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Optional Federal Charter (OFC)—Another Acronym, Another Concern

By Norman E. HIll

Recent Developments and Proposals

At the December, 2007 National Association of Insurance Commissioners (NAIC) meeting, one commissioner said that her Congressman informed her that any Optional Federal Charter (OFC) legislation was strictly on the "back burner." Since issuance of a U.S. Treasury Department Report this spring, there has been a dramatic resurgence of movement towards OFC for the entire insurance industry, life/health and property/casualty. While the report dealt primarily with banks, financial markets and the sub-prime mortgage lending crisis, it also called for optional federal charters for insurance companies.

The report described the current state regulatory framework for insurers as antiquated and inadequate. It could not point to insurer financial problems with sub-prime mortgages, since none have been publicized. No prominent life insurance failures have occurred since the 1990s. Instead, the Treasury report concentrated on two failings of state regulation:

1. The Interstate Compact for uniform product approvals (ISC) covers life, annuity, disability and long-term care filings. So far, 33 states have joined the compact, but large states such as New York, Florida and California have not; as a result, only about 54 percent of aggregate premium volume for these products is covered by the Compact.

2. International insurers seeking to be licensed in the United States or desiring accreditation as reinsurers have no single regulator in this country with which to deal.

In addition to bills for OFC directly, a companion bill has also been introduced in the House and even passed out of its subcommittee. Bill 5840 would create a national Office of Insurance Information (OII) to "collect, analyze, advise, and issue reports on domestic and international insurance matters." Many consider this bill and a new OII organization as the opening wedge to full OFC enabling legislation.

Current Developments

Advocates of OFC have become even more vocal during the current economic crisis. They have pointed to the $85 billion federal loan/bailout of AIG as a sign of failed state regulation. The NAIC and others have replied that insurance companies

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Editorial

By James R. Thompson

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This issue is the first one in a while where the lead article is not about Principle-Based Reserves (PBR). It is about another issue of consequence, which has not attracted as much attention—the Optional Federal Charter (OFC). The PBR issue is one being considered (as we write) by the National Association of Insurance Commissioners (NAIC). The NAIC has been the traditional body for regulating insurance. We are all now familiar with the quarterly meeting frequency. We know that the actuarial model regulations and guidelines are examined by the Life and Health Actuarial Task Force (LHATF) and then passed by the NAIC. There is an exposure and comment process. Many of us have attended NAIC meetings on behalf of a client or employer.

Once a model regulation is passed by the NAIC as a whole, it must be passed by an individual state to become effective there. Passage by 26 states has tax implications. Sometimes there are transition times. Passage by many states, especially some key ones, often forces compliance in all states simply because most big companies are in all or almost all states, and it becomes easier to make one's procedures and valuation uniform.

We all know how to deal with this process. Many smaller companies are single state or regional. Thus the conformity to nationwide trends does not always affect us, at least not so quickly. An idea which has been slowly gaining momentum is the OFC. Essentially this allows a company to choose to be chartered by the federal government and thus get around the 50-state (plus Washington, D.C.) regulatory process.

Many of us have not taken an interest in this, maybe because it's been on the back burner. But we must remember the old adage by Judge Gideon J. Tucker: "No man's life, liberty or property are safe while the legislature is in session." The recent congressional interest in the financial industry has included the insurance industry. The current status of the OFC is explored by Norm Hill in our lead article, "Optional Federal Charter (OFC)—Another Acronym, Another Concern." Norm shows why we should begin to take this move seriously and closely examine its implications. He has also provided an analysis of PBR trends in his article, "Principle-Based Reserves (PBR)—More Trends, But Not Resolution." Please note that the article was current at the time he wrote it, but we all know how quickly things can change. This newsletter will likely reach you after the December NAIC meeting where the issue is expected to be resolved. Possibly, however, PBR will be carried forward. Norm's analysis of unresolved issues should be useful.

Our newsletter's purpose is to bring relevant issues to your attention. We often find material elsewhere which, when

reprinted here, might bring to your attention information you might not have read. One such matter is a recent study on lapse-supported experience. Lapse supported life products are those which require a certain level of lapsation to be profitable. This market is one of the more popular ones.

Companies which sell large volumes of such products have their own experience. If they price for a certain level of lapsation and there is less, they presumably will know how to make an adjustment. Companies with less experience are always on the outside wondering whether they can afford to price at a certain level. What level of lapsation can they expect to experience? Dominique Lebel has some lapse-supported experience. His article, "Lapse Experience Under Lapse-Supported Policies: Updated Studies from the Canadian Institute of Actuaries" was previously published in the June issue of the product development newsletter, *Product Matters!* Based on Canadian experience, it gives us something concrete to examine.

Reinsurance has a significant impact on smaller insurance companies. Although some sell only low face amount products and may not need much, many which sell average or higher sizes rely on a reinsurer to cover their capacity and to give them underwriting guidance. This may actually help them gain entry into a market. A recent update on reinsurance is provided in an article by Stephen Irwin from the February 2008 issue of *Reinsurance News*. "*A.M. Best* U.S. Life Reinsurance—Market Review Consolidation Brings Rational Pricing but Greater Competition" is based on the work of *A.M. Best*. He notes the decline in cession rates. Does this situation relate to what you are seeing in your own company? Can you seek reinsurance to enter new or riskier lines? The relation between reinsurance and capital markets is discussed. While many smaller companies have higher ratios of capital and surplus to assets than larger ones, this may still be useful to you.

As I write, the subprime market still hammers the stock market. Stephen's article discusses worries over the subprime effect on XXX funding. When this newsletter reaches you, the situation may be different.

We are pleased to have an article from Sheldon Summers, chief actuary of the California Department of Insurance, who is one of the LHATF members working on the reinsurance section of VM-20, a key document in PBR. He has written an update on how risk transfer will be treated entitled, "Reinsurance Under PBR: An Update on the Treatment of Risk Transfer." This is a subject of concern to various parties. His department made a suggested compromise between what had been suggested by the American Academy of Actuaries and LHATF. It will be interesting to see what the wording on this will be for the version presented at the December NAIC meeting.

We have an article on section metrics, "Who We Are: Smaller Insurance Company Section," by Leon Langlitz. This is the beginning of a demographic analysis and should help us understand what types of education, research and meetings to provide. Look for more developments on this very important topic.

Finally we have a write up of the face-to-face meeting of the Smaller Insurance Company Section at O'Hare Airport on Sept. 18, 2008. Our outgoing chairman, Bill Sayre, has focused on the lively discussion we had on various subjects in his article "Section Council Face-to-Face: A Productive Meeting Indeed!"

Among other matters, we discussed two research proposals relating to PBR and redoing our communications to members, including changes to our newsletter and using other more timely means of communication. We live in a fast moving world and we continue to work to keep pace, and oftentimes step to the front of the line.

I hope you enjoy this issue of *Small Talk* and encourage you to share your comments and feedback with us. ●

under the AIG holding company are all (as far as can be reviewed) solvent without surplus strain. The holding company problems—outside the reach of state regulation—stemmed from its credit default swaps, which do not appear to be on insurers' books, and were federally regulated by the U.S. Office of Thrift Supervision. Moreover, their argument is that these types of assets fell under AIG's federal products division.

