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# Small Talk

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# Investing a Few Minutes Now Could Save Hours Later

By Lori A. Newberg

**E**xaminers for State Insurance Departments have moved their attention from a formula reserve review to a risk-based focus examination. Thus, the examiners are paying more attention to the asset adequacy analysis (AAA) and the risk-based capital (RBC) analysis. Each of these analyses requires a supporting memorandum or report as required under the Actuarial Standards of Practice (ASOP). We all know proper documentation is good practice. Further, it will assist a state examiner or auditor in conducting their review. Proper documentation is greatly appreciated by the examiners, and it also helps jog your memory when asked a question. Additionally, when principle-based reserves (PBR) are introduced, documentation will be of the utmost importance.

The Actuarial Opinion Memorandum Regulation (AOMR) states that the AAA memorandum should demonstrate that the analysis has been done in accordance with ASOP, should document each major assumption and strategy used, should cite all material reliances, and should contain other disclosures as specified by the AOMR and ASOP. In my experience, most memorandums seem to contain adequate documentation of major assumptions, strategies employed, and reliances. Where most memorandums fall short is the disclosures for providing why an assumption is appropriate whether by judgment, company experience studies, industry tables, etc. This small but important detail will be even more critical when implementing PBR since assumption setting will have more flexibility.

When describing the assumptions in the AAA memorandum, be sure to defend the degree of rigor used in setting the various assumptions. Ask yourself, “Where did this assumption come from?” In most cases, it only takes an extra sentence or two to answer this question. A brief checklist of assumptions to be described, including the degree of rigor, in the AOMR is provided here.

Liability derivation of assumptions:

- a) Lapse rates (both base and excess)
- b) Interest crediting rate strategy
- c) Mortality
- d) Policyholder dividend strategy
- e) Competitor or market interest rate
- f) Annuitization rates
- g) Commissions and expenses
- h) Morbidity

Asset derivation of assumptions:

- a) Default costs
- b) Bond call function
- c) Mortgage prepayment function
- d) Determining market value for assets sold due to disinvestment strategy
- e) Determining yield on assets acquired through the investment strategy

Another documentation item often lacking in the AAA memorandum is a model validation. The model validation should include such items as:

- a) Renewal premium as reported in Exhibit 1 Part I
- b) Net investment income
- c) Benefits such as death, surrender, annuity benefits, and policyholder dividends
- d) Commissions
- e) Expenses
- f) Investment expenses

If the results from the model assumptions deviate from the annual statement amounts, give a brief explanation of the difference, and why it is appropriate.

The RBC analysis must include a supporting memorandum as stated in the ASOPs similar to what is prepared for the AAA analysis. However, in practice, many actuaries have yet to prepare the required report. The change in examination focus will bring this oversight to light. The supporting report should identify the amounts tested, as they relate to that of the AAA memorandum for the various product lines, as well as all the assumptions and their appropriateness. It may appear as a duplication of effort since the AAA memorandum is quite similar, but it is a requirement, and will be requested by the state insurance department examiners and auditors. The differences in the business subject to testing between the AAA and the RBC analysis may soon be alleviated in 2011. However, in the meantime, a separate RBC report should be prepared.

Having served as both an auditor and an appointed actuary, I have learned a few extra minutes spent on defending and validating assumptions can save hours of discussions when it comes to financial examinations. ●

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