

Article Title: ARCHIVE | Criteria | Insurance | Life: C-3 Phase II Adoption For Variable Annuity Risks Provides Enhanced Comparability And Consistency For Use Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by paragraphs 180-186 in "Criteria | Insurance | General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model," published June 7, 2010.) Standard & Poor's Ratings Services believes the 2005 adoption by the NAIC of the C-3 Phase II revision to the regulatory risk-based capital model to reflect evolving risk in variable annuities is necessary and appropriate. We will incorporate the stochastic results from this new approach in our capital model without the NAIC's transition phase or the deterministic standard scenario. We have long been concerned that offering policyholder options whose risks have not been consistently managed or accounted for has fueled the tremendous growth of variable annuities. Although these variable annuity option risks have been reflected in ratings, the new analysis and NAIC reporting requirements provide enhanced comparability and consistency for use in Standard & Poor's capital models. Variable annuity assets now exceed \$1.2 trillion, with recent growth driven in part by death and living benefit options such as guaranteed accumulation, income, and withdrawal features. Prudent insurers have recognized the risks associated with these long-dated options and have developed sophisticated hedge programs to mitigate a large portion of the exposure. Though Standard & Poor's has reviewed these programs as part of its analytic process, it will now be requesting C-3 Phase II results through its annual survey process and explicitly incorporating the results into its capital model. The use of advanced modeling techniques and dynamic hedging programs has greatly improved risk management of these options, although the uncertainty as to policyholder behavior makes a perfect hedge impossible. As a result, Standard & Poor's will continue to both quantitatively and qualitatively assess these risks. Capital Model Adoption Ultimately Standard & Poor's strongly prefers principle-based risk assessments and, through its enhanced Enterprise Risk Management (ERM) review process, we will pursue incorporating company-specific economic capital models into our overall assessment of an insurer's capitalization. However, C-3 Phase II provides quantification of a specific economic capital charge that will be built into Standard & Poor's capital model now. Standard & Poor's will be correlating conditional tail expectation (CTE) results provided by companies through the survey process with capital requirements associated with ratings. In the revised capital model currently under development and described in the Nov. 7, 2005, article "Upcoming Changes to Insurance Risk Based Capital Model," capital requirements will be calculated for various ratings levels and compared to a company's actual capital. Similarly, the correlation process for C-3 Phase II will relate CTE results to target capital levels for a given rating. For instance, it may be determined that capital to be held at a CTE(90) is equivalent to a 'BBB' capital standard and CTE(95) is equivalent to an 'A' capital standard, although this relationship has not yet definitively been determined. The calibration analysis will likely be completed in the second quarter of 2006. A simplified approach will likely be taken with the current capital model that produces Standard & Poor's capital adequacy ratio (CAR). It's important to note that Standard & Poor's use of the C-3 Phase II stochastic results in its capital model will not alone result in immediate rating or outlook changes. Standard & Poor's will use the process to refine its analysis of insurers and consider their response to the new capital charge. Standard & Poor's will be requesting both the deterministic standard scenario and stochastic CTE results at various levels for typical variable annuity benefits. The CTE-based data should be based on the American Academy of Actuaries prepackaged scenarios to ensure reasonably comparable results. The stochastic results will be gathered both with and without the benefit of Clearly Defined Hedging Strategies (CDHS). The capital charge will allow credit for 50% of the benefit of the hedge program. In other words, if a company's variable annuity capital at a given CTE level was \$100 million without hedging and \$50 million with hedging, Standard & Poor's would require \$75 million to be held in capital for a given ratings target. The initial conservatism associated with hedging programs may be adjusted as Standard & Poor's gains comfort with each insurer's specific hedge programs and broad ERM. It is also conceivable that Standard & Poor's will allow scenarios other than the prepackaged versions, but a deeper, company-specific review will be required. Standard & Poor's is not adopting the NAIC's deterministic standard scenario or phase-in. The standard scenario has been adopted by the NAIC as a floor for the C-3 Phase II capital component. As a result, the NAIC variable annuity capital requirements are the greater of the stochastic and deterministic scenarios. We view the standard scenario as

typically very conservative. The standard scenario also substantially limits the benefit for dynamic hedging programs, usually producing results in excess of CTE(99). As such, the standard scenario results will only likely be conservatively incorporated into the assessment of capital if an insurer cannot comply with the required stochastic modeling. The American Council of Life Insurers has recommended smoothing and transition rules that the NAIC has also agreed with. The transition rules are designed to ease the potential immediate impact of C-3 Phase II. Standard & Poor's is not using a mechanical phase-in; rather, we will evaluate material impacts and the insurer's course of action. Standard & Poor's will continue to update its measure of capital adequacy to better evaluate the risks inherent in insurance companies. Risk-based capital models are a useful tool for relative peer comparison; however, capital adequacy only constitutes one part of a multifaceted analysis. Capitalization is only one of the eight key rating factors including Management and Strategy, Competitive Position, Operating Performance, Investments, Liquidity, Financial Flexibility, and ERM. The combination of these factors leads to an inherent stability of ratings, and in and of itself, the revision to this analytical tool is unlikely to result in any significant number of rating changes.