SOCIETY OF ACTUARIES

Article from:

Small Talk

October 2012 – Issue 38

Regulatory Update

By Norman E. Hill

This article was written on Sept. 23, 2012. I was surprised to see that, for the principle-based reserves (PBR) portion, in 2012, the topic remains as time sensitive as in prior years. Therefore, I recommend that readers continue to monitor developments. The Smaller Insurance Company Council provides supplementary blast emails as we have breaking news.

Solvency Modernization Initiative-Statutory Accounting

Several times recently, I've heard hints dropped from regulators, including prominent regulators, about scrapping statutory accounting (SA) and substituting some type of GAAP. The only argument advanced for such radical change is that U.S. GAAP is likely to be replaced by international GAAP (IFRS) and therefore SA ***must*** cease to exist.

In my opinion, this argument is without foundation. While SA is defined as U.S. GAAP with adjustments, SA is completely codified and self-contained. Adjustments are all built in, so no separate GAAP reference is required. Even though new GAAP proposals are routinely discussed by the National Association of Insurance Commissioners (NAIC), there is no requirement for adoption or even discussion. If IFRS replaced GAAP, fully codified SA could remain just as it is and function.

One major problem could arise under IFRS as the new statutory. The IFRS reserve basis is a form of gross premium reserve (GPV) with annual assumption changes. With early principle-based reserves (PBR), many felt that GPV was not acceptable as an underlying statutory basis for federal income taxes. This gave rise to Net Premium Reserves (NPR) as a PBR floor, and under IFRS, could cause an entire new set of complications.

AG38 Controversy Re: Statutory Reserves for Universal Life with Secondary Guarantees

Much universal life with secondary guarantees (ULSG) is sold as de facto term, with level guaranteed no-lapse premiums. The intent of AG38 was that these premiums, when in effect, would be reserved on a long-term basis. However, it recently came to light that some insurers were making minor adjustments to premiums that allegedly were supported by a Practice Note that allowed them to reserve ULSG on a Yearly Renewable Term (YRT) basis when these long-term, no-lapse premiums were in effect.

The Life Actuarial Task Force (LATF) issued a report, precluding this YRT practice. However, one EXWG NAIC parent overruled part of this report. For new issues apparently after 2012, an approach close to stringent LATF reserving would be required. However, three safe harbor provisions are included for these products. For ULSG sold before this date, a form of GPV would be allowed, subject to an independent actuarial review. These reserves would be subject to separate asset adequacy testing, with an attempt at achieving uniform actuarial assumptions and methods.

This amendment to AG38 was approved by Executive/Plenary on a Sept. 12, 2012 conference call.

PBR—Current Status through Sept. 12, 2012

The main PBR governing document is a section of the new Valuation Manual (VM) labeled VM20. After nearly seven years in development, VM20 for life has been reasonably stable for several years. Several portions, especially a somewhat liberalized mortality assumption, were amended, although not with complete consensus. Adoption of VM by LATF occurred on August 2, 2012. Its parent A Committee adopted VM on Aug. 17, 2012 by a 10-to-3 vote. Of the three no-adoption votes, only New York actually voted against, and all three states raised only the problem of scarce regulatory testing resources. The next approval step is Plenary.

VM includes many portions besides VM20, such as scope (VM00), definitions (VM01), non-forfeiture (removing the historic link between and PBR interest, VM02), PBR report-

ing formats (VM30 and 31), variable annuities, (VM21), non-variable annuities and health (currently left on statutory in VM22 and 25, subject to later post-adoption PBR proposals), and mandatory experience reporting (VM50 and 51).

Both credit and preneed products are exempt from PBR reserves, although preneed is subject to mandatory experience reporting. Companies with under $50 million direct life premiums are exempt from this reporting. Only new issues after legislative adoption are covered by PBR reserves, and, even then, companies may defer adoption for another three years.

The new VM and Standard Valuation Law (SVL) make some provision for actuarial judgment in setting PBR reserves. However, section 11G of the new SVL allows any state commissioner to require revisions to PBR reserves for any admitted company if he believes reserve assumptions are unsound.

Once Plenary adoption by a super majority takes place, the NAIC's goal will then be to send a package of the new SVL, authorizing PBR, and VM itself, to state legislatures for 2013 approval. Similar to Plenary requirements, super majorities in legislatures will also be required—42 of 55 jurisdictions representing more than 75 percent of aggregate life and health industry premiums.

Unexpectedly, at an Executive Committee/Plenary call on Sept. 12, 2012 the A Committee chairman requested deferral of VM adoption by this group. The chairman said new issues had arisen (but with no further explanation), and added a later conference call for approval would be scheduled.

PBR and VM20—Key Provisions as of Sept. 12, 2012

First, all products must undergo a Stochastic Exclusion Test (SET), with two versions. The more stringent SET involves computing 16 GPV scenarios, based on stipulated interest rates. A ratio is computed, with the numerator equal to the excess of the worst GPV scenario over the base GPV, and the denominator equal to the present value of benefits for the base scenario. If this ratio is less than 4.5 percent, the product has passed.

As an alternative, an actuarial certification can be prepared, stating that the product does not possess material asset or investment volatility risk. A robust, well-documented asset adequacy test may suffice for this test, but other alternative evidence may also be provided. This alternative is not available for ULSG or variable life, although it is for term.

