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ACLI Valuation Proposal: A Quick Start to the Revision of the Valuation Law?

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Introduction:

The regulatory community is considering revising the Standard Valuation Law (SVL) significantly to create a less formulaic approach that will be tied to company or industry experience assumptions. The name adopted for this approach is Principles Based Reserving (PBR). The law incorporating this will be the SVL II. Even though this is going on, at the December meeting of the Life and Health Actuarial Task Force (LHATF) prior to the NAIC meeting, the ACLI proposed some quick changes to the current SVL. Many issues are involved, so they continued their discussion in a conference call on Feb. 3. This article will discuss this and what its implications are.

Current Valuation Principles

To summarize the current state of valuation, we have a formulaic SVL that specifies the mortality, interest and method (CRVM). The interest rate is updated annually by a formulaic approach that qualitatively sets longer term guarantees at lower rates. The mortality table was recently updated from the 1980 CSO to the 2001 CSO with a mandatory applicability of Jan. 1, 2009.

The only way experience assumptions get into valuation is through the asset adequacy analysis in the Actuarial Opinion and Memorandum Regulation (AOMR). There are two versions of this. The older one allows some companies, based on size in net admitted assets and passing certain other tests, to be exempt from the asset adequacy analysis. Others must perform such analysis. A newer version, which has passed in only a handful of states, mandates the analysis



annually for all. On Jan. 1, 2009, when all companies must issue policies on the 2001 CSO, asset adequacy analysis will be required in connection with that. Knowledge of this may be slowing passage of the newer AOMR.

Although the margins in the 2001 CSO mortality are less than in the 1980 CSO, this table only has distinctions by sex and smoking status. Many companies in the better underwritten markets use one or more grades of preferred mortality and find both the 1980 and 2001 CSO tables to be too conservative. This is especially so for products which must be reserved under XXX. These include the popular reentry term (with and without the Return of Premiums Rider). These have level periods which are usually fully guaranteed from 10–30 years.

Another type of policy is the universal life with a secondary guarantee. This means that, so long as a minimum premium is paid, the policy will not lapse. This is written by some large stock companies, and they feel that the Actuarial Guideline 38, which regulates this, creates too high reserves. That the reserves are too high can

be considered by cash flow testing or GAAP. There appears to be no way to lower reserves under current statutory methodology.

ACLI Mortality Study

Mike Taht, an actuary from Tillinghast, was largely responsible for the creation of the 2001 Valuation Basic Table (VBT), which is the mortality table underlying the 2001 CSO. The ACLI hired him to come up with a table that could be used to value preferred mortality. He presented this at the December NAIC meeting. Significantly, if adopted, this table would be the first to be created by a source outside the Society of Actuaries official committee structure. This can be found as Appendix A (133 pages) for the Feb. 3 conference call.

In essence he estimated the ratio of preferred to aggregate mortality, the prevalence of preferred products underlying the 1990–95 experience and then using the principle of conservation of deaths to estimate the residual standard mortality. There were two preferred categories for non-smokers and one for smokers.

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Since the definition of preferred mortality has varied, one challenge was to develop a valuation assumption for the level of preferred mortality. The level of early duration preferred risk mortality and the persistence of differentials were important issues. To obtain the level, he used the Tillinghast Old Age Mortality Study (TOAMS) (for years 2000–2002) and the SOA Preferred Underwriting Survey.

Although there is no published late duration experience for insured preferred risk lives, the TOAMS provided credible preferred nonsmoker mortality up to duration 15. To demonstrate the possibility of persistence beyond duration 15, several analogous situations for such persistence were cited (studies of alcoholism, cholesterol and blood pressure, urine anomalies and diabetes). He went on to discuss the changing prevalence of preferred risk in the insurance industry.

Lapse, the Standard Valuation Law and AG 38
The secondary guarantee UL policies have statutory reserves which are considered overly conservative. There appears to be no way around this. The ACLI obtained from a law firm a position paper entitled “Proposed Revision to the Actuarial Guideline XXXVIII.” In essence, the ACLI proposal is to allow lapse to be considered in calculating a net single premium in one step of the reserving method in AG 38. The issue presented to the law firm was whether such a revision was permitted under the Standard Valuation Law.

They qualify the situation as one where a state has passed the Regulation XXX and the NAIC UL Model Regulation and that the NAIC Accounting Practices and Procedures Manual has been adopted as the state’s codification of statutory accounting and that amendments to it become operative without further action by the commission as long as they are not inconsistent with state law or regulations. Further, they assumed that AG 38 is operative in that state upon its adoption by the NAIC without the need for the insurance commissioner to adopt it as a regulation and that

there is no prescribed statutory accounting practice inconsistent with the ACLI’s proposed revision to AG 38.

