Small Talk

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More Regulation, More Uncertainty

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For those not able to attend the Spring 2009 National Association of Insurance Commissioners (NAIC) meeting or the Spring 2009 National Council of Insurance Legislators (NCOIL) meeting, this article summarizes current regulatory activity, both state and federal.

Optional Federal Charter (OFC) Related Items

Terri Vaughan, the new CEO of the NAIC, is headquartered in Washington, D.C. Her title is more prestigious than merely executive director or even president. She is to serve as the NAIC's (and presumably, the insurance industry's) prime spokesperson to Congress, FASB, SEC and international insurance and accounting regulators. The NAIC seems to be hoping that, if a federal takeover occurs, this organization will be federally designated as some type of central regulator.

In early March, she already testified to Congress, primarily on a new buzzword, Systemic Risk. It seems that the definition of this term is trending to, "Risk in one company that can affect a great number of companies." Vaughan's testimony relayed, among other things, that the insurance industry is less subject to systemic risk than other industries. Her background includes industry, regulatory and academic experience, and while she is an excellent speaker, it remains to be seen how effective she can be.

In a broad sense, the NAIC may be exploring further expansion of its role. We know there is widespread dissatisfaction with the main rating agencies, S&P and Moody's, so the NAIC may be considering setting up its own rating agency as competition, something broader than the Securities Valuation Office (SVO) role.

At the most recent NCOIL meeting, a panel discussed the state of the Optional Federal Charter and a possible federal takeover of the states' role. The panel generally agreed that, with the current makeup of Congress, state regulation, as we know it, is not doomed, but faces an uphill fight.

Congressman Barney Frank has recently proposed establishment of a new federal systemic regulator. This term ties in with the abovementioned systemic risk. It remains to be seen whether this new position would extend to insurers, as well as to banks. The even broader question is what the regulator's responsibilities and powers would be with regard to dealing with this ill-defined term.

In addition, the entire insurance industry is suffering from the financial condition and recent activities of AIG. As widely publicized, AIG received massive federal bailout money, due to greatly depressed market values of its CDS portfolio (Credit Default Swaps are guarantees on the financial performance of other corporate bonds). A non-insurance internationally based unit of AIG had sold these swaps on a massive basis, even though the argument could be made that at least some of these CDSs are really insurance. Although evidence is lacking of any massive defaults from these CDSs, their market and carrying values are apparently still depressed. An even greater backlash has occurred from AIG's bonus payments. These were partly made to key executives, but even greater amounts, for whatever reasons, have been made to other financial institutions. Despite the non-insurance nature of these CDSs, all too many articles have appeared which attack the financial soundness of the entire U.S. insurance industry.

ACLI's Proposed 2008 Surplus Relief Portions on Current Business

Late in 2008, when the NAIC refused to adopt these proposals on a national basis, it promised that they would be considered on a more thorough, well-researched basis during 2009.

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These tasks were allocated to committees last December, as follows:

- Reserves for term and universal life with secondary guarantees (UL2G)—to Life and Actuarial Task Force (LHATF).
- Variable annuity risk based capital—to Life Risk Based Capital (RBC) Working Group.
- Mortgage Experience Adjustment Factor (MEAF)—same.
- Deferred federal income tax asset (DTA)—to Statutory Accounting Principles Working Group.

LHATF agreed to forward again copies of its December reserve reports to the Capital & Surplus Relief Working Group. Some members complained about doing additional work, when a thorough study had already been made. LHATF's report had been favorable on term life, primarily to liberalize use of XXX factors without a 20 percent minimum ratio. However, it had been unfavorable on UL2G and a proposed extended use of lapse rates.

The other three topics will be studied in detail by the above assigned groups. The Life RBC Working Group will study a survey of reports submitted under current C3 Phase 2 requirements, with an emphasis on thoroughness of company documentation. Any liberalization of MEAF will depend on a study of industry experience that reflects the current economic turmoil. DTAs will be studied during 2009, with an emphasis on recoverability of assets at current levels.

