



SOCIETY OF ACTUARIES

**SOA 09 Annual Meeting & Exhibit  
October 25-28, 2009**

**Session 30 PD, Hot Topics in the Principle-Based  
Approach to Reserves and Capital**

**Moderator:**

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# Hot Topics in the Principle-Based Approach to Reserves and Capital

Society of Actuaries Annual Meeting  
October 26, 2009

**Alice Fontaine**  
**Fontaine Consulting, LLC**

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## PBR Initiatives



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- Actuarial Guideline 43
- RBC C-3 Phase II
- RBC C3-Phase 3
- SVL II & Valuation Manual

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## Actuarial Guideline 43

### Implementation Issues:

- Assumption setting (expenses, hedging, policyholder behavior, margins)
- Reinsurance
- Model efficiencies
- Reporting change in methodology

## RBC C-3 Phase II

- Results from survey
- Implementation Issues:
  - consistency with AG43
  - timing of work
- Updates to Practice Note

## RBC C-3 Phase III

- Similar to Phase II in that stochastic testing is required instead of 12/50 scenarios
- AAA Fixed Asset Scenario Generator
- Stochastic Exclusion Test and Alternative Amount options
- Proposed Effective date is:

**12/31/2010??**

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## RBC C-3 Phase III (cont.)

- Recently addressed issues:
  - Minimum C-3 factor;
  - Deduction of reported or “CTE” reserves from TAR;
  - Level of aggregation;
  - Date of testing allowed;
- 9/21/09 AAA report exposed for comments
  - Comments requested regarding:
    - Documentation requirements;
    - SET “pass mark” & difficulty of calculation;

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## RBC C-3 Phase III (cont.)



- AAA is re-writing the Report in the form of NAIC RBC Instructions
- AAA has exposed a draft of Report to assist in implementation;
- ASB has exposed a discussion Draft for an ASOP

## RBC C-3 Phase III (cont.)



### Implementation Issues:

- consistency with VM-20/ C3-Phase II
- aggregation
- stand alone asset adequacy testing

## SVL and Valuation Manual

- SVL – Adopted at NAIC FALL 2009 meeting
- Valuation Manual – in progress
  - VM-00: Scope
  - VM-01: Definitions
  - VM-20: Life Reserves
  - VM-21: Variable Annuity Reserves
  - VM-25: A&H
  - VM-26: Credit
  - VM-30: AOMR
  - VM-31: AOMR Reporting Requirements
  - VM50/51: Experience Reporting Requirements
  - VM-G

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## VM-00: Scope

- Scope Issues:
- What to include by December Meeting for adoption of “complete” Valuation Manual?
- Options:
  - At least AG43;
  - VM 20 may be excluded for now, with inclusion later if finalized;

Adoption of SVL by super majority could occur in 2011 or 2012 – VM can be updated until then.

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## VM-20: Life Reserves

- Recently resolved issues
  - Approach to asset default rates
- Outstanding issues
  - Details of asset default rates
  - Scenario generator parameters
  - ACLI Net Premium proposal

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## Hot Topics in the Principle-Based Approach to Reserves and Capital

- For more information, or to be included in my quarterly NAIC update newsletter, contact
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# Hot Topics in the Principle-Based Approach to Reserves and Capital

## Legal Framework and Corporate Governance

Society of Actuaries Annual Meeting  
October 26, 2009

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## Overview

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1. Legal Framework
2. Corporate Governance: VM-G

## Legal Framework

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- Current Standard Valuation Law (“SVL”) requires a formulaic approach to calculating reserves for most life insurance and annuity products
  - Formulaic approach dates back to legislation originally adopted in the mid-19<sup>th</sup> century and has not changed significantly since
  - Minimum reserves based on a formula, with prescribed mortality and interest rates

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## Legal Framework (cont’d)

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- Revisions to SVL implement two fundamental changes:
  1. a principle-based approach to valuation
  2. a Valuation Manual (“VM”) – the SVL includes general guidelines for a principle-based valuation, but details will be in the VM
- Minimum reserving standards for policies issued on or after the operative date of the VM are set forth in the VM
- NAIC plenary adopted revised SVL at September 2009 National Meeting
- State legislatures must enact revised SVL
- NAIC still working on VM

