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The End of A Tumultuous Year

by Larry M. Gorski

The December 2004 meeting of the Life and Health Actuarial task force (LHATF) brought to an end a year that was filled with exciting meetings and conference calls focused on controversial issues.

Reserves for Variable Annuities (C-3 Phase 2 reserves)

After a brief status report concerning the risk-based capital component of the C-3 Phase 2 project, Tom Campbell (Hartford Life), chair of the American Academy of Actuaries (AAA) Variable Annuities Reserve Working Group, gave a status report that focused on key items.

Since the prior NAIC meeting, one of the hot topics has been the recognition of "revenue sharing" income. The regulatory issue arose because the receipt of revenue sharing income may not be subject to a long-term contractual arrangement and so recognition of revenue sharing income in the calculation of reserves using the cash-flow modeling approach or alternative methodology (AM) approach may be problematic. Tom reviewed the language in the AAA report that attempts to deal with regulatory concerns.

The AAA discussed new language that attempts to resolve a regulatory issue with the methodology in the report that quantifies the risk of guaranteed minimum income benefit margins to decreasing interest rates. The new language changed the methodology by recognizing that "risk premia" embedded in interest rates increases with duration. The new language generally decreases "market based expected" future interest rates.

Another key issue discussed dealt with mortality assumption underlying the AM factors. Possibilities range from 65 percent to 100 percent of the 1994 GMDB Table, and perhaps allowing insurers to recognize their own experience. A motion to use 85 percent of the 1994 GMDB table failed. The AAA will continue to work on this topic in 2005.

The next item discussed was the Standard Scenario (SS) methodology. The SS methodology is not an AAA recommendation but is included, with a "disclaimer," in the draft Actuarial Guideline and by the AAA. The discussion on this topic focused on three items: (1) the relationship between reserves based on the SS to model based reserves. The higher level of reserves based on the SS were attributed to the requirement that SS reserves be calculated on a seriatim basis and therefore lose the value of aggregation, (2) a memo from the AAA discussing the reasons why they did not support the adoption of the SS requirement and (3) a personal memo (not an AAA document) from Tom Campbell that presented ideas for modifying the Standard Scenario. LHATF agreed to form a subgroup to explore the ideas contained in the memo.

Another major item discussion was the definition of prudent best estimate. The basic idea is that the actuary is supposed to set assumptions in a conservative manner in the face of uncertainty. New language that attempts to explain and apply the concept was included in the December AAA report. The regulatory issue is whether application of the prudent best estimate concept requires inclusion of margins for adverse deviation and whether there is sufficient guidance to ensure uniform application of the definition.

The last major item discussed was the appropriateness of the so-called calibration table, used to determine whether the scenarios are conservative enough. Some regulators questioned the appropriateness of the calibration table because of the perceived bias of the historical return data used to determine the calibration table. The perceived bias is attributed to the upward trend of stock P/Es to high levels that occurred in the very recent past. The AAA presented information concerning a calibration table with a constraint on the Sharpe Ratio based on analysis of "World ex Japan Index" data. The AAA is expected to continue working on this issue in 2005.

The LHATF voted to expose the AAA Variable Annuity Reserve Draft Actuarial Guideline. As an aside, the AAA is busy trying to deal with concerns expressed by the regulators. Weekly conference calls have been held since mid-December. The proposal is still on target to be adopted with an effective date of Dec. 31, 2005.

Actuarial Guideline 38

Two agenda items dealt with Actuarial Guideline 38 (AG 38) issues. The first item was a status report by David Neve (representing the AAA) on the work of the AAA Universal Life Working Group. The charge to this working group is to develop a long-term solution to the problems that are driving the Actuarial Guideline discussion. *(Editor's note: see David Neve's article in this issue for more information regarding this working group.)*

The report discussed the working group's ideas concerning: (1) the methodology for calculating reserves, (2) asset modeling, (3) the mortality assumption, (4) reinsurance and (5) expense assumptions.

David requested input from LHATF on two questions: (1) Should the modeling recommendation focus solely on a stochastic approach, or should a principled-based approach be complemented with a seriatim and/or deterministic component? (2) Should mortality be included on a stochastic basis or on a deterministic with margin basis? Due to time constraints there was not much discussion of these two questions.

