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Notes on the Status of the Principles-Based Approach, Including Utah Meetings with Academy Representatives

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On Aug. 23, 2007, David Sandberg, American Academy of Actuaries (AAA) vice president for life insurance issues, and Craig Hanna, AAA director of public policy, visited Salt Lake City and held two meetings to discuss issues related to the Principles-Based Approach (PBA) for both reserves and risk-based capital (RBC). In the morning they met with a group of company actuaries based in Utah; in the afternoon they talked with Utah Commissioner D. Kent Michie, several members of his staff and representatives from several companies domiciled in Utah. The purpose of this article is to share some of the author's notes and impressions from these two meetings, as well as other information provided in preparation for these gatherings.

Prior to the meetings, the author sent e-mails to several members of Subgroup 4 of the Valuation Manual Team, asking for their perspectives on the current status of PBA. This subgroup, chaired by Pam Hutchins of Government Personnel Mutual Life, has been working with the AAA's Life Reserve Working Group (LRWG) to recommend certain changes in PBA that would accommodate the needs of companies valuing smaller blocks of business or blocks of business with less risk. The goal of this subgroup is that the final regulation should contain practical guidelines so that resources for extensive PBA work are spent on the products with the most risk and that simplified processes are used where reasonable for products with less risk. An extensive PBA calculation process for a product—where the reserve results are likely to have little variability across a wide range of economic scenarios—is a waste of resources and should be discouraged.

The responses I received identified issues that are currently being addressed by the subgroup, including the following:

1. Phase-in of PBA over time, beginning with the products containing the most risk. A survey of regulators has indicated solid support for this proposal.
2. Complete company exemptions from PBA for smaller companies. Except for single-state companies that the commissioner would be authorized to exempt, this proposal has met with resistance.
3. Limited product exemptions, such as for credit life and disability, final expense insurance and traditional whole life. This proposal has met with some support, based on the lower risks associated with these products.
4. Development of a test for Material Tail Risk (MTR) which, if passed, would provide a safe harbor exemption for certain products such that no stochastic testing would be required. This proposal has met with good support from LRWG. The modeling work to develop the test is being done by the Modeling subgroup of the LRWG, chaired by Steve Strommen. Initial results appear to be promising.
5. Relief regarding expense allocations for smaller blocks of business, including newer lines of business. A proposal to use the Generally Recognized Expense Table (GRET) has met with opposition. Similar opposition was voiced to a proposal to use an exit value expense, but progress has been made in finding an acceptable basis of expense allocation.
6. Mortality margins for companies with immaterial experience. This has been a controversial issue. Some have proposed that larger margins should be required for blocks of business with less experience and the current version of the LRWG proposal includes this provision. (This may also include larger margins for other assumptions, such as lapses and expenses.) Concerns include the uneven playing field for pricing created by requiring higher reserves and RBC on smaller blocks, as well as the possibility

that requiring higher reserves for smaller blocks creates "currency" for larger companies to use in making acquisitions (some of the funds used for the acquisition would in effect come from the release of the higher reserves of the smaller company). Simplification of the process for setting the mortality assumption has also been discussed.

7. Projecting Non-Guaranteed Elements (NGE) such as dividends and cost of insurance rates. Some companies are concerned about legal issues and would prefer to project only guarantees.
8. The requirement to model all in force business for RBC. This would require a great deal more work than the reserve requirement, which would apply only to new business issued after the effective date. There is concern that the RBC requirements and reserve requirements may not be consistent with each other, due to a perceived lack of coordination between the groups responsible for developing these separate proposals.
9. Simplifications to PBA treatment of supplemental benefits and other areas, including the policyholder behavior assumptions.
10. Simplifications to PBA treatment of reinsurance, particularly YRT excess of retention reinsurance.
11. Relief on experience reporting requirements for companies with immaterial experience. There is currently a proposal for simplified reporting requirements for companies with less than $25 million in life premium.
12. Relief on the expense of PBA review by an independent actuary. There is a concern that the total cost of PBA to smaller companies may put them at a competitive disadvantage.

I would emphasize that the above refers to life insurance issues only. Annuity issues are on a separate track and, while the annuity working group is behind the life working group in the development of PBA, they will have a proposal to present to the Life and Health Actuarial Task Force (LHATF) in September.