If SET is failed, three reserve sets must be computed for the product—stochastic, GPV and NPR—the latter two serving as floors to stochastic. The expectation is that most ULSG will fail SET. Also, the actuary has to be prepared to demonstrate that any simplifications in computing these reserves do not materially understate results.

If SET is passed, another test is made, the Deterministic Exclusion Test (DET). This test is a comparison of the product's net valuation premiums versus gross premiums. If net (presumably for the entire product) exceeds gross, DET is failed. PBR reserves for the product must then be based on GPV with an NPR floor. If SET is passed, reserves revert to Commissioner's Reserve Valuation Method (CRVM) statutory. The expectation is that many term products will fail DET.

NPR itself is CRVM statutory for traditional products and certain types of term and ULSG. The latter two must still be defined, although they should represent the more traditional varieties. For more competitive types of term and ULSG, NPR as ultimately defined in VM20 would most likely represent the reserve floor.

Expense assumptions in GPV and stochastic reserves should represent a fully allocated approach, but also assume a going concern. In my opinion, this would allow reasonable adjustment to current unit expenses to the level of a critical mass of operations.

As a result, VM20's current methodology would allow most traditional products to retain current CRVM statutory.

One other VM aspect should be mentioned. The above exclusion tests are not mandatory. If companies wish, and see value, they can reserve on a full stochastic or GPV basis, with appropriate floors.

A revised mortality proposal was presented by the American Academy of Actuaries (the Academy) and labeled as a simplification. Under this approach, blending of industry experience with less than fully credible company experience is no longer required. Instead, company experience may often be fully used initially, for a prescribed number of durations. This number depends on credibility of company data and also its volume, and was reduced from the Academy's recommendation. The lower the credibility and volume of data, the lower the number of years allowed. Company experience must then be graded to an industry table. The rapidity of grading is also determined by credibility and volume. Without full consensus, LATF adopted most of the Academy's proposal.

Since current VM20 deals with all life products (and may be labeled full scope PBR), there will likely be some additional expense for small companies. Even for those selling only traditional products, completing even simplified exclusion tests

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will require some additional time, if done internally, and some additional expense, if done through a consultant. However, compared to full stochastic reserving, as required seven years ago, my opinion is that additional expense should be noticeably lower.

New PBR Proposed Amendments

Despite A Committee adoption of a VM version as of Aug. 17, 2012, several new amendments to PBR, primarily VM20, have been proposed. The first two below were discussed on a Sept. 20, 2012 LATF call, one of several scheduled through early November. In my opinion, methodology covered by these amendments is more substantive than mere clarification.

1. On GPV and NPR reserves, intended as floors. This wording may make it more difficult to use aggregate groupings as floors, rather than seriatim policy by policy floor comparisons with the stochastic base.
2. On term products with higher renewal premiums, require actual experience of favorable cash flows in these durations before allowing inclusion in reserve assumptions.
3. On Economic Scenarios for GPV and stochastic reserves, require tightened requirements for the SET Scenario 12 and, for all Economic Scenarios, a prescribed average historic formula for a dynamic mean reversion rate for 20-year treasuries.
4. Further tightening of the mortality assumption, limiting the number of years for mortality data to be considered sufficient and moving up the duration when grading to an industry table must begin and be completed.

The LATF chairman indicated that numerous other amendments would be considered by LATF.

Post-LATF Adoption Areas Related to PBR and VM20

The ACLI pledged that it would support the VM through the 2013 legislative approval process. However, it expected resolution in 2012 of several critical areas:

1. Satisfactory completion of a small-scale impact study to supplement the major one from several years ago. Involving around 10 companies, this test would primarily analyze the liberalized mortality assumption on ULSG. As of the writing of this update, impact study results have not been released by ACLI. Also, newly proposed amendments to PBR methodology could significantly affect results of this latest study and even call for another test version.
2. Official NAIC installation of a process for ongoing VM changes after legislative adoption. This process should correspond to RBC changes.
3. NAIC resolution of the question of independent actuarial reviews of PBR calculations, to address widespread concern over limited state regulatory resources.

Other Regulatory Area Related to PBR and VM20

For RBC, C3Phase3 for life companies will probably be revisited after VM completion. A complete report from the Academy was submitted several years ago. Although full stochastic reserves are the proposed base, exclusions are available for small companies and others. These include the same SET as under PBR (before the liberalized alternative version) and an Alternative Amount, based on a similar type of actuarial certification for products deemed less risky.

Other Regulatory Area—Own Risk Self-Assessment

This Model Act, stating own risk self-assessment (ORSA) requirements, was also adopted by Executive/Plenary on Sept. 12, 2012. Company groups with under $500 million premiums are exempted. ORSA requires company-wide projections and analyses of experience under a broad range of scenarios. Both current and new business, as well as surplus and balance sheets, must be included. If a Commissioner requires, companies otherwise exempt may also have to provide these projections.

Summary

Even though some simplifications have been made, many regulatory requirements and proposals are quite complex and require detailed study. As always, small companies need to stay alert to all new developments. The latest VM deferral and further proposed amendments further complicate the issue. The main question for VM and PBR is, will a version be finally adopted by Executive/Plenary by Dec. 31, 2012 and, if so, which version?

Norman E. Hill, FSA, MAAA, is president of NoraLyn Ltd. in Gilbert, Ariz. He can be reached at *nhill@noralyn.com.*