Historical Developments

There have already been several federal takeovers of insurance regulation, actual and proposed. Medicare Supplement plan design, minimum loss ratios and refund formulas are now based on federal statutes. Agent licensing, reciprocity and uniformity are substantially covered by the Gramm-Leach-Bliley Act (GLB). In 1994, Congressman Dingell proposed a federal takeover of insurance, primarily in response to several prominent bankruptcies shortly before (this was before uniform Risk Based Capital standards from the NAIC came into effect).

Since then, the ISC was proposed and submitted for state approval, in response to widespread complaints about the impossibility of uniform nationwide product offerings. This development came about, partly to correct an obvious failing in state regulation, but also to mitigate future agitation for OFC.

On the property/casualty side, auto insurance companies in particular hoped that federal charters would allow market pricing, rather than pre-approved rates. The former approach has been in effect in certain states such as Illinois for some time, but not in most states.

Opponents and Proponents

The American Council of Life Insurers (ACLI) has come out in favor of OFC. Several large property/casualty companies, as well as some P&C trades, also have favored this approach. However, several trade associations, such as the National Alliance of Life Companies (NALC), representing smaller life insurers, the National Council of Insurance Legislators (NCOIL), and some agent organizations, have remained strongly opposed to the federal approach. Prudential, the largest life insurer in ACLI, State Farm and Allstate have been leading proponents of OFC, while substantial insurers such as AFLAC, are opposed.

Recently, the NAIC surprised many by offering conditional support for OII, while still stating official opposition to OFC. This especially drew the wrath of NCOIL, which claimed a sellout. The current OII proposal would give NAIC a seat on an advisory council, composed of a wide variety of constituents.

The U.S. Treasury Department report was expected to cover recommendations for legislation to deal with the subprime mortgage crisis, but its broad extension to insurance and all financial markets was unexpected. Since then, several congressmen have assured states that their premium tax revenues from companies would not be touched. Since money to fund a new OFC federal agency(ies) would have to come from additional revenue sources, some critics have denounced these statements as untruthful.

In short, there are a wide variety of organizations favoring and opposing OFC. While the majority of small insurers are probably opposed to it, this attitude is not unanimous.

Implications of OFC—General

From either ISC or OFC, the hope among nationwide life and health insurers is that uniform product forms could be achieved, and approvals could be obtained in much shorter time intervals than currently. Today, products may take a year or more before sufficient approvals are obtained before going to market. New York State Insurance Department has apparently decreed that, for domestics, no product can be sold anywhere without its own approval (most states do not seem to require home state approval before they will approve).

One critic of a national approach pointed out that federal agencies such as the Food and Drug Administration are notoriously slow in approving new drugs. While the parallel to insurance products may not be exact, there is no automatic guarantee of insurance products coming to market faster, when federally regulated.

Auto premium levels are enmeshed in political pressures. Some critics have remarked that it is incredibly naïve for property/casualty companies to believe that OFC legislation would automatically allow market rates nationwide. They point to California, where a referendum was passed by voters that actually required blanket reductions in auto rates, regardless of whatever the prevailing market conditions were.

Implications of OFC—Accounting

Another possible question about OFC is the future of statutory accounting. In the early 1990s, the proposal from Congressman Dingell for a federal takeover of insurance apparently envisioned only a GAAP accounting framework. With current congressional proponents of OFC, there is no evident reason to assume this approach. If it did, for companies that wished to adopt OFC, but did not yet prepare GAAP financial statements (probably some small insurers), they would face the considerable expense of initial GAAP conversions.

If GAAP ever replaced statutory, what would be the basis for insurer solvency? Possibly, Risk Based Capital standards would be employed. Some of those standards are based today on statutory reserves, which might be modified to include PBR reserves.

Compared to other countries, only the United States has two sets of accounting for most life companies, statutory and GAAP. If OFC was ever adopted, there would be no automatic reason to change this situation. Some have predicted that international accounting standards (IFRS), including reserve standards, will replace US GAAP within a few years. The AICPA reported on 9 30 08 that the SEC has "…outlined a series of steps that could lead to the required use of IFRS by U.S. issuers by 2014." Even so, if that were to happen, there is no automatic reason for statutory accounting in this country to be replaced.

Today, the entire body of statutory accounting is codified and independent of GAAP. If PBR was adopted for statutory reserves, it could easily be integrated into the statutory accounting literature. Further, even if US GAAP were to disappear, statutory accounting, other things being equal, would remain viable.

"Another implication for small insurers lies with the flexibility inherent in a variety of state licenses."

Suppose the situation became more complicated, and US GAAP replaced statutory under OFC, and then IFRS replaced US GAAP. Current IFRS proposals for reserves have many objectionable elements. A description of such reserves would not match US GAAP, current statutory, or PBR statutory concepts. Dealing with IFRS and opposing its extension to the United States would be the basis for a separate article.

In any event, it is obviously very important to study in detail all aspects of any proposed OFC legislation, and to keep up on United States accounting developments.

General Implications of OFC for Small Insurers

Unlike Principles-Based Reserves (PBR), implications and impacts are much less clear. There should be no substantial start up expenses for OFC, other than analyzing and understanding the legislation. No revisions to reserve systems should be required for OFC as such—unless statutory accounting were ever replaced by US GAAP in some form.

A few years ago, anticipating some form of OFC, the ACLI developed its version of an insurance regulatory code. Basically, this combined all adopted NAIC Model Laws and Regulations, to apply nationwide. It should be remembered that many of these Models had not been widely adopted. Depending on the progress of OFC legislation, companies should make a comprehensive study of these Models, since their prior impact had often been minimal.

As for PBR, if the NAIC adopted a new Standard Valuation Law (SVL) before OFC, that included PBR, it might become effective, regardless of the extent of state legislative passage. If the Valuation Manual for PBR was still incomplete and being debated, it might become effective automatically under OFC.

Another implication for small insurers lies with the flexibility inherent in a variety of state licenses. Some companies are admitted in a limited number of states. Sometimes, too much effort would be involved in expanding licensing. In other cases, certain states may impose regulatory burdens that minimize incentives to seek admittance. More to the point, if state regulation in one state becomes overly burdensome, arbitrary or similarly undesirable, companies can always exit the state. In some cases, they can even redomesticate to another state (the "vote with your feet" phenomenon). Obviously, this approach to onerous regulation would be impossible if a company had a federal charter.

Of course, the OFC is still labeled as "optional." Companies could retain the state licensing approach if they chose. Some have complained that the possibility of federal charters would create another version of an unlevel playing field, and give the latter type of companies an unfair advantage.

Legislative Outlook

Many have reported that a full House vote on OII or OFC will not be made until 2009, at the earliest. No Senate action at all on the Treasury report has occurred as yet. Passage of OII does not automatically mean adoption of OFC.

In the meantime, with the OFC resurgence, which has intensified since the recent economic crisis, small life companies should in any event decide on a position pro or con. If a com-

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pany is opposed, ACLI membership should not be helpful, since that organization is solidly behind OFC. Instead, insurers could ally with other trade associations, agency organizations, or rely on their own efforts.

Companies could write to Congress, giving thoughts on OFC legislation. They could also communicate with the NAIC, stating whether they support or oppose the organization's apparent attempt to compromise on the OII question.

