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Small Talk

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This issue includes:

Smaller Company Actuary/Consultant Dialog on Principles-Based Reserves

By Don Walker and Terry Long

Other SOA section newsletters have recently featured dialogs between practitioners on the topic of Principles-Based Reserves (PBR). As an example, see the lead article in the May issue of *Taxing Times,* the newsletter of the Taxation Section. We thought that we would have a dialog between a smaller company actuary and a consultant who works with smaller companies. The participants are Don Walker, chief actuary at Farm Bureau Life Insurance Company of Michigan (FBL-MI), and Terry Long, a principal with Lewis and Ellis Inc. (L&E).

An important issue for smaller companies is the possibility—some would say probability—that the implementation of PBR will be costly. Smaller companies may not have the staff to routinely support the changeover and may be forced to go to outside resources to make the transition. They may also find it challenging to perform the annual work to support PBR. Finally, they may have to incur the additional expense of an outside reviewer.

Long: Don, what kind of products does FBL-MI sell?

Walker: We sell fixed annuities (FPA, SPDA and SPIA), universal life with no secondary guarantees, par whole life and term. We do not sell variable products, UL with secondary guarantees or return-of-premium term.

Long: How big is FBL-MI and what is its market?

Walker: We have roughly $1.66 billion in assets, $115 million in premium and $277 million of surplus as of year-end 2006. We are the life affiliate of the Michigan Farm Bureau Insurance companies, which market Life and property and casualty products through a multi-line field force in the state of Michigan.

Long: Isn't that a pretty big company, at least compared to what is usually thought of as a small company?

Walker: I know we sound "big," but we think "small." Our management is very cost-conscious. I always say that "small" is a state of mind, not a particular set of financials. The fact that we write exclusively in the state of Michigan also contributes to our self-image as a "small" company.

Long: Describe FBL-MI's actuarial staff, both in terms of size and experience. To what extent do you use consulting actuaries?

Walker: I've been with FBL-MI for 34 years; the first 20 in information systems, the last 14 in actuarial. I'm a career ASA; I've been FBL-MI's appointed actuary for 11 years. I have a FSA with over 25 years of experience in my pricing slot; I have a

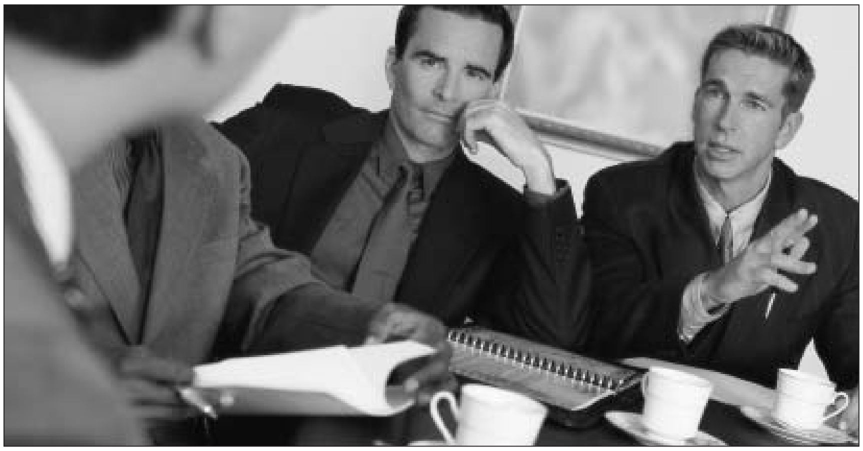
continued on page 4

continued from page 1

CLU with 21 years of experience and an FLMI with two years who do reserves and pricing. Until a year ago, I had an in-house FSA for CFT; that work is now being outsourced to a consulting firm. Other than that, we have made minimal use of consultants.

Long: How sophisticated are FBL-MI's reserving and asset-liability management (ALM) practices?

Walker: Our Exhibit 5 reserves are calculated using a commercial reserving software system. We also do annual cash-flow testing using a commercial actuarial modeling system. Due to time and manpower constraints, we perform the testing using ending third quarter assets and liabilities. We segment our business in the model. All segments are run against a standard set of 16 scenarios (NY7 plus inverted, current and normalized yield curves); we supplement those results by running the interest-sensitive segments (UL and deferred annuities) against the RBC200 set. ALM studies are done infrequently; our staff is currently fully committed to migrating our products to 2001 CSO.



