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Small Talk

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Updated Regulatory Gamut—From OFC to PBR and In Between

By Norman E. Hill

Things have remained on somewhat of an even keel since the June 2009 National Association of Insurance Commissioners' (NAIC) Meeting. However, there are always some developments worth reporting.

Optional Federal Charter (OFC)/Federal Oversight

The latest insurance-related bill from Treasury Secretary Timothy Geithner did not contain any provision for OFC or a mandatory version. However, it did propose federal regulation for various investment-related products, including annuities. The bill was not specific on how broad reaching this regulation would be. However, inclusion of annuities could be very significant for the insurance industry, including some smaller companies.

In addition, the bill proposed some type of federal regulation of large insurers that posed systemic risk to the economy. As reported before, systemic risk is not a well-defined term. Large insurer is an equally ill-defined term but surely includes AIG. The bill called for the Federal Reserve to be the oversight agency.

International GAAP Accounting and Fair Value

Finally, the International Accounting Standards Board (IASB) has published an international GAAP accounting guide for small and medium enterprises (SMEs). IASB designed the guide for smaller, private companies. Supposedly, it would be easier to implement than full-blown International Fair Value (IFRS) would be.

It does not address insurance issues, particularly the long-standing contentious issue of fair value methodology for policy reserves. However, a recent discussion paper revived the controversy over why realized capital gains could be booked upon a company's credit rating downgrade. Unfortunately, the paper implies that another objectionable provision would eventually remain, namely, that policy reserves should reduce in similar fashion when credit ratings deteriorate.

As before, there is still confusion about the full implications of international accounting replacing U.S. GAAP. There is no reason why U.S. Statutory accounting for insurers must be replaced if GAAP is changed or replaced. Unfortunately, several presentations made to the NAIC have implied that such replacement is the case.

Part of President Obama's regulatory reform proposal calls for clarification of fair value accounting and making substantial progress towards the development of a single set of global accounting standards. The deadline is the end of 2009. Therefore, small insurers who report on GAAP or are concerned about the viability of U.S. Statutory accounting need to follow events here.

Risk-Based Capital (RBC)

As reported previously, the NAIC deferred the implementation date for C3 Phase 3 for life insurance until 2010. Shortly before the June 2009 NAIC meeting, the industry raised numerous theoretical objections to various methodology components of the American Academy of Actuaries' (the Academy) RBC proposal.

At the time of this article, no further work has been done on testing an appropriate threshold for the Stochastic Exclusion Test (SET) for nonparticipating traditional life products. The question remains whether results below the proposed 4 percent threshold would allow retention of current C3 factors.

National Conference of Insurance Legislators (NCOIL)

As reported previously, at least one legislator was very critical

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of the currently proposed Principle-Based Reserves (PBR) during the July 2009 NCOIL meeting. He stated that small companies are all strongly opposed to PBR.

Actually, this assertion seems to be an overstatement. Many small insurers are not necessarily opposed to PBR, especially if the scope is defined appropriately. It is true that small and large insurers have questioned the value of PBR, especially after three years of uncertainty over its final resolution and structure.

I believe some legislators may have become disenchanted with PBR, for various reasons. Several of these reasons probably relate to the way in which PBR was presented to them previously, including:

1. **The assertion that the current valuation system is broken**. In my opinion, this is simply not true; the system can be described as flawed for certain products.

2. **PBR is the wave of the future, completely supported by the insurance industry and everyone should climb aboard.** In my opinion, this is simply not true. This is based on my numerous conversations and correspondence over the last three years with company actuaries, ACLI actuaries, regulatory actuaries, company executives, insurance commissioners, state legislators and some consultants as well. I have seen this skepticism and lack of support grow over the last three years. One memorandum that summarizes the situation was prepared in June 2008 by Robert Meilander, FSA, MAAA, and sent to the LHATF chairman.

3. **Under PBR, all reserves will be significantly reduced.** Again, this is not true, although it probably is accurate for certain products, such as competitive term and Universal Life with Long Term Secondary Guarantees (UL2G). Moreover, since PBR would only apply to new issues, this reserve reduction would be very small for at least a decade.

4. **The surplus relief proposal from November 2008 may have originally been described as an expansion of PBR to all issues in force.** Actually, proposed reserve reductions were confined to those for term and UL2G and not literally on a PBR basis. However, other surplus relief was a significant part of the package (deferred tax assets and risk-based capital