Scope Proposals for Principle-Based Reserves (PBR)

Two approaches that effectively limit the PBR scope have been proposed, one by the American Council of Life Insurers (ACLI), and one by the Texas Department, working through the American Academic of Actuaries (the Academy). The ACLI discussed its net premium reserve proposal. When introduced last December, it seemed quite positive. This approach was designed primarily from concerns about federal income tax and whether gross premium reserves (GPRs) under PBR would endanger the status of tax reserves computed under the current Code.

In summary, net premium reserves would work as follows:

> These reserves would be computed for all products subject to PBR, based on prescribed assumptions of mortality, lapse and CRVM-type expense allowances. All products would be subject to two tests, the Stochastic Exclusion Test (SET) to measure volatility and a new net premium versus gross premium test to measure adequacy. Products that pass both tests, presumably traditional products, would use net premium reserves with a seriatim cash value floor. Products that passed SET, but not net versus gross, would use deterministic GPRs. Net premium reserves would serve as a floor, presumably an aggregate one. Products that did not pass SET, regardless of net versus gross, would use stochastic processing for reserves (GPR plus any excess of stochastic over GPR). For these products as well, net premium reserves would serve as a floor.

One problem is that, in March, the ACLI did not provide any further details about net premium reserve workings. Items not specified included the size of expense allowance, mortality table prescribed margins, interest rate formula and prescribed lapses. With this type of delay, one risk is that the proposal could be subverted so that the net premium reserve becomes just another reserve floor across all products. Possibly, one reason for the lack of guidance on details of the net premium reserve workings could be due to trying to fit net premium term reserves to be close to deterministic GPRs. Since, for this product, net premium reserves would serve as a floor, there would be an advantage from a close fit.

The second proposal stemmed from the Academy's Valuation Manual team, chaired by Mike Boerner of the Texas Department. He has formed a subgroup (of which the author is a member) to propose ways to limit the scope and effective dates of PBR. One of our several approaches, which seems to have some support, is to limit PBR to competitive term and UL2G. An earlier complete exemption for preneed life was removed, possibly due to lack of uniform preneed definitions across all states.

On the positive side, no conceptual LHATF objections were raised in March, when these proposals were made by our subgroup. One member did question why this proposal was made, in light of the ACLI's net premium reserve proposal. Also, in a later meeting of the Commissioners Working Group on PBR, the LHATF chairman did say that he thought any exemptions or limited scope for any products would be only temporary. No action on scope was taken at this meeting.

Other PBR-Related Developments

One problem could affect small companies and others as well. Now, LHATF ignored an earlier promise that it would not press for adoption of a new Standard Valuation Law (SVL) until the Valuation Manual (VM) was done or nearly done. Instead, LHATF hopes to adopt a new stripped down SVL by conference call in about 30 days, before the June meeting.

Risks from an incomplete VM after an NAIC-adopted SVL include:

1. Subverting the net premium reserve proposal so that, for traditional plans, it would only be a reserve floor, not THE reserve.
2. Avoiding additional testing on the 4 percent threshold for the SET—Preliminary tests indicate that some non-par permanent plans need a higher threshold or comfort with varying other assumptions besides interest.
3. For non-variable annuities and long-term care, where no VM work has been completed as yet, requiring complete stochastic processing for reserves.
4. Unfavorable resolution of items that now seem trending towards favorable.

New York did not push for a completely prescribed interest rate assumption. Their argument had been that no company should be allowed to hold lower PBR reserves due to allocating riskier assets to those reserves. Instead, LHATF listened to an American Academy proposal for prescribed asset default rates. These would tie in with using an asset portfolio rate reserve assumption (from investment grade assets) less these default rates. The proposal includes a very complex formula for computing defaults, with the goal of keeping default assumptions fairly high. The downside is that required use of such complex default rates would result in interest assumptions close to current prescribed statutory interest anyway. The Academy's report and proposal will be studied further.

"There was agreement that the ceding company should definitely compute net of reinsurance PBR reserves."

It looks like the 2008 Basic Table will not be adjusted by margins into a valuation table. This means that companies will not have to incur the expense of new statutory factors quite yet. The Society of Actuaries (SOA) said that a new mortality table would be likely by 2012. If the ACLI's net premium reserve concept holds up and SVL became effective on an optimistic timetable, the year 2012 would be a likely time new net premium statutory factors would be needed anyway.