Long: How much have you, your staff and FBL-MI management heard about PBR?

Walker: I try my best to keep up with it. I went to the VA Symposium the last two years (and am going again this year). I get information from my contacts at other small companies, especially the national network of Farm Bureau companies, whose actuaries get together each year. Dale Hall of Country Life has been a good source; he's on one of the committees. I also count on my contacts in the consulting community, like you and Jim Thompson.

My management has their own sources (such as ACLI); they come back from those meetings shaking their heads in dismay, saying, "What are you actuaries trying to do to us? Are you all crazy?"

Long: How do you respond to them? Do you share their concerns?

Walker: Let me share a story with you. As I said, I attended the VA Symposium last year, where I went to a session that talked about PBR as it is being practiced in Canada. An actuary in the audience stood up and asked the speaker how many small insurance companies are left in Canada. The answer came back "none." The speaker went on to point out that conversion to a PBR-like system would involve an initial expense in the range of $800,000 or more.

Needless to say, this exchange made me think a lot about the potential cost and benefits of PBR. There are obvious concerns for smaller companies. Their costs—as a proportion of their size—will be larger than those of the big companies; the benefits they will gain (reserve relief?) would seem to be less, since they won't be writing the same volume of new business—subject to PBR—as larger competitors. Note that I'm not even considering (yet) the ongoing costs, such as the outside reviewer.

Long: Based on the PBR proposals you've seen, what do you think small and medium-sized companies can do to alleviate this cost issue? Are there other changes to the PBR proposals you would suggest?

Walker: I have ideas that could work at some smaller, maybe even medium-sized, companies, assuming that their managements would prefer to hold higher reserves rather than spending the extra money to do full-blown PBR. Needless to say, a company would need to have some surplus to spare and stakeholders that could tolerate the deviation.

For example, I've read—in a paper by Chris DesRochers and Doug Hertz in the May SOA *Actuarial Practice Forum*—that PBR reserves should generally be lower than CRVM reserves because of the margins in the gross premiums. Chris and Doug were talking about tax reserve issues, but I think their assumption would certainly hold for a line like par whole life. On that basis, why couldn't a company just continue to hold CRVM reserves for par whole life?

I'll give you another example. A few years back, I attended a seminar on 2001 CSO migration; the presenter said that reserves for an accumulation-type universal life product would tend to end up at the cash value floor after roughly eight to10 years. The context was why accumulation UL reserves wouldn't get much benefit from 2001 CSO. That implies to me that, barring special product guarantees or asset issues, UL CRVM reserves based on the UL Model regulation should end up roughly the same as PBR. They will both end up at the CV floor. So, under those circumstances, why should a company spend extra money to do PBR on an accumulation UL? The reserves can't get any lower because of the cash value floor. And if they need to be higher, won't the cash flow testing that needs to be done for the A.O.M. be sufficient to identify and quantify the problem?

Almost everyone agrees with the contention that XXX term reserves are too high. If a company is willing to hold "old-style" XXX reserves for their term, however, why shouldn't they be permitted to do so?

Finally, if a company is doing a good job of cash flow testing of their interest-sensitive business, what's wrong with CARVM reserves for fixed deferred annuities?

Please note that I am not advocating simplistic approaches for lines like variable annuities with sophisticated guarantees or for ULs with significant secondary death benefit guarantees. If a smaller company wants to play in the big boys' sandbox, it should be willing, and required, to do the extra work.

Terry, let's turn this around. As a consultant who might be acting as a reviewer, what would be your reaction to my deviations from "pure" PBR?

Long: First, I agree there should be provisions to allow companies to limit the costs of a new reserving methodology, especially for products or lines of business for which that methodology will have limited benefits for the company or policyholders. However, I believe this principle should apply to all companies, not just smaller companies. For instance, you mentioned participating whole life as an example where CRVM reserves currently being held would typically be larger than the reserves under PBR. However, due to the cash value floor, there is a relatively small amount by which reserves could decrease even if a "pure" PBR reserve is calculated.

However, due to the cash value floor, there is a relatively small amount by which reserves could decrease even if a "pure" PBR reserve is calculated.