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## Legal Framework (cont'd)

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- Operative Date of VM is January 1 of the 1<sup>st</sup> calendar year following the 1<sup>st</sup> July 1 as of which all of the following have occurred:
  - VM adopted by NAIC by vote of the greater of 75% of members voting or 42 members;
  - Revised SVL, or substantially similar legislation, enacted by states representing > 75% of direct life and health premium in 2008; and
  - Revised SVL, or substantially similar legislation, enacted by at least 42 U.S. jurisdictions.
- Changes to the VM require a similar super-majority vote of NAIC members

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## Corporate Governance

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- Because a principle-based valuation approach allows flexibility in assumptions, methods and models, oversight and corporate governance are important
- Corporate governance is addressed both in the revised SVL (Section 12.B) and the VM (VM-G)
  - At the September 2009 NAIC National Meeting, the Principles-Based Reserving (EX) Working Group adopted VM-G
  - Specific corporate governance guidelines are still in flux, as the NAIC revises and finalizes the initial VM

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## Corporate Governance (cont'd)

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- The revised SVL requires a company using a principle-based valuation to:
  - Establish procedures for corporate governance and oversight of the actuarial valuation function consistent with those described in the VM;
  - Provide to its board of directors and the commissioner an annual certification of the effectiveness of internal controls with respect to the principle-based valuation; and
  - Develop, and file with the commissioner upon request, a principle-based valuation report that complies with standards prescribed in the VM.

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## Corporate Governance (cont'd)

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- The September 2009 draft of VM-G
  - States that it does not “[expand]...the existing legal duties of a company’s board of directors, senior management and appointed actuary and/or other qualified actuaries,” but
  - Indicates that it is intended “to emphasize and clarify how their duties apply to the principle-based reserves actuarial valuation function of an insurance company or group of insurance companies.”

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## Corporate Governance (cont'd)

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- Just as directors in general are responsible for overseeing a corporation's affairs, VM-G notes that directors are responsible for "general oversight" of the principle-based reserves actuarial function that is "[c]ommensurate with the materiality of principle-based reserves in relationship to the overall risks borne by the insurance company." This includes overseeing:
  - The process taken by senior management to correct material weaknesses in internal controls;
  - That the infrastructure to implement and oversee principle-based reserving is in place; and
  - The documentation of "review and action undertaken by the board" relating to principle-based reserving in the minutes of the board's meetings.

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## Corporate Governance (cont'd)

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- VM-G implies that the board may rely on experts (e.g., senior management and the appointed actuary or qualified actuaries) in performing its duties. Specifically, the exposure draft notes that its guidance for a board of directors is "consistent with [the board's] oversight role," and that, under its guidance, the board:
  - "[R]eceives and reviews reports" and "interacts with senior management to resolve questions and collect additional information as needed;" and
  - "[D]etermines what additional steps or direction, if any, are necessary to rely on the principle-based reserving and the valuation function established by senior management."

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## Corporate Governance (cont'd)

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- VM-G notes that senior management has the roles of:
  - Oversight of the actuarial function (including by ensuring that adequate infrastructure has been established, reviewing principle-based reserving elements and results, and addressing significant or unusual issues);
  - Adoption of internal controls;
  - Determining that resources are adequate;
  - Overseeing various processes and review procedures; and
  - Communicating on certain matters to the board.

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## Corporate Governance (cont'd)

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- VM-G notes that one or more qualified actuaries have the roles of:
  - Overseeing the calculation of principle-based reserves;
  - Reviewing assumptions, methods and models;
  - Providing a summary report to senior management and the board and an opinion on the adequacy of company statutory reserves; and
  - Cooperating and working with internal and external auditors, regulators and senior management.