Perhaps more important, if opposed, they could render support to NCOIL—through their own state legislatures—to maintain strict public opposition to OFC. If their own state has not yet joined ISC, they could pressure their state legislature to do so. Pointed references to the Treasury report's carping on ISC might help prod legislatures.

Summary

Together with PBR, a host of other NAIC models, the nationwide economic situation and other matters, OFC is now another development that warrants the concern and close attention of small insurers.

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Principle-Based Reserves (PBR)—More Trends, But Not Resolution

By Norman E. HIll

In an earlier 2008 article on the same topic, I wrote that Principle-Based Reserves (PBR) has evolved over two-plus years from "an onerous theoretical construct over to proposed procedures that fit small insurers' needs more reasonably … the rigor of proposed procedures now varies with riskiness of products offered." At this point, in late 2008, the situation in those terms has not changed. However, various trends can be observed, which are worth mentioning.

Overview

It is possible that the National Association of Insurance Commissioners (NAIC) will adopt a new Standard Valuation Law (SVL) this year. If so, it would very likely be adopted by itself, without the accompanying Valuation Manual (VM), containing several defacto model regulations for PBR. Current emphasis seems to be on completing SVL first, with major, controversial issues left for resolution in VM at some future date.

An actuary for the American Council of Life Insurers (ACLI) described what would happen from passing a form of SVL with limited controversial issues, leaving the latter addressed elsewhere: "When state legislatures adopt SVL, they have in fact adopted VM, even if it is not yet completed." While some states do require advance legislative approval of model regulations, I believe they are a distinct minority.

It should be kept in mind that VM so far contains substantial work on life and variable annuities (VM20). However, no work suitable for insertion in the manual has been completed at all for non-variable annuities (VM21) and health insurance, including long-term care (VM25). If SVL was adopted among the states, completely new VM sections for these latter products could become effective automatically, once adopted by the NAIC for VM purposes.

Recent Developments

During the Fall National NAIC meeting, an educational session was held on PBR. One speaker, the ACLI's chief actuary, made two significant comments:

1. A recommendation that the NAIC limit current application of PBR to three products, variable annuities, term life and universal life with secondary guarantees.

2. A statement that, for tests made so far on reserves for permanent life products, PBR reserves differ little from formulaic statutory reserves.

After the Life and Health Actuarial Task Force (LHATF) session, a revised exposure draft of the new SVL was exposed for comments. The provision for seriatim reserve floors was watered down somewhat, but was admittedly unresolved. Therefore, this draft does not constitute a stable product.

Unresolved Issues

In SVL, one unresolved issue remains, the minimum floor (seriatim or otherwise) for reserves. As described above, the trend seems that details of any reserve floor and their application would be left to VM. However, some regulators want some mention of a floor to remain in SVL. Words might be something like, "The floor must be the greatest of zero, cash value or present value of cash flows with details in the Valuation Manual."

In VM, there are a host of unresolved issues, such as:

1. Discount Rate—The basic dispute about this rate is between the American Academy of Actuaries (the Academy) and the New York Department. The Academy wishes to use net asset earned rates, as

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long as and to the extent that the current asset portfolio remains on the books. For reinvested assets, the Academy seems to support a risk-free rate. New York wishes to use a more conservative rate from day one, tied to Treasury bond or risk free rates, plus some small margin, yet to be specified. The choice of discount rate has a very significant impact on the size of reserves for permanent policies. Using a risk-free rate, as proposed by New York, would probably keep reserves on permanent products close to current statutory levels.

As a compromise, the Academy has proposed that net asset earned rates be eligible only for investment grade securities (grades 1 and 2 of the NAIC). Even those assets must not be of some kind of exotic nature, a definition itself that must be specified.

The concept of discount rate is normally thought of as applicable to deterministic reserves. Also, it could be applicable to stochastic reserves, once the greatest value of accumulated deficiencies is determined so as to be discounted. In fact, it could be applicable to the accumulation rate itself.

2. Reserve Floors—Currently, VM contains the possibility of three reserve floors. All of them could be required to be tested on a seriatim basis. They are:

   a. Cash value, on products providing such values.
   b. Present value of cash flows, using a risk-free (or risk-free plus 50 basis points or equivalent) discount rate. This is a longstanding New York proposal. It is not entirely clear if the discount rate here would be in addition to the risk free discount rate used in reserves themselves.
   c. A form of net premium reserve, as proposed by the ACLI. So far, very little specifics have been revealed about this reserve. Apparently, it was intended to aid in FIT calculations, and to answer some of the concerns raised by the Treasury in its earlier release, 2008-18. Very likely, the net premium would be locked in at issue and would have significant formulaic elements.

3. Nonguaranteed elements (NGEs), including policyholder dividends—C.9 1 of VM20 contains a key sentence for NGEs: "Where NGEs are based on some aspect of experience, reflect future changes in the level of NGE in the cash flow models based on the experience assumed in each scenario." This wording seems subject to different interpretations, including:

   a. If no experience is assumed in cash flows to justify NGEs, do not project them at all.
   b. If experience assumed in cash flows justifies only the current level of NGEs, project them.
   c. If a portion of NGEs is not based on experience, such as unusual, nonrecurring NGEs stemming from capital gains or other, do not project this portion.

In an attempt to clarify these points, amendment No.17 to VM was recently presented. It was deferred, pending discussions with the Academy's LRWG. Also, C.9 1 contains a drafting note, "The LRWG (Life Reserve Work Group) is considering…a simplified procedure (for NGEs) … for policies that do not have material tail risk."

The point is, both aspects of the unresolved nature of NGEs could further delay VM20.

4. Aggregation of reserve results by lines, such as poorer performing lines combined with better performing ones. New York insists on separation of reserve results. Probably, product lines could be separated, such as fixed premium vs. universal life, term vs. permanent, etc.

5. Aggregate margins or separate margins for each assumption. New York insists on separate margins, even though some have complained that the resulting aggregate margin is illogical or overstates reserves.

6. Reinsurance—New York and other regulators want to require separate cash flow projections for direct and reinsurance ceded portions.

7. Numerous other substantive, unresolved issues of VM20 were summarized in a June 23, 2008 letter by Bob Meilander, FSA, MAAA, of Northwestern Mutual. This letter was included in a recent NAIC mailing. Issues include:

   a. Lack of definition of a CTE level. In a recent LHATF call, its subgroup leaned to 70CTE as a recommendation to LHATF. This is higher than the Academy's recommended 65CTE, which the ACLI also advocated.
   b. Lack of definition of the threshold for the Stochastic Exclusion Test (formerly the MTR test), measuring the volatility and riskiness of products. In the above call, the subgroup recommended 4 percent (Amendment 33) to LHATF. Many believe that more tests are needed to measure the suitability of 4 percent for permanent nonpar products.

c. Margins for mortality, lapse, etc. are undefined, even though mortality methodology seems closer to stability.

Other unresolved issues remain for other portions of the VM, and elsewhere, including key small company issues. See No.1 through No. 3 below:

1. Experience Reporting—Currently, Forms VM50 and VM51 cover this topic. Calendar year reporting is called for, rather than the traditional, more rigorous policy year. Some degree of more limited reporting is allowed for small companies, although small companies is not defined here.

   During the summer National NAIC Meeting, a proposal was made to provide further exemptions from experience reporting for small companies. Either:

   a. Complete exemption if under $75 million premiums, or similar size description.
   b. Limitation of experience reporting to mortality experience only.
   c. For any extent of experience reporting, utilize valuation runs for denominators of rates to the greatest extent possible.