Dave and Craig met with William Leung, Stacey Haws, John Van Valkenburg, and Mark Birdsall in a breakfast meeting. During this meeting, the following issues were discussed:

1. The ACLI is about to have their second discussions with Treasury regarding PBA.

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2. The Consistency Working Group of the Academy is charged with ensuring that RBC and reserve PBA proposal are fundamentally consistent.
3. There are fewer legislative and regulatory steps involved in adopting PBA for RBC than for reserves, so it has a higher probability of being implemented and may be adopted first, even though it requires modeling all the in force. By the way, C-3 Phase 3 is identical to RBC under PBA.
4. Experience data submission details are still being developed. Long term, it could be an evolving tool for companies to use to help them see how their experience compares with the industry. The data submitted could include any transactions that relate to the modeled business: premiums, death claims, lapses, surrenders, policy loans, annuitization, partial withdrawals, ETI, RPU, dividend options, etc. This data resides in company administration systems and just needs to be submitted in an orderly way. There hasn't been any discussion about submitting asset data as yet. Dave hopes that this can be a value-added process like the preferred mortality project data currently being worked on.
5. Modeling is needed to determine whether requiring larger margins for smaller blocks of business (and companies) makes a material difference in reserve levels. If material, this larger margin requirement could create "currency" for larger companies to use in acquisitions, as well a pricing disadvantage for smaller companies to the extent they operate in the same markets as larger companies. Dave points out that such currency already exists today, since large companies can currently generate gains by selling off mortality reserves to the market, which is not an option for smaller companies. Some of these deals represent a market value equal to a tenth of the reserves. Therefore, if the currency available today is much larger than the new currency created by new PBA requirements, acquisitions activity may not be significantly affected.
6. Dave is cautiously optimistic about the state uniformity issue-outside pressures such as international accounting issues or the threat of federal regulation are a strong incentive for states to accept

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more uniformity. Dave has been making presentations to NCOIL members to help prepare the way for the needed legislative actions in implementing PBA. 2010 is a key year for international accounting standards and European capital requirements under Solvency 2, so we need to move forward to be consistent with this timing or other solutions may be imposed on us.

7. The Academy is working to support the new regulatory and industry culture and practices that will be necessary for PBA to work well.
8. Companies that are not as efficient will likely have this impact show up in reserves and capital in PBA. Either big or small companies can be inefficient.

Dave and Craig received the following feedback from the group:

1. The written words in LRWG documents are generally more onerous than the verbal descriptions given by Academy members, such as Dave Sandberg and Dave Neve.
2. Actuaries don't want to be required to use assumptions that don't make sense for the business being modeled.

In the afternoon, Dave and Craig met with the commissioner and representatives of the Utah Insurance Department and several Utah-domiciled companies, including Beneficial Life, Deseret Mutual, Equitable Life & Casualty, Great Western and Security National Life. Dave made a presentation based on PowerPoint slides he had prepared and distributed as handouts to the assembled group. Among the issues discussed were the following:

1. PBA may put a strain on actuarial resources. There will be a need for independent PBA reviewers, new hires at many companies and additional volunteer resources to serve on Project Oversight Groups for the new industry experience studies. It was pointed out that Canada has been able to provide for all of this needed support for some time now within its own country.
2. PBA should foster product innovation, helping consumers. Reworking the Standard Nonforfeiture Law will be a next step, helping to foster innovation. Setting assumptions for new product features would probably need to be coordinated with the independent reviewer.
3. International developments are in part driving the PBA project forward.
4. The tax code was not written with PBA in mind. The hope is to find philosophical common ground with treasury around the idea of establishing more appropriate reserves without needing to change the tax code.
5. The paradigm is changing to a risk analysis thought process. Dave used the example of a health exam for a person. The doctor performs tests, asks questions and distills all the results down to a relatively small set of recommendations for the patient. This smaller set of recommendations is what needs to be monitored.
6. A change to SVL is a three-year process and working with 51 legislative jurisdictions, whereas changes to RBC Instructions, APPM or Blanks and NAIC Examiner's Handbook, can be done much more quickly and uniformly. The new Standard Valuation Law (SVL) will reference the Valuation Manual, which can be updated through an NAIC process, like the RBC Instructions. The Valuation Manual may provide for coordination with RBC requirements.
7. Expressed areas of concern:
   a. Exclusion from stochastic processing-Material Tail Risk Test.
   b. Experience reporting for a myriad of assumptions-should be value-added as a research tool. Think five to 10 years down the road. This could be technology-enabled with little, if any, human intervention in the data collection process.
   c. Larger margins for smaller blocks of business may result in larger reserves and an uneven playing field.
   d. If PBA is just a rote compliance function, rather than adding value, it may put smaller companies at a disadvantage due to higher expenses and an uneven playing field.
8. Subgroup 4 of the AAA's Valuation Manual Team is working with LRWG on simplifications to the PBA process, including the Material Tail Risk Test.
9. Phase-in Example, with control of implementation of the phases through the Valuation Manual. As experience is gained with each phase, refinements in PBA can be implemented in the Valuation Manual.
   a. Possible Phase 1:
      i. Equity-indexed Life Products
      ii. Separate Account Life Products
      iii. Term with level guaranteed period of 20-plus years
      iv. UL with secondary guarantees of 20-plus years
   b. Possible Phase 2:
      i. In addition to Phase 1 products, all fund-based life products and all other individual term insurance
      ii. Implement Material Tail Risk Test
   c. Possible Phase 3:
      i. All other life products, except possible exemptions for Credit Life & Disability, Final Expense and Traditional WL.
10. Independent PBA reviewers should help promote uniformity in interpretation and application of PBR. So could a Centralized Regulatory Resource.
11. The insurance commissioner of each state would have authority to exempt single-state companies from PBA requirements.
12. Use of reinsurance could dampen the inequities introduced by requiring higher margins for smaller companies or a smaller company could enter into a relationship with a larger company.