One actuary I talked to stated that if PBR allowed him to set his company's traditional life reserves equal to the cash values, total reserves would decrease no more than $3 million even if PBR was applicable to *all* existing business. This company already performs cash flow testing annually and the reserves have always been found to be sufficient. I find it difficult to believe that requiring them, or any company, to spend tens, if not hundreds, of thousands of additional dollars to possibly reduce reserves a relatively small amount is in the benefit of the company, its policyholders or the industry.

Second, I could not agree more with your statement about "playing in the big boys' sandbox." For those products and lines of business with material tail risk, company size should not allow a company to avoid PBR. There will likely need to be concessions with respect to recognition of your own experience since smaller companies will be less likely to have credible experience. But the process of determining reserves should be similar.

As far as your proposed deviations are concerned, I would be comfortable with most of them assuming they are permitted by the final PBR regulations. I have already commented on my thoughts of holding CRVM reserves for participating whole life insurance supported by asset adequacy analysis versus full-blown PBR reserves. Subject to a review of your cash flow testing, your suggestions for universal life without secondary guarantees and fixed deferred annuities appear to be reasonable alternatives to PBR. And most of us would agree holding "old style" XXX reserves would be more than adequate.

You did not specifically suggest an alternative for determining reserves for SPIAs, but I have assumed you meant to exclude them from full-blown PBR as well by holding some "safe" level of reserves. Given the nature of both the longevity and interest risks associated with this product, I am not confident there is a "safe" level of reserves similar to CRVM reserves for participating whole life or CARVM reserves for fixed deferred annuities. Unless the SPIA reserves are immaterial, I would prefer those reserves be calculated consistent with PBR principles.

Key to your entire proposal is the condition that a company has the means and willingness to hold the larger reserves. While FBL-MI might satisfy those conditions, not all smaller companies will. Even then, will FBL-MI be able to continue offering reasonably competitive products as some, if not most, of your competitors move to PBR? If not, you will eventually have to move to PBR. When that time comes, will there be alternatives that allow you to hold something less than the "safe" reserves you have described without incurring all the expense of full-blown PBR?

Walker: I tend to agree with you that competition in some lines will eventually force companies to move to PBR. I think that term is the line where this is likely to be the biggest issue. Term is also the line where current methodologies (XXX) are already forcing companies to do periodic tweaking of reserve assumptions (such as annual x-factor validation). I'm not sure that there will ever be a compelling reason to do PBR for par whole life, accumulation UL or non-bonus fixed annuities. The competition is coming from other lines, like variable and secondary guarantees, and I have doubts that small adjustments in reserves will make a difference.

I agree that SPIA will have to be addressed, but that it may well be immaterial for many companies.

I also note that I've heard talk that there are proposals out there that would allow companies to use existing CRVM approaches for product lines that do not have "significant tail risk." Some of the motivation for this has to do with the other piece of the reserve puzzle—tax reserves.

continued on page 6 ▸▸▸

continued from page 5

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Terry Long, FSA, MAAA, is senior vice president and principal of Lewis & Ellis, Inc. in Overland Park, Kansas. He has been a frequent speaker on smaller company issues. He can be reached at *tlong@lewisellis.com.*

Long: So, now that you've brought them up, how might a company that doesn't want to invest a lot in PBR handle tax reserves?

Walker: This could be harder to swallow for management, since no one likes paying any more tax any sooner than they have to. However, I think that some companies might find it acceptable to hold cash values as their tax reserves for certain lines. And that assumes that the Internal Revenue Service decides to accept PBR as the basis for tax reserves. There are a number of practitioners that have doubts about that happening.

Term might well be the line where a company will need to invest in PBR to deal with the tax side as well as the stat side. But, a company could still compare the cost of PBR in hard expense dollars versus the benefits in softer tax-shifting dollars and decide that the overall benefit of PBR just isn't there.

Long: What about the additional experience studies that PBR seems to demand? How will smaller companies deal with those?

Walker: With the tightening of the exemption rules for the A.O.M. already in place, it is questionable whether companies can avoid doing these studies anymore. Just to satisfy the needs of their Cash Flow Testing process alone, they will need to do more frequent studies of all kinds. I can only hope that the NAIC will recognize the burden that may be put on the smaller companies. But remember what I said about the "big boys sandbox."

Editor's Note: *Stay tuned as these and additional questions are debated and discussed in future issues. We welcome your opinions and input.*