2. Deferral from PBR Calculations—Another VM section allows deferral for five years after state PBR adoption. Wording states that all products without exception can be elected (or not) to be covered under PBR. So far, no objections have been raised to this approach,

3. Expenses—Many small companies have not reached critical mass, so that actual current unit expenses may be significantly above pricing expenses. The question is whether gradual progression can be made from current to ultimately assumed (pricing or other) expenses, based on a going concern approach and a track record of reasonable growth.

Summary of Where We Are

Since two-plus years have elapsed in the PBR project, it might be appropriate to sit back and contemplate where we are. The entire project arose because of concerns expressed that the current SVL does not work satisfactorily, at least for certain products. These products are term insurance that gives rise to statutory deficiency reserves and universal life with secondary guarantees. In the latter case, the dissatisfaction apparently arises from any humpbacked reserves after account values are zero and minimum defacto term premiums kick in.

Another product with widespread insurer dissatisfaction with statutory reserves is variable annuities with minimum guarantees, where the standard scenario is mandated. Guideline VACARVM, retaining the standard scenario, has been under discussion for around five years and was recently adopted by LHATF. Therefore, procedures for variable annuities are a part of current statutory requirements.

PBR, if implemented, would only be applicable to new issues. If any credit crisis in the term/secondary guarantee market exists—related to asset problems due to mark to market requirements—then existing in-force needs of securitization, lines of credit or other reinsurance outlets would not be alleviated.

> "Since two-plus years have elapsed in the PBR project, it might be appropriate to sit back and contemplate where we are."

The new CSO Table with preferred mortality is almost completed, although it has to go through the state adoption process. Some have said that, because of PBR, there is no need to add margins to the already completed basic portions. For new issues, especially if X factors continue, deficiency reserves should virtually be eliminated for this portion of the market. Significant relief should already have been provided from the preferred unbundled version of CSO2001, with X factors. However, sizable deficiency reserves and humpbacked reserves would remain on older term and secondary guarantee products.

Statutory reserving in general has often been denounced, with terms varying from antiquated, redundant, obsolete, atrocious and even stronger epithets. Excellent arguments can be made that the process is not working as well as it should for the above types of special products. However, in fairness, the following characteristics of statutory reserves should be remembered:

1. The process traditionally is one of applying preset factors to current, actual in force. In other words, this in force reflects actual mortality and lapse experience of in-force business, even if the preset factors do not. An excellent argument can be made that this approach

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wipes out much of the factor redundancy and includes a substantial dynamic element. This argument applies equally to fund reserves.

2. For new business, statutory interest rates are automatically adjusted based on published bond indices. Even though they remain conservative and locked in at issue, such interest rates represent a form of dynamic adjustment.

3. When new mortality tables are adopted by legislatures—and become effective for new issues—they also represent the same form of adjustment.

4. Deficiency reserves, of course, are a different case. They are set up at issue, as a special form of loss recognition. The problem is that these are not economic losses, but, rather, are based on conservative assumptions which can produce onerous results and severe statutory surplus strain. Even so, deficiency reserves, using preset factors, are released according to actual experience of mortality and lapse.

Conclusion

The abovementioned letter to the NAIC contained one blunt comment. Many practitioners don't yet take PBR seriously, because of its moving target status and utter lack of a stable product. There is no doubt that many actuaries from industry and insurance departments and other professionals are still working very hard to bring the project to completion.

The outcome is certainly unclear.

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Who We Are: Smaller Insurance Company Section

By Leon L. Langlitz

Out of all of the Society of Actuaries' (SOA) member Sections, the Smaller Insurance Company Section is probably the hardest to define. What does smaller insurance company mean? Who does it include? Who should it include? What do members of the Section want and need from the Section itself? What should the Section be doing to assist its members? These and many other questions have arisen over the course of the past few months. In order to address some of these questions—and hopefully find some commonality amongst the membership—the Section Council decided it was time to perform some analytics on our membership. This article will highlight some of the findings we discovered as we began to look at what it means to be a member of the Smaller Insurance Company Section.

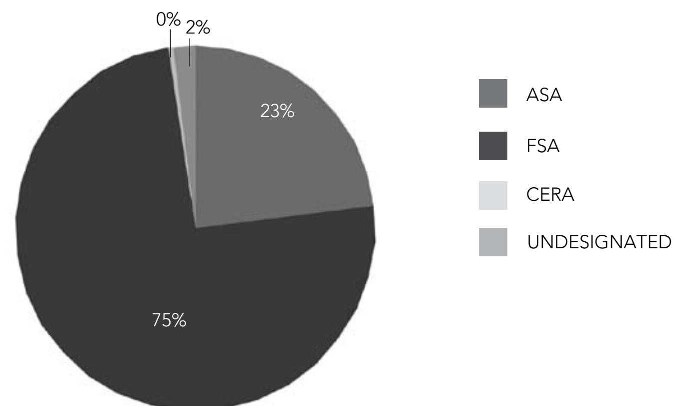
The following analyses were conducted from a database of information provided by the SOA. The information did not include any names, but did include company information, if listed. It also included various other attributes which made the following results possible.

First and foremost it appears that small is in the eye of the beholder. Members of our Section work for companies with assets from as little as $6 million to those that have over $10 billion in assets. They may work as a "one-person" shop or have dozens of colleagues. In fact many of our members do not work at an insurance company at all.

The rest of this article will provide various snapshots of what the Section looks like from a variety of different angles.

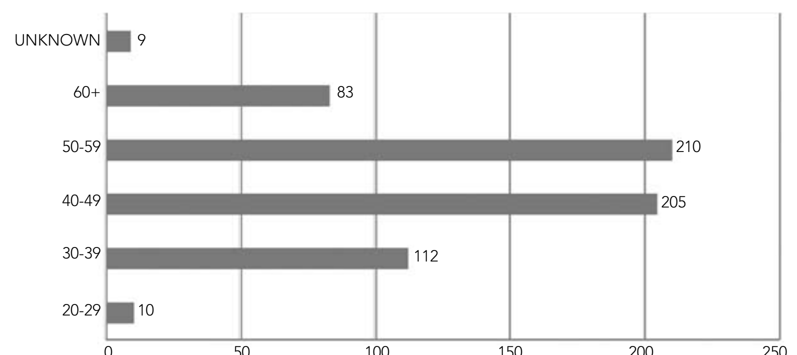
Based on the data at the time of analysis, there were 629 members of the Smaller Insurance Company Section. The chart at the top of the next column shows the breakdown of these members by their professional designations. Three quarters of our members are FSAs, with three members having the CERA designation and 12 who reported no designation. I assume that when the data is updated, the number of members with the CERA designation will increase.

Total ASA, FSA, CERA Involvement



Next we looked at the age range of our members. It appears we would track the overall Society membership in this regard.