13. The extra cost of PBR should be offset to some extent by adding value to the company in terms of understanding and accurately modeling and pricing its business.
14. Use of credibility in setting assumptions and margins would dampen the effect that good or bad management decisions have on the level of reserves and required surplus a company holds.
15. Possible Timetable
    a. VA RBC (C-3 Phase 2) already in place
    b. VA Reserves (AG VACARVM)-2007 possible, but not likely
    c. Valuation Manual—2007 possible
    d. Passing new SVL at NAIC—2007-2008
    e. Life RBC (C-3 Phase 3)—2008 year-end
    f. Life Reserves and SVL passed in state legislatures—2009. Implementation 1/1/2010
    g. Annuity Reserves and Annuity RBC—too early to tell. While lagging the life proposal, it could still be ready for 2010 implementation.

Final Thoughts

The material presented here is based on the author's notes, recollections and interpretations of what was said in the e-mails and meetings described. This is quite a lengthy summary, but with PBA it seems that "the devil is in the details." It is worth taking time to understand the details in order to form an opinion of what PBA will mean to your company. As you do, make an estimate of what you think PBA will cost your company to implement, including software, hardware, additional personnel or consulting fees, and the cost of the independent reviewer. Utah Commissioner Michie asked our assembled group for thoughtful, rational letters regarding what should be done regarding PBA and why. He was interested in our cost estimates. Taking action can help. Write a thoughtful, rational letter to your commissioner about PBA. Include your best estimate of what compliance with PBA will cost your company in the first year and in subsequent years. Doing so will give your commissioner a much better sense of the impact these new requirements might have.

It is not clear to the author that the NAIC has yet seen the fruits of the AAA Consistency Working Group's efforts to ensure the consistency of the reserve and RBC proposals. This consistency is critical to minimizing the cost impact of PBA on all companies. The National Alliance of Life Companies (NALC) has written letters to responsible parties expressing concern about this consistency issue and other PBA-related issues. Copies of these letters can be obtained from the NALC.

The uncertainty regarding tax reserves and the consistency of state adoption of PBA seem to be the wild cards in the entire PBA adoption process. Some actuaries and other tax professionals are concerned about how well the PBA proposal fits into the current tax code. The ACLI is having discussions with the treasury, so we may be getting better information on how valid these concerns might be. For many, the even bigger concern is if we end up opening a Pandora's Box: Congress trying to update the tax code to fit PBA in the midst of all the other possible political issues that would undoubtedly go along with that effort.

The state adoption issue is also uncertain. Will all the states uniformly adopt the Standard Valuation Law and Valuation Manual as eventually approved by the NAIC or will a number of states make significant changes to either or both documents? State differences in valuation laws have heretofore been a relatively minor issue. This may not be the case for PBA. Imagine being required to set assumptions and run your PBA models multiple times in order to satisfy requirements of several different states and then document all those results in separate memoranda and review them with the independent PBA reviewer. Would there be different reserves required for different states? Different blue books? Would there need to be multiple PBA reviewers in this situation? One hopes not.

The work of the Modeling Subgroup of the LRWG could play an important role in determining the structure and thresholds associated with the Material Tail Risk Test, as well as evaluating the effects of larger required margins on the modeling assumptions of smaller blocks of business. The playing field between larger and smaller companies is already uneven in some respects. How much more would the competitive playing field be tilted by PBA? The author hopes there are enough resources devoted to the work of this subgroup and that they have sufficient time to do a thorough job. The author believes they should represent a model company stepping through the various PBA requirements in order to test the practicality and desirability of various aspects of the PBA proposal. ●