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## Corporate Governance (cont'd)

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- Conclusions
  - Directors will have the same basic governance duties as they do today
  - Directors must oversee senior management, which in turn must oversee the appointed actuary or other qualified actuaries
  - Boards should establish procedures for explicit compliance with the guidance of VM-G as evidence of effective oversight
  - Directors may continue to rely on experts as appropriate, consistent with the VM-G guidelines

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## Hot Topics in the Principle-Based Approach to Reserves and Capital

### Legal Framework and Corporate Governance

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# Hot Topics in the Principle-Based Approach to Reserves and Capital

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## Tax Issues Associated With AG 43/PBR

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- Background on basic tax reserve deduction rules
- Summary of tax reserve deduction issues related to AG 43/PBR
- IRS Notice 2008-18
- Interrelationship of AG 43/PBR and current tax reserve audit issues

Slide 2

## Basic Rules for Deduction for Life Insurance Reserves

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- An insurer may deduct increases in its “life insurance reserves”
- I.R.C. § 807(d) prescribes how deductible life insurance reserves must be computed
- The amount of life insurance reserves **per contract** equals the greater of (1) the contract’s net surrender value, and (2) the “federally prescribed reserve,” but (3) not in excess of statutory reserves for the contract

Slide 3

## What are “federally prescribed reserves”?

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- Federally prescribed reserves for a life contract are the annual statement reserves for the contract recomputed using:
  - The reserve method prescribed by the NAIC for that type of contract (CRVM or CARVM under current law)
  - The greater of the federally prescribed interest rate or the prevailing state assumed interest rate (published by the IRS annually)
  - The most recent prevailing commissioners’ standard mortality table (the table permitted by 26 states)

Slide 4

## Other Tax Rules for Reserves Deduction

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- ❑ Deductible life insurance reserves must be for “future unaccrued claims”
- ❑ Life insurance company expenses and policyholder dividends deductible only on an accrual basis
- ❑ No deduction for deficiency reserves

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## Tax Issues Related to AG 43/PBR

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- ❑ Is the Standard Scenario or Deterministic Reserve a CARVM or CRVM reserve for tax purposes? What about a stochastic reserve? Does it matter?
- ❑ Does a reserve computed using a gross premium valuation method qualify for a reserve deduction?
- ❑ Is any portion of the AG 43/PBR reserve a deficiency reserve or non-deductible because unaccrued expenses are reflected in the calculation?
- ❑ How does the introduction of non-guaranteed elements affect tax reserves?

Slide 6

## Tax Issues Related to AG 43/PBR (cont'd)

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- ❑ How is the discount rate used under I.R.C. § 807(d) determined if the stochastic reserve is deductible? Is there a prevailing State assumed rate?
- ❑ What are the mortality and morbidity tables used under I.R.C. § 807(d)?
- ❑ How are contract-by-contract comparisons made to statutory reserves and net surrender values?
- ❑ Are explicit margins for conservatism permissible?

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## Tax Issues Related to AG 43/PBR (cont'd)

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- ❑ Will reserves on pre-existing business be computed under the new reserve rules?
- ❑ How are annual adjustments to reserve assumptions reflected?
- ❑ How will the IRS audit I.R.C. § 807(d) compliance?

Slide 8

## IRS Notice 2008-18

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- ❑ Identifies tax issues on VACARVM and PBR
- ❑ Suggests tentative conclusions on several issues
- ❑ Expresses concern about ability of VACARVM stochastic reserve and PBR to satisfy several tax issues

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## IRS Notice 2008-18 (Positive Aspects)

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- ❑ No desire for VACARVM/PBR to trigger disqualification as life insurance company
- ❑ No desire for VACARVM/PBR to change standards for qualification as life insurance contracts for policyholders
- ❑ Demonstrates flexibility on compliance with specified rules for interest rate and mortality tables
- ❑ No concern about transition rules

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## IRS Notice 2008-18 (Primary IRS Concerns)

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- ❑ Deduction for reserves in excess of “expected value”
- ❑ Use of company-specific expenses, lapse, and margin assumptions
- ❑ Annual adjustments to assumptions
- ❑ Gross premium method and inclusion of expenses in cash flow assumptions
- ❑ Difficulty in auditing