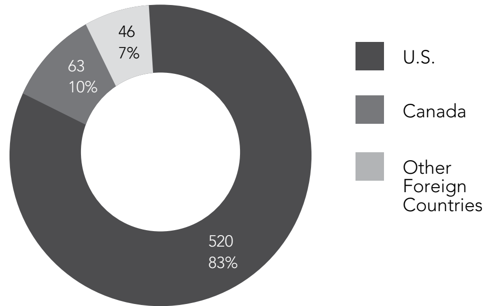
Total Involvement by Age Group



Continued on **page 12**

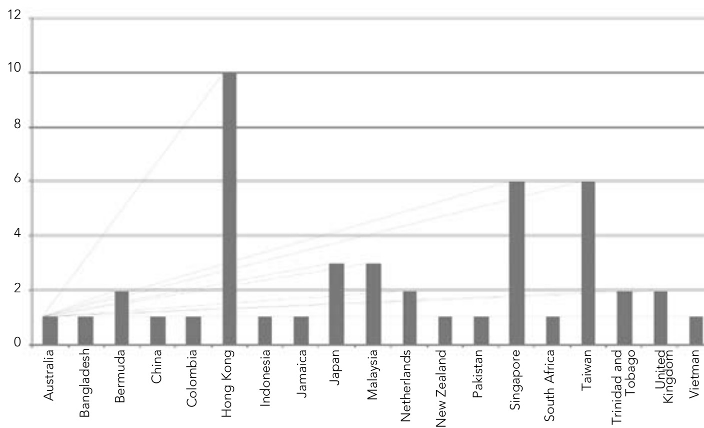
As might be expected, the number of Section members who report the United States as their place of work is more than 83 percent. However, members can be found all around the world from North America, to Europe, to Asia. The following graph shows the breakdown between the United States, Canada and other foreign countries.

U.S. vs. Canada vs. Other Foreign Countries Total Involvement



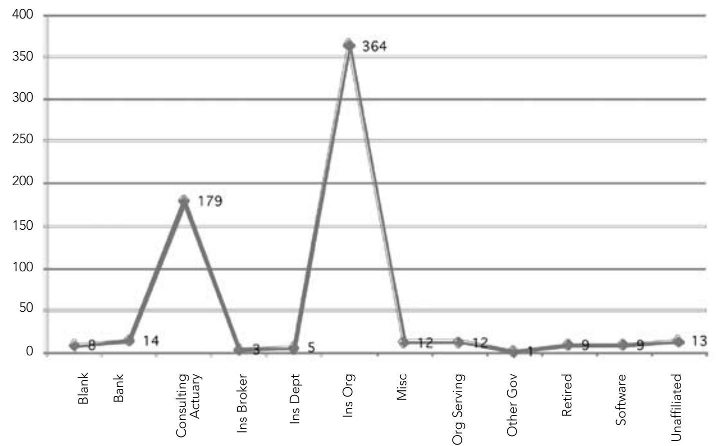
We then looked at those members who do not work in the United States or Canada to determine if there was one area where our members were concentrated. One-third of the foreign total resides in Hong Kong, Taiwan or mainland China. We do span the globe!

Employment Totals in Foreign Countries



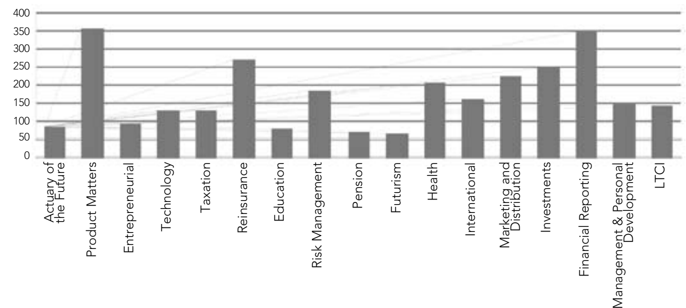
Earlier I mentioned that our members work in areas other than insurance companies. Of course, the majority work for insurance organizations, but 58 percent of the total does not seem to represent a huge majority of the members. As might be expected, the second largest category of members comes from the consulting ranks. This would seem logical as smaller companies may not have their own actuaries and thus rely on consultants. They, in turn, belong to the Section to keep abreast of those issues that are pertinent to their work. There are, however, many other areas in which our members work.

Employment Type Totals



It appears that our members are involved in a wide variety of activities as many are members of other Sections. We looked at a subset of members, those with the FSA designation, and found there are 89 members who belong to at least 10 different Sections of the SOA. Almost all members belong to at least one additional Section in additional to the Smaller Insurance Company Section. The following chart illustrates shows the other Sections to which our 469 FSA Section members belong.

Other Section Membership



This is just the beginning of learning what our members do and what kind of services or resources the Section Council needs to be looking at to enhance the value of a Smaller Insurance Company Section membership. The Council will be reviewing this data and new data as it becomes available in order to provide the appropriate types of educational, research or meeting sessions that will benefit SIC members. Any suggestions or ideas from our members are always welcomed. ●

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Reinsurance Under PBR: An Update on the Treatment of Risk Transfer

By Sheldon D. Summers

The current draft of VM-20 reflects the recommendation from the American Academy of Actuaries (the Academy) that current rules regarding risk transfer not be applied under a principle-based system of calculating reserves. The rationale is that the reserves will incorporate the cash flows expected between the reinsurance parties. Reinsurance agreements that transfer little risk will generally result in small changes to the reserves, while reinsurance agreements that transfer substantial risk will generally result in greater changes to the reserves. Furthermore, prescribed assumptions would be used for reinsurance provisions that present public policy concerns.

The National Association of Insurance Commissioners' (NAIC) Life and Health Actuarial Task Force (LHATF) PBR Reinsurance Subgroup did not agree with the elimination of the risk transfer rules and submitted a proposal to LHATF to amend VM-20 to only recognize reinsurance agreements in the principle-based reserves if they (1) comply with the existing risk transfer rules, or (2) if including them would result in a decrease in company reported surplus. Thus, in the case of a non-compliant reinsurance agreement, one of the reinsurance parties may be subject to deposit accounting and not be able to reflect the agreement in its reserve calculation, while the other reinsurance party may have to reflect the agreement in its reserves.

LHATF is also considering an amendment proposal submitted by the California Department of Insurance. This proposal attempts to find a middle ground by limiting, rather than disallowing, the reserve impact of reinsurance agreements that do not comply with current risk transfer rules.

The California Proposal

This proposed amendment was introduced to encourage more discussion of ways to reflect the following views:

- A reinsurance agreement that is not in compliance with current risk transfer rules should be recognized under a principle-based reserving system if it has a valid business purpose and its provisions are reflected in the reserves.
- A reinsurance agreement with the purpose of reducing reserves without a comparable transfer of risk should be discouraged in most cases through the limitation of reinsurance credit.*

If a reinsurance agreement does not comply with existing risk transfer requirements, the company may only reduce reserves by the lesser of the proportional reduction in the stochastic and deterministic reserves. In the second sample treaty described below, the stochastic reserve would be minimally impacted and therefore the impact on the minimum reserve would also be minimal. The commissioner may further reduce the reduction; this is primarily to be able to deal with reinsurance agreement provisions separately. Otherwise, a treaty could contain one provision aimed at reducing the stochastic reserve and another aimed at reducing the deterministic reserve. In such a case, each of these should be dealt with separately.

The commissioner may also limit the recognition of any related assets. In the first example below, the commissioner would want to take account of the $10 million cash together with the impact on reserves in limiting the recognition of the financial impact of the reinsurance.