For experience reporting, I repeated again to LHATF an exemption proposal made by some small companies. I do not believe there will be a blanket exemption for companies under $75 million premiums. However, based on the fallback included in the proposal, most smaller companies would have to report only summarized mortality experience. Documentation of these results would be required anyway for the SET 4 percent calculations. This issue, too, is still unresolved.

Two issues in reinsurance are still unresolved. First, current VM20 wording for life reinsurance requires complete risk transfer for a treaty to be accredited. However, on some UL2G products, after cash values go to zero and minimum premiums kick in, reinsurance coverage only starts under those conditions. Arguments have been made that such coverage should be considered valid reinsurance. Second, there has been considerable discussion over whether reinsurance calculations should be made on a net basis, for the credit portion only or for the gross portion. Admittedly, the ceding company may not possess sufficient information to calculate meaningful reserve numbers for the gross portion. The assuming company's asset portion might result in different interest assumptions. It might pool mortality experience so as to use different assumptions from the ceding company's assumptions.

There was agreement that the ceding company should definitely compute net of reinsurance PBR reserves. Also, it should compute reserves for the reserve credit it takes. However, New York recently proposed that two credits should be computed, one with the ceding company's assumptions, and one that, somehow would use the assuming company's assumptions. The greater of the two would be the reserve credit. New York's argument for this test was that, for unauthorized reinsurance arrangements, the greater of the two was needed to compare against collateral. This issue is still unresolved.

Another unresolved issue is margins themselves. Should margins be employed assumption by assumption or in the aggregate? In any event, should some overall margin be tested to ensure reasonable results?

One addition to the new SVL was made. A separate Corporate Governance Working Group added a paragraph that basically would require companies using PBR to have Board of Director controls in place over reserve calculations and processes.

PBR Summary—LHATF and Commissioners PBR Working Group

As indicated above, LHATF did not discuss with the more senior working group its earlier promise made about presenting SVL and VM as a package. The working group chairman seemed to be pushing as hard as anyone was for rapid adoption of the stripped down SVL. He talked about making more presentations to NCOIL about a new SVL.

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There will probably be a 30-day exposure period for the new governance addition to SVL. Any phone adoption of the new SVL before the June NAIC meeting would be very difficult.

Life Risk Based Capital (RBC)

No change took place in the approach discussed in December. For traditional products, testing for a maximum 4 percent SET would allow continuation of current RBC factors. These SETs must be tested on all in force. There is also the possible use of the alternative amount, although that is not precisely defined. Through some use of traditional calculations (again, not precisely defined), companies may be able to show that current statutory reserves plus capital are covered with a 90 percent confidence rate.

If neither of these steps is feasible, then full stochastic processing of special RBC reserves for all issues is required. This would be an onerous burden for small and many larger companies. The current RBC proposal will have one more 60-day exposure period before the working group moves to have its parent adopt new procedures for year-end 2009.

GAAP and International Accounting (IFRS)

Predictions have been made that current U.S. GAAP will be replaced in the foreseeable future by international accounting. This would extend to reserves as well as invested assets.

Earlier proposals for reserves had talked about a form of exit value calculations. This seemed to connote a type of fire sale approach that has plagued many bank assets recently. Now, there may be a change towards a value closer to current U.S. standards. Reserve net premiums would not generate anomalies such as gains or losses at issue, and apparently would cover acquisition expenses.

One unresolved issue was an earlier proposal that the size of reserve liabilities would vary with the credit standing of the insurer. In other words, a company with a lower rating would hold LOWER reserves than would a more highly rated company.

Summary

In a Nov. 11, 2008 letter, the ACLI stated that it would oppose adoption of a new SVL unless it was substantially satisfied with the status of VM. Currently, there are several important unresolved issues about VM content.

Congressional hearings over the next few months could determine the future of state regulation and status of the NAIC. The status of international accounting is probably not on such a fast track. It has its own set of unresolved issues and possibly onerous calculation requirements.

Overall, there is a great deal of uncertainty facing the life industry, which calls for close and ongoing attention.

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