserves were truly based on fundamental actuarial principles, applied on a case-by-case, product-by-product and company-by-company basis, then there should be no excesses to finance. Sometime in 2014, the attitudes of some of these regulators shifted and they began to see the regulation of reserve financing (e.g., AG 48) as a bridge to the future — an interim step toward final implementation of PBR. That is one of the reasons we saw the process guided by the PBR Task Force and the Required Level of Primary Security based on a PBR valuation model (VM-20). In the event that PBR is finally adopted and implemented, an interesting question is whether that will actually eliminate the need for life reinsurance finance transactions. While some regulators would say absolutely, most industry participants would disagree. It is highly unlikely that regulators would ever permit a strictly principles-based system, without some ancillary rules of general application. Therefore, the era of structured life insurance finance is probably far from its sunset.

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