* Examples of reinsurance agreements that reduce reserves without a comparable reduction in risk transfer:

- Company A receives $10 million from Company B in exchange for guaranteed annual repayments of $1.05

Continued on **page 14**

million per year for 10 years. Excluding recognition of the agreement, Company A's projected cash flows in one of the tail scenarios is negative $2 million in each of the first five years followed by positive cash flows of $2 million every year thereafter. The stochastic scenario reserve would recognize the negative cash flows in the first five years but not the positive cash flows afterwards. Including recognition of the transaction, the scenario reserve would increase by the present value of the additional $1.05 negative cash flow in the first five years, but would not be impacted by the final five years of payments since these would just change the magnitude of the positive cash flows in years six through 10.

- Company A reinsures the cash value benefit of its life insurance policies on December 31 for only one day. Company A's deterministic reserve as of December 31 would therefore not include the actual cash value floor.

Conclusion

The challenge in opening the door to more types of reinsurance agreements is to not open the door so far as to allow agreements whose main purpose is to reduce reserves without a comparable reduction in risk. We welcome new ideas on how to meet this challenge.

Stay tuned.

Sheldon D. Summers, FSA, MAAA, is chief actuary of the California Department of Insurance in Los Angeles. He can be reached at *summerss@insurance.ca.gov.*

Section Council Face-to-Face: A Productive Meeting Indeed!

By William M. Sayre

On Thursday, Sept. 18, 2008, the Smaller Insurance Company Section Council had an all day, face-to-face meeting in Chicago. To my knowledge, this was the first time our Section held such a meeting and, given the valuable discussion we had, I suspect it won't be the last!

This meeting was the brainchild of Chris Hause, incoming Section Chairperson. In addition to our normal meeting agenda, Chris wanted us to view our responsibilities from the perspective of a Section member and ask, "What should we be doing to provide the most value to our constituency?" We need to regularly evaluate how we provide such value.

Typically, our Section has only held a two-hour meeting in conjunction with the SOA Annual Meeting. It's been only partially attended and is merely a live version of our regular monthly calls. For our September 18 meeting, not only did we have the advantage of a longer meeting period, we had 15 Council members and friends of the Council in attendance, including all three newly elected Council members.

Our first order of agenda was to elect Chris to serve as Section chair for 2008-2009, with Joeff Williams elected to vice chair. Jeff Miller will continue to serve as secretary/treasurer until the election at our next meeting.

One of our major discussion items related to communication of important information to Section members. While our newsletter, *Small Talk*, is a useful communication medium, oftentimes current information is not disseminated in time due to delays between the receipt of articles until publishing date. For instance, we have often endeavored to provide a prior National Association of Insurance Commissioners (NAIC) meeting summary in advance of an upcoming NAIC meeting. I believe that due to the *Small Talk* publishing deadline, this preference has only been accommodated once in the past several years. Our solution is use of blast e-mails. The Health Section has used this approach in recent months to great success, especially with time sensitive material. These e-mails would supplement, rather than replace, *Small Talk*.

Also, related to timely communication, many actuarial clubs and trade groups provide seminars which satisfy the requirements for continuing education credit. With the increase in CE credits required starting in 2008, it is important for smaller insurance company actuaries to take advantage of regional—and, as such, possibly more affordable—seminars to help satisfy the organized portion of CE credit. In addition to making information about these CE opportunities available to our Section through blast e-mails and inclusion of a listing on our Web site, we will also establish a liaison position through our Section so that we stay in contact with outside groups and remain abreast of any seminars.

We are hopeful that the use of blast e-mails becomes a value-added impetus for our members and encourages more memberships in the Section. We are contemplating a period of a free membership trial to allow others to experience the benefits of Section membership.

One major responsibility of our Section is the direct educational opportunities we provide to smaller insurance company actuaries through SOA meetings. As we discussed this, we noted we have received mostly positive feedback about our meetings, with the possible exception of the Spring Health Meeting. This is likely due to the limited involvement of smaller insurance company health actuaries and we need to increase our recruitment to this segment of our constituency. Other possibilities we are considering for providing more educational opportunities include:

- A smaller insurance company event in conjunction with the Product Development Symposium.

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Section Council Face-to-Face ... | Continued from **page 15**

- A Smaller Insurance Company Symposium, possibly in an affordable, central location.

- Using webinars at an affordable price point (these would also be made available to those who can't participate via a podcast).

There was some discussion of the use of our Section information database to glean useful information about our membership (see Leon Langlitz's article, "Who We Are: Smaller Insurance Company Section," in this issue. Since we are interested in using this information for the benefit of the Section, please let us know if you think of other data summaries you feel will better help us serve you.

We spent a large portion of the meeting discussing two possible research proposals we think would benefit smaller insurance company actuaries as we move rapidly toward a principle-based approach environment.

1. A cost analysis of implementing PBA. While there has been some hypothetical discussion of the costs for a "typical" company, we have not seen any comprehensive analysis of such costs; and,

2. Evaluating the proposed stochastic exclusion test based on actual company blocks of policies. This would involve tests of actual company in force business. Our goal would be (1) to evaluate the difficulty of implementing the test itself and (2) to evaluate the test result in light of the proposed pass mark and in light of the company's expectation as to pass/fail for that block.

Both of these proposals will be discussed with the Financial Reporting Section with the ultimate goal of submission to the Committee on Life Insurance Research for consideration.

Finally, we discussed the need to encourage more involvement in our Section activities. You do not need to be a member of the Council to participate in our calls and assist with Section activities. If you are interested in being involved, please feel free to contact me.

This is my last formal responsibility as 2007-2008 chairperson. I truly enjoyed serving over the prior three years. This past year, I was impressed by the willingness of the Council members to step up and take on Section responsibilities. I am confident our Section will make great strides forward next year with Chris at the helm of this hard-working Council and implementing direction based on our brainstorming at the meeting! ●

William M. Sayre, FSA, MAAA, is a consulting actuary at Milliman, Inc. in New Jersey. He can be reached at *bill.sayre@milliman.com.*

Lapse Experience Under Lapse-Supported Policies: Updated Studies from The Canadian Institute of Actuaries

By Dominique Lebel

The Canadian Institute of Actuaries (CIA) recently updated its studies of lapse experience under universal life (UL) level cost of insurance (COI) and term-to-100 (T100) policies. These studies can help U.S. actuaries set lapse assumptions for other lapse-supported products where no or little ultimate lapse experience exists, such as return of premium (ROP) term and UL with no lapse guarantees. The financial implications of overestimating ultimate lapse rates for these products can be significant.

This article provides an overview of the results of the following two CIA studies:

1) "Lapse Experience under Term-to-100 Insurance Policies," Canadian Institute of Actuaries, October 2007

2) "Lapse Experience under Universal Life Level Cost of Insurance Policies," Canadian Institute of Actuaries, October 2007

Universal Life Level Cost of Insurance Products Sold in Canada:
Similar to U.S. universal life with no lapse guarantee products in that this product is frequently sold for the lowest premium that will keep the policy in force until the policyholder's death. Cost of insurance charges are level and guaranteed.

Term to 100 Products Sold in Canada:
Guaranteed level premium whole life products generally without cash values.

Table 1 summarizes some of the key statistics from each study.

TABLE 1
Summary Statistics

Study	Study Years	Number of Policies Exposed	Last Duration Published	Relatively Low Statistical Credibility Beyond Duration[1]
T100	1999–2004	4,057,080	25	20
UL Level COI	2002–2004	2,130,860	15	12

[1] As described in the study reports.

