Approach in Drafting a Unified Valuation Law—Issues without End

by Norman E. Hill

"Start with a clean slate and develop from scratch a completely new valuation law." This was basically the charge from the NAIC's Life and Health Actuarial Task Force to a new task force of the American Academy of Actuaries. This latter group has met to try to fulfill its charge. One goal is to prepare a complete draft of a new law by the June 1998 NAIC meeting.

As a member of this task force, I have taken an approach to drafting the new law. Because of my company affiliation, I have particular interest in how such a law would affect smaller companies with limited resources. Nonetheless, I hope I am keeping a broad industry perspective. In this article, all opinions are my own, and not those of the Academy task force.

So far, some members have summarized broad concepts that should exist in a new law. Instead, I have chosen to go further and prepare a complete legal document for valuation. Even here, in a complete document, I do not yet claim to have complete answers, much less opinions, on the host of practical and theoretical questions that must be addressed fairly soon.

General Approach

My starting point was the existing standard valuation law and regulation of one state chosen at random. I removed all references to specific assumptions in my new standard law and regulation drafts. Also, I added the following new sections:

- Law—Method of Valuation, which defines the new approach to reserves. The defined net premium method (similar to the gross premium reserve method) is intended to be applicable to single-premium policies, such as SPDAs, credit, and so on, as well as annual premium policies.
- Regulations—Under Required Opinions, new sections on applicable percentage, assumptions, assumption adjustments under method #2, and risk profile. The purpose of the applicable percentage is to limit the extent of actual deferred acquisition expenses, similar to the CRVM allowance.

In addition, I have eliminated the phrase "life" when it appears in front of "insurance company."

I drafted a model law and regulation that call for defined net-premium reserves with actuarial judgment substantially substituted for formula reserves and specified ranges of assumptions. To answer questions of "best estimates," "margins," and "reasonable conservatism," I have included two options. The first calls for assumptions that provide an 85% confidence level. The second calls for starting with best estimate current assumptions and then grading to 90% or 110% of the base, as appropriate, in 15 years.

In our discussions, several parties stressed that reserves should allow profits to emerge gradually each year. Because they front-end profits, this objective rules out gross premium reserves. A net premium approach leaves at least two options: compute net premiums on an issue-age basis using the same assumptions as present values at attained ages, or predefine net premiums by backing out predefined profit margins. This is similar to a dilemma that has plagued companies attempting to adjust historical GAAP reserves over to purchase accounting reserves.

Actuarial Opinions

One proposal has been for an actuarial opinion stating an *X*% confidence that reserves are "correct" or will not vary more than some range, such as one standard deviation from the mean or, say, 10% either way. However, an approach providing a desired confidence level inherently requires stochastic processing and a great many repeat valuations. This can mean hundreds or thousands of duplicate valuations applied to a single in-force file. The resulting computer complexity, computer run-time, and drain on limited resources would cause a storm of protest from many small companies (including mine) and others as well. Perhaps, there is a common-sense approach that would allow actuarial opinion stating *X*% confidence without going through the above, elaborate routine. However, I do not believe that it is supported in current standards of practice.

Some proposals have been for "reasonable conservatism" as opposed to "best estimate" or "bare bones." Note that the current standard of practice for gross premium reserves refers to "best estimates." This alone would be unacceptable to many regulators and would seem to conflict with the tradition of statutory accounting.

Therefore, I provided the above alternative for reaching desired conservatism in reserve assumptions. It calls for a two-step process:

- Start with best-estimate current assumptions
- Grade these assumptions to a 10% more conservative level. Depending on the nature of the assumption, this may involve grading to 110% or 90%. I chose a 15-year grading period, although others are possible.

Actuarial Assumptions

A critical question is determination of actuarial assumptions. My approach calls for assumptions that are closer to GAAP than traditional statutory. Lapses would be included, along with mortality assumptions. Expenses and commissions would also be included. As a starting point, these variables should be based on each company's experience, followed by adjustments to achieve either *X*% confidence or the above-mentioned grading.