The firm concludes that “Notwithstanding the absence of clear legal guidance... using lapse assumptions for reserves for secondary guarantees does not violate the express terms of” or principles underlying the SVL or Regulation XXX and the UL model regulation and that, although the SVL does not expressly permit the use of lapse for UL with secondary guarantees, the SVL does provide state regulators the discretion to allow lapse so long as that practice can be “demonstrated to be appropriate, as an actuarial matter, in light of the benefits and the pattern of premiums.”

They quote Section 9 of the SVL dealing with indeterminate premium plans where reserves held must be “appropriate in relation to the benefit and the pattern of premiums” and be “computed by a method that is consistent with the principles of the Standard Valuation Law, as determined by regulations promulgated by the Commissioner.”

They also quote the AOMR in dealing with reserves in light of the asset held and consideration to be received.

Discussion on Feb. 7

The ACLI proposal was to introduce the preferred mortality rates, the use of lapse rates for calculating reserves for UL with Secondary guarantees and allowing non-premium paying UL contracts with secondary guarantees to use the surrender charge offset to the additional reserve calculation. They briefly discussed the mortality table and the legal opinion.

In the conference call, the regulators discussed the proposal. William Carmello of N.Y. produced a memo earlier with some comments on it. In essence, he supported giving relief to preferred business as a general concept but did not accept the proposed tables. One point he did not support is the use of preferred underwriting to age 95 regardless of issue age and would want a grading to ultimate. He also wanted the new nonsmoker table to tie in the aggregate to 100 percent of the 2001 CSO nonsmoker. The ACLI proposal would tie to about 77 percent. Mike Taht said this 77 percent reflected more modern proportions of preferred.

Carmello also opposed the changes to AG 38. He believed that a change in the SVL is needed to permit the use of lapse. He also did not want to change the surrender charge offset for the non-premium paying UL. It was noted that the proposed mortality table had not come from an SOA committee and that the SOA was considering producing one.





One issue discussed was timeliness. How long would it take to revise the SVL to explicitly allow lapse? How long would it take for the SOA to publish a table? Finally, a vote was taken on whether to expose the ALCI proposal. There was some discussion whether exposing it would be considered an endorsement. In the end, some who voted for exposing it said they did not support it but would let it be discussed anyway. Further discussion of this will occur at the March NAIC meeting.

Update From Spring LHATF Meeting March 2
Ted Schlude's article discusses what happened at the LHATF meeting. The NAIC legal counsel is reviewing the legal opinion regarding allowing lapsation for the UL secondary guarantee. Regulators want the SOA to do a peer review on the ACLI preferred mortality tables. There was some question as to why the ALCI was rushing into such an interim solution when the SOA mortality table update was underway with completion expected soon.

My Comments

This is a serious issue with some strong support. Now that it is exposed, it can be voted up or down. Since we have all been taught that valuation is based on mortality, interest and reserve method, introducing lapse seems wrong. The way the ACLI's law firm approached it has subtleties. It sets a highly qualified precedent to allow lapse and it does this by allowing the commissioner of a state the discretion to use it in a limited sense.

As with much other law in our society, not just in insurance, sometimes a little precedent is expanded into something

much larger. I think many regulators understand this and will be reluctant to allow this. Because many insurers (and their reinsurers) feel that the reserves required under AG38 are excessive, there will be pressure to lower them somehow. Thus, this is a tempting area for setting a precedent.

Concerning the mortality, I agree with Carmello that, from the valuation point of view, we should not have the effects of preferred underwriting lasting to age 95 regardless of issue age. Mike Taht used a reasonable approach in citing industry studies of various diseases for ongoing mortality differentials but applying it to preferred underwriting is a projection. Valuation should be conservative.

This is an interesting proposal, and I commend it to the members of the Smaller Insurance Company Section to follow and comment on. The Principles Based Reserving (PBR) is being pushed. Whether this succeeds is another matter. Is the ACLI proposal really necessary? What if it passes but PBR does not and gets bogged down? Then it will be used for years.

As a smaller company, are you in any way more affected by the ACLI proposal? Do you write UL with secondary guarantees? Do you need the preferred mortality table? Do you use reinsurance heavily for such products? Will this help your reinsurer? If reserves were less, would you retain more? Give this serious consideration. We welcome your thoughts. ●



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