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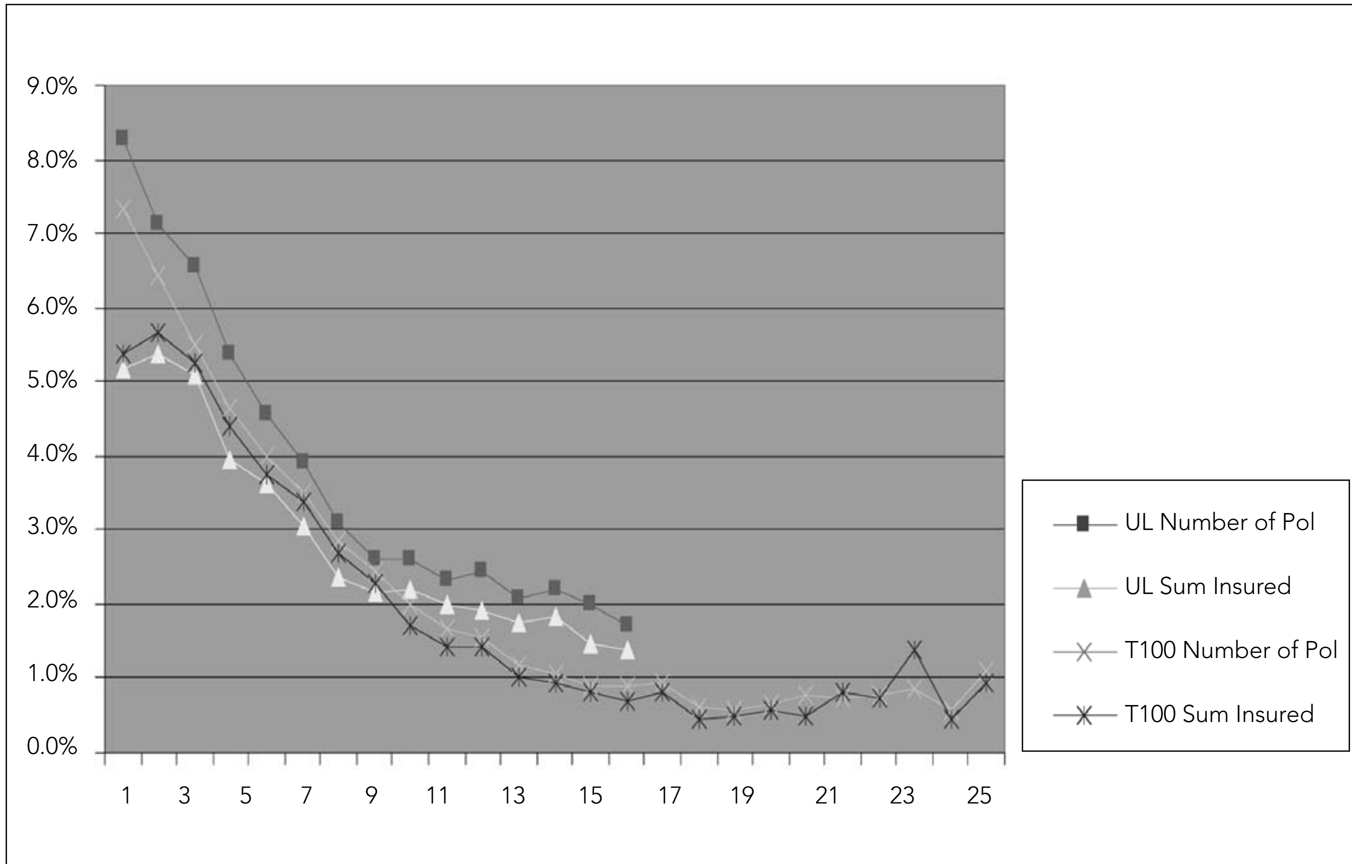
Composite lapse rates by number of policies and sum insured are presented in Chart 1 below. Ultimate lapse rates are in the 0.5–2.0 percent range, which is quite low. Both types of products exhibit similar lapse rate patterns.

Chart 1
Composite Lapse Rates



The CIA studies provide additional information such as scope, methodology, limitations, contributing companies and results broken down along multiple criteria such as calendar year, gender, smoking status, policy size, issue age and premium frequency. The reader is encouraged to read each of the studies for additional details.

(Reprinted with permission from Product Matters! *June 2008)*

Dominique Lebel, FSA, MAAA, FCIA, is a senior consultant with TowersPerrin in San Francisco, Cal. He can be reached at *dominique.lebel@towersperrin.com.*

A.M. Best U.S. Life Reinsurance—Market Review Consolidation Brings Rational Pricing but Greater Competition

By Stephen Irwin

There has been a period of major change in the reinsurance landscape including the demise of Annuity and Life Re and the elimination of a number of companies with weaker franchises or lack of commitment to the market. As recently as 2000, the life reinsurance market included Lincoln National, American United Life, ING Re, Allianz and Employers Re—all of which either have exited the life reinsurance market or sold their life reinsurance books of business.

ING Re was sold to Scottish Re in 2004. This major acquisition was unique in that Scottish Re was paid (in the form of a negative ceding commission) to take the business. Although Scottish Re continues to assume a very significant volume of business from its in-force book of business, rating downgrades have resulted in a sharp reduction in new business. The transaction was a major event in the U.S. life reinsurance market for two reasons. First, Scottish Re, a relatively new player in the market, was catapulted from a modest market position to the top tier of the industry. The economics of the transaction underscored the underpricing that occurred in the late 1990s and early 2000s. The pricing environment has since rationalized, leading to better returns, but the volume of business ceded to the life reinsurance market has contracted.

While A.M. Best believes that most of the remaining companies will continue to thrive, certain elements of their business models may need to fundamentally change in reaction to an evolving landscape. The remaining players, for the most part, have very strong franchises, are well capitalized and compete head-to-head for a reduced volume of ceded business. Given that four companies now assume three-fifths of all business ceded and hold three-fourths of all life reinsurance in force, A.M. Best believes the major wave of consolidation has run its course.

Cession Rates Continue to Decline

As recently as three years ago, the percentage of new U.S. mortality business ceded was as high as 60 percent. In sharp contrast, the 2007 estimate is only 40 percent.

In the United States, the amount of business ceded has decreased significantly due to a number of factors. The decline may be attributable to direct writers' stronger balance sheets and excess capital, reflecting solid operating results, consolidation and benign credit markets, all of which have enabled the life direct market to fund greater retention levels. There has been a marked shift from coinsurance—with as much as 90 percent of the risk going to reinsurers—to excess of retention, whereby direct writers retain most of the business. Typically this would mean that direct writers are leaving themselves open to increased reserve strain. However, A.M. Best has not seen direct writers' profitability decrease yet. Should margins compress further—given the continued low interest rate environment and credit quality erosion due to the spillover effects from the subprime residential mortgage crisis—direct companies may again rely more heavily on reinsurance for capital strain relief. However, A.M. Best does not foresee any major increase in the amount of business ceded to life reinsurers over the near term.