The next critical question is which standards should be in place for setting actuarial assumptions. One proposal is that this should be left completely to the professional judgment of the valuation actuarial. Even here, however, standards for setting assumptions would be governed by the Actuarial Standards Board (ASB). My approach is to rely on the ASB for this purpose. However, I have specified in my drafted law that

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its standards must be definitive. Vague statements such as "the actuary should consider" are not enough. Guidance must be more specific. In the 1960s, the profession faced a similar controversy over a proposed textbook standard for pension actuaries. Unfortunately, before resolution the issue was preempted by ERISA legislation.

ASB positions would have to deal with both assumptions and methods. Controversial areas of methodology such as for term reserves, equity- indexed products, annuity benefit streams, and others would have to be addressed in considerable detail.

In my regulation draft, I have included a very broad array of areas in assumptions that need specific guidance from ASB. I do not believe that regulators would be willing to conform to actuarial judgment without such a considerable preparation of standards.

When I called for assumptions closer to GAAP, I was referring to GAAP under the original Audit Guide and *FAS 60* issued by the Financial Accounting Standards Board. Even here I am proposing another significant deviation. Traditional GAAP calls for the lock-in approach to assumptions. Except for expense recoverability problems and (possibly) health insurance rate increases, assumptions for each issue year are not changed. Instead, I propose that assumptions be updated each year. In general, the array of assumptions should be appropriate for new business. For existing business, that is, say, at duration 10, the new business assumption for duration 10 would be applied. However, this general approach would need modification if underwriting standards, for example, have changed over the 10 years. Also, there is a serious question of whether smaller companies can readily reapply new business assumptions to all in force.

When we refer to current GAAP, it is with the understanding that most companies are governed by *FAS 97*. For annuities and universal life, full account values are required for reserves, with no reliance on actuarial judgment in setting assumptions. I have deliberately departed from any reference to this version of GAAP.

Scope of New Law

My intention was that a defined net- premium approach would apply to all lines of business. This would include single-premium annuities and credit insurance, with zero net premiums.

The Task Force charge is for a valuation law that applies to all liabilities for life, annuities, and health. This means that standards are needed for active life reserves (including unearned premiums) and claim reserves. If the description of present values of benefits includes incurred, unaccrued, and not yet incurred, these can be covered by a general classic prospective reserve formula.

Even more broadly, the charge appears applicable to both life and property casualty insurers. The main liability of the latter company is claim reserves, referred to as "loss reserves." If so, the law's standards for preparing claim reserves have to be expanded to include property casualty loss reserves and loss adjustment expense reserves.

There is a question of whether complete GAAP reserves or their equivalent should be included in statutory financial statements. The entire tradition of statutory accounting is that front-end acquisition expenses are immediately charged off. It is true that CRVM reserves and two-year preliminary-term reserves for health insurance do provide a limited expense deferral. However, full GAAP reserves, including a deferred-acquisition cost (netted or shown as a separate asset), would be a significant departure.

In my draft I have stated that only a percentage of acquisition expenses would be included in financial statements. In other words, only 25% or some defined percentage of a total deferred acquisition cost would be netted against reserves or shown separately. This limitation on acquisition expenses is more consistent with the broad thrust of statutory accounting.

Asset Adequacy

One key portion of my approach is expansion of asset adequacy in setting reserves. My draft requires that all companies, both large and small, file actuarial opinions that include asset- adequacy analysis. However, I have specified in the law that such analysis is *not* synonymous with cash-flow testing. In other words, I have eliminated the difference between Section VII and Section VIII opinions, but with some restrictions to reassure small companies.

Several regulators have complained that Section VII reserve opinions avoid any question of invested assets underlying reserves. Their complaint is that, with so many interest-sensitive products sold today, valuation actuaries must always consider the link between reserves and invested assets.

Many smaller companies are strongly opposed to elimination of Section VII opinions. However, I believe that the main reason for this attitude is fear that "asset adequacy" inherently equates to cash-flow testing. The law does not specify this tie, but does not rule it out either. Small companies complain that Section VIII opinions are unduly burdensome and provide minimal value. I believe that their main objection is to blanket requirements for annual cash-flow testing.