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## Comments on Notice 2008-18

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- ❑ American Council of Life Insurers
- ❑ National Association of Insurance Commissioners
- ❑ American Academy of Actuaries
- ❑ Society of Actuaries Taxing Times

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## Interrelationship of AG 43, PBR and Tax Reserve Audit Issues

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- Retroactivity of AGs
- Gross premium reserves
- Aggregate stochastic reserves
- Asset drop assumption
- Non-I.R.C. § 807(c) reserves in statutory reserve cap
- I.R.C. § 807(f) change in basis of computing reserves

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## Retroactivity of Actuarial Guidelines

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- I.R.C. § 807(d) – life insurance reserves required to be computed by reserve method prescribed by NAIC in effect as of issue date of the contract.
- Legislative history sets forth rules to implement this rule.
  - Rule 1 – Taxpayer required to use method prescribed by NAIC at issue date, including NAIC recommended factors in NAIC model regulations and AGs
  - Rule 2 – When no NAIC factors recommended, interpretation recommended by 26-states should be followed
  - Rule 3 – When no NAIC or 26-state factors apply, the factors used for statutory reserves should be followed if they were a permissible interpretation of the SVL as of the contract issue date

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## AG 43 Retroactivity of AGs Audit Issues

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- AG 43
  - Can AG 43 apply retroactivity?
  - If not, what is the cut-off date for determining when the AG is in effect as of the contract issue date?
- Audit Issues
  - AG 33
    - TAM 200328006
    - *American Financial* case
  - AG 34
    - TAM 200448046
    - *CIGNA* case

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## Gross Premium Reserves

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- Rev. Rul. 77-451 – IRS ruled that gross premium reserves do not qualify as life insurance reserves
- Treas. Reg. § 1.801-4(e) – reserve for expenses does not qualify as a life insurance reserve
- PBR – Does the deterministic reserve qualify as a life insurance reserve?
  - If not, can it still qualify as a deductible tax reserve?
- AG 39 – Does the charge accumulation reserve qualify as a deductible tax reserve?

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## Asset Drop Assumption

- Rev. Rul. 67-435 – IRS ruled that reserve based on a percentage of actuarially computed life insurance reserve is not deductible; in doing so, the ruling stated that losses on assets are a solvency concern.
- AG 43 – What is the effect of the asset drop assumption?
- AG 34 – *CIGNA* case – IRS asserts that asset drop assumption impermissible – but to what effect?

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## Aggregate Stochastic Reserves

- I.R.C. § 807(d) – implies that deductible life insurance reserves should be computed on a contract-by-contract basis and requires recomputation of tax reserves using specified mortality and interest assumptions
- AG 43/PBR – Do the stochastic reserves qualify as life insurance reserves?
  - If so, how are they recomputed under I.R.C. § 807(d)?
- AG 39 – Is the asset adequacy reserve a deductible tax reserve?
  - If not, what is the deductible CARVM reserve?

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## Non-I.R.C. § 807(c) Reserves in Statutory Reserve Cap

- I.R.C. § 807(d) – life insurance reserves capped by statutory reserves for the contract
- I.R.C. § 807(d)(6) – statutory reserves defined as aggregate amount set forth in the annual statement “with respect to” tax reserves
- AG 43/PBR – If stochastic reserves are not deductible, are they included in statutory reserve cap?
- AG 39 – Is asset adequacy reserve included in statutory reserve cap? If so, how is it allocated to individual contracts?
- Deficiency reserves
  - 1984/1986 legislative history – deficiency reserves are in statutory reserve cap
  - 1993 FSA – concluded deficiency reserves not included

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## I.R.C. § 807(f) Change in Basis of Computing Reserves

- I.R.C. § 807(f) – Requires a 10-year spread for change in basis of computing reserves
- AG 43 – If statutory reserves are less than Federally prescribed reserves on pre-2010 contracts, is capping subject to 10-year spread?
- Current audits – same issue arises frequently for both increases and decreases in statutory reserves

Slide 20



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## What's next for AG 43/PBR Tax Issues?

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