Cost is another major factor driving cession rates lower. Traditional life mortality reinsurance is sensitive to price increases. Life reinsurance was viewed as quite inexpensive in the early 2000s. Indeed many organizations viewed reinsurance as an arbitrage opportunity, often citing that the rates were too favorable to pass up. Inexpensive reinsurance translated into sub par returns and prices necessarily rose. In turn, demand from direct writers waned. A.M. Best believes cession rates will stabilize around the 2007 level—the lowest level seen in recent years. After experiencing very strong growth in past years, the life reinsurance market growth rate is expected to decline and should mirror closely the 4- to 5-percent estimated growth trends of direct life insurance writers.

Additional downward pressure may be placed on cession rates when Principle-Based Reserves (PBR) are implemented. Given that the framework is still being developed by the various regulatory working groups, coupled with

Continued on **page 20**

challenges associated with state-by-state approvals, full implementation is likely to be two to three years away. However, when PBR become a reality, the mandated level of redundant reserves is expected to be reduced for some products. A.M. Best believes that any such change in reserving practices could further depress the amount of business ultimately reinsured.

Limited Growth Causes Reinsurers to Branch Out into Riskier Lines

As the U.S. life reinsurance market contracts, higher-risk avenues for revenue and growth are becoming more appealing. Product lines that reinsurers had stayed away from—such as variable annuities with secondary guarantees and long-term care—are now being offered or are under consideration. These lines have been underserved for several years as most reinsurers that underwrote these risks exited the market due to poor experience. Such product lines diverge from traditional mortality dynamics. For variable annuities with living benefits, mortality risks are intertwined with long-term financial market performance. With long-term care, longevity risks are coupled with health risks. A.M. Best's view on this trend is cautious as reinsurers have less experience in a number of these product lines that carry more risk.

These competitive pressures, along with the shareholder or parent company expectations of continued favorable growth rates, also have fuelled expansion overseas. A prime example is RGA, a traditional U.S. and Canada mortality player that generates about one-fourth of its earnings outside of North America. Insurance in developing markets tends to be higher margin, although increased competition will likely reduce this somewhat. Some markets, however, have higher cession rates and are actively seeking reinsurance expertise in product development and other areas. While reinsurers may welcome these opportunities in developing markets, data is less robust and assumptions for mortality, morbidity and lapses may be more difficult to come by. Regulatory limits on ownership structure may also present challenges. Still, it appears that greater growth opportunities exist overseas, and that the reinsurance trends in international expansion should track with those of direct writers.

Reinsurance/Capital Markets Converge

Reinsurers not only provide mortality protection, but continue to offer direct writers capital management solutions. Although pure mortality cover is still the mainstay of most life reinsurers, capital management solutions are an important business line for many reinsurers. Unfortunately, capital management solutions are no longer within the sole domain of the insurance community and now include an increasing number of financial institutions who provide cost-effective alternatives to reinsurance. The convergence of the capital markets with reinsurance solutions picked up substantial momentum in recent years with the need to fund the so-called XXX redundant reserves (related to funding reserves required under Regulation XXX for level premium term products). And as life reinsurers function as an aggregator of redundant reserves on behalf of their clients, the life reinsurance industry itself has employed capital market solutions.

> "Although pure mortality cover is still the mainstay of most life reinsurers, capital management solutions are an important business line for many reinsurers."

The largest insurance companies have the scale to avail themselves of capital market solutions directly and thus often cut out the reinsurance middle-man. However, smaller companies seeking statutory reserve relief still rely primarily on life reinsurers. A.M. Best believes the market solutions available to smaller organizations will remain limited, thus providing reinsurers a continued source of XXX-type financing business.

Worries over Subprime's Effects on XXX Funding

The balance sheets of the major highly rated life reinsurers remain strong. However, reinsurers have not been immune from the impact of the subprime contagion as Scottish Re and Swiss Re recently made headlines about losses related to their exposure to subprime assets. The spillover effects from the subprime crisis has negatively impacted overall liquidity in the marketplace, including the Dutch auction market, which was used as one method of funding XXX reserves. Even if the disruption is temporary, failed auctions result in higher costs that ultimately translate into lower earnings. The contagion impact may also impact direct writers and reinsurers currently working with the capital markets for XXX reserve funding.

Regulatory Changes May Be On the Horizon

The National Association of Insurance Commissioners (NAIC) has been studying the issue of collateral requirements on a national basis for some time. At the winter 2007 National Association of Insurance Commissioners meeting,

commissioners from 22 jurisdictions approved a framework Reinsurance Regulatory Modernization Proposal. The proposal reviews issues related to cross-border transactions including a potential reduction in collateral levels for non-U.S. reinsurers. The framework focuses on three main areas: a new department within the NAIC to determine which non-U.S. jurisdictions are entitled to enter into mutual recognition agreements; a single state regulator for U.S. reinsurers to adopt uniform minimum standards; and a single state regulator for non-U.S. reinsurers to allow access to the U.S. market through port of entry jurisdiction.

Earlier this year, a reinsurance task force had recommended creating a new Reinsurance Evaluation Office (REO) which would help set collateral requirements for all reinsurers. The amount of collateral required would depend on the rating each carrier received from the REO. In October 2007, the New York Insurance Department announced plans to change long standing collateral requirements for foreign reinsurers. Under current rules in the state, any reinsurance company not authorized or accredited to operate in New York must post collateral equal to 100 percent of its share of policyholder claims. Under the proposed rules, which if adopted would take effect for new contracts in July 1, 2008, reinsurers with the highest credit rating from any two rating agencies (including A.M. Best) would have to post zero collateral. A sliding scale is employed down to reinsurers with "bbb"—any reinsurers below this rating would still have to post full collateral. A.M. Best believes that new opportunities may exist for global carriers, but this will add to competition in the United States. However, the pace of progress on this issue remains slow.

Reinsurers Need Effective ERM

In light of greater risks in product designs, softening credit market markets, continued low interest rates and recent market problems stemming from subprime mortgages, A.M. Best believes enterprise risk management (ERM) needs to be a key component of companies' culture, accountability and ability to understand, measure and manage risks on an enterprise-wide basis. This is especially important for large global players that need to understand risks being assumed not only in the United States, but in the numerous countries in which they operate. All organizations—especially insurers participating in global reinsurance—must develop and constantly refine an ERM framework, as strong ERM is integral to the success of complex global life players. Most major domestic life reinsurers have large international parent companies and A.M. Best looks for an integrated ERM process. Companies, who in A.M. Best's opinion lack a strong ERM process, are expected to come under increased rating pressure as weak controls ultimately may result in entering businesses and product lines that are not well understood or that underperform.

Conclusion

A.M. Best's outlook for the U.S. life reinsurance market segment is stable. Some recent trends in the industry, however, lead us to be vigilant about the industry's future performance. Reasons for caution include: the significant reduction in cession rates, the high concentration among a few companies, competition between these players and from the capital markets, and increasingly complex regulatory and product challenges. Balancing these factors are the industry's strong capitalization, generally tighter treaty terms, stricter underwriting and rational pricing. In addition, reinsurers are looking outside of North America where certain markets, such as Asia, offer greater growth opportunities.

Our stable view follows a period of major changes in the marketplace. Reinsurers remain focused on growing traditional life business but are expected to enter previously avoided lines and markets. As they do this, they potentially add to their risk metrics, and create further uncertainty about the long-term performance of the U.S. life reinsurance business. ●

(Reprinted with Permission from Reinsurance News*, February 2008)*

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