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Instead, I am proposing that the need for cash-flow testing for a company of *any* size should be governed by its risk profile of assets, liabilities, and products. I have included specific trigger points in the regulation that would require cash-flow testing. These are based on relatively large product mixes of annuities, universal life, or outside-indexed life or annuities. They are also based on large asset mixes of volatile CMOs with high "flux" scores or illiquid assets such as real estate or commercial mortgages.

These trigger points vary somewhat by company size, so that the traditional four categories in the current law, A

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through D, are retained. Even here, I have specified that actuarial judgment in each company situation may still require cash-flow testing, regardless of the above risk profiles.

Regulatory Review

An important question is the extent to which actuarial reserves based on judgmental assumptions would be subject to regulatory review. Only a few state insurance departments have the resources to conduct such a review of all domestic companies (let alone of all licensed companies).

Tied in with this concern is the question of the proper status of valuation actuaries. In some European countries, these actuaries appear to be quasi-regulators rather than members of management. In the U.S. of course, company actuaries are members of management. Consulting actuaries are agents of management. Regulatory actuaries are insurance department employees and are not tied to companies.

A third related issue involves possible review of the new type of actuarial opinions by a new, designated regulatory body or an expanded division of the NAIC. There is a very sensitive question of whether states are willing to delegate their legal powers to an outside agency.

To answer all these related concerns, my proposal is to retain the basic, current U.S. approach. Company actuaries would be accountable to their own management and, in a professional sense, to the ASB. Each state would retain the power to review or challenge any actuarial opinion. In addition, as a normal annual process, the NAIC would be charged with limited, prescribed reviews of all actuarial reserve opinions. However, this review would be limited to the completeness of each opinion's assumptions and documentation. The NAIC would report to each domestic state only those opinions deemed to be incomplete. It would then be up to each state to ask companies for more information about problem opinions.

Even this type of limited review would require an expansion of NAIC (or other body) actuarial resources. However, it could still serve to retain current prerogatives of each state.

General Considerations

For reinsurance, I have included a requirement that the actuary of the ceding company must be satisfied that the assuming company is holding appropriate reserves on the ceded block. My thought was that the assuming company would provide some type of statement and description about its reserves to the ceding company. One complaint against New York's Regulation 20 for "mirror image" reserves is that ceding and assuming companies can legitimately set different reserve assumptions for the same block.

One objection to my approach on reinsurance could be that the valuation actuary should merely be satisfied that the assuming company is in sound financial condition. My own preference is to go beyond this, so that some comfort about the magnitude of assumed reserves is provided to the ceding company.

I have not included any specific legal protection for actuarial liability. Many consultants and other actuaries are very concerned about the lack of such protection in the current law. They believe that if actuarial judgment is allowed in setting reserve assumptions, legal protection is even more crucial.

Unfortunately, at this stage, even the entire insurance industry has not persuaded Congress to allow insurance liability caps. Therefore, I question the practicality of attempting to limit actuarial liability in a valuation law.

Risk-based-capital calculations are an important part of statutory financial statements. Reserves are an important part of these calculations. If the valuation law is changed, it is likely that the bases for risk-based capital would also automatically be changed.

It is unlikely that federal income tax calculations can be built into a standard valuation law. However, the implications of reserve changes and possible tax impacts should always be kept in mind.

I added another section dealing with new business projections. This is to satisfy another objective of a new valuation law for dynamic financial information. New business projections would use reserve assumptions along with the added key assumptions of new business volume and mix. The actuary would need to be satisfied that the company's financial condition would remain sound under new business conditions. If acquisition expenses are completely deferred, the traditional trigger of statutory surplus strain would no longer be present. Therefore, the extent of asset adequacy, specifically, *invested* asset adequacy, would have to be included in such projections.

Conclusion

Within the industry and among regulators, there are a host of differing and conflicting opinions and objectives for a valuation law. There is a serious question of whether it is possible to prepare a new valuation law and achieve even widespread agreement, let alone consensus. I have prepared a completely new law, based on my own background and experience. I hope the description of my approach as provided in this article will serve to stimulate discussion among smaller companies, as well as other parties, and help foster greater agreement.

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