The other item on the agenda was the status of AG 38. LHATF adopted two amendments to the 11/19/04 draft. One amendment dealt with defining the intent of the ratio calculated in the fourth step of item 8. In addition the paragraph after step 9 was deleted.

After much discussion by people championing the formulaic approach in AG 38 and those favoring a principle-based modeling approach, LHATF voted to expose the amended AG 38.

Things got really exciting after the NAIC meeting. At the AAA committee meeting., the presentation of the LHATF Report became the opportunity for insurance department commissioners and other "upper-management" personnel to discuss the appropriateness of the formulaic reserving methodology in today's environment. The discussion turned from "What is the 'spirit and intent' of Actuarial Guideline 38?" to "Are current formulaic reserve requirements generating excessive reserves and therefore proving costly to the policy holder?"

At the end of the day, while not directing LHATF to drop the formulaic AG 38 approach, the AAA Committee gave LHATF strong direction to move quickly to resolve the current issue in a way that was consistent with the long-term approach being developed by the AAA Life Working Group. LHATF will report back with a recommendation "in a form that could be adopted by the AAA Committee as a solution to the current problems" within six months. *(Editor's note: In light of this new directive from the AAA Committee and the potential delay in a resolution of the reserve issue, the New York Insurance Department made an emergency amendment to New York Regulation 147 effective year-end 2004, that makes formula changes to AG 38 for policies issued in 2003 and later.)*

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In addition, a number of other agenda items were also discussed. The amount of LHATF agenda time or space in this article is not intended to signify the significance of the projects.

Annuity Nonforfeiture Regulation

No changes were made to the Oct. 14, 2004 draft. Additional discussion of the "premium bucket" issue will take place during an upcoming conference call in 2005.

Possible Revisions to the Standard Valuation Law

This project has a very long-term perspective. Its objective is to establish a framework for a standard valuation law that relies on a principle-based approach rather than a formulaic approach as is currently the case. The AAA Standard Valuation Law 2 Subgroup will not be working on specific actuarial modeling but on issues of governance and accountability. The key points made during the presentation by Dave Sandberg, representing the AAA, were: (1) "Actuarial Discretion without accountability is not a principle-based approach" rather than (2) "Peer review is not synonymous with a second opinion." Sandberg also presented a work plan for the AAA SVL2 Subgroup.

Actuarial Guideline ABC

The purpose of this actuarial guideline is to address certain issues concerning the projection of guaranteed benefits that have arisen with the adoption of the new Annuity Nonforfeiture Law and development of the draft Model Annuity Regulation. LHATF did not make any changes to the Sept. 9, 2004 draft.

Referral on Accounting for Life Reinsurance Reserve Credits

Over the summer, an issue concerning reinsurance reserve credits on YRT reinsurance had been referred to the LHATF. The issue stems from language in the NAIC Statutory Accounting Practices and Procedures Manual (codification manual) concerning the kinds of reinsurance treaties that qualify for reinsurance reserve credit and the nature of the reinsurance reserve credit. The referral stems from a request to modify the language in the codification manual that limits reinsurance reserve credits on YRT treaties to 1/2 qx type credits in cases where the reinsurance premiums have long-term guarantees. LHATF discussed the issue during an interim conference call but after discussing a draft response, decided to defer action.

C-3 Phase 2 – Risk Based Capital

The discussion of the AAA Life Capital Adequacy Subcommittee (LCAS) Report on Risk-Based Capital (RBC) for Variable Annuities at the NAIC Capital Adequacy Task Force meeting (CADTF) was decidedly different than the discussion concerning the reserving requirement for these products that occurred during the LHATF meeting.

The discussion at the CADTF meeting focused on the instructions necessary to implement the AAA recommendations (and recommendations from other groups) and not the contents of the recommendations. The LCAS agreed to develop instructions for the 2005 Life RBC Booklet that would bring together the recommendations from the AAA, the recommendation from New York concerning the RBC Standard Scenario and the American Council of Life Insurers' recommendation concerning transition and phase-in. The LCAS has been very busy with weekly conference calls to develop the RBC instructions.

The revised RBC instructions are still on target to be adopted with an effective date of Dec. 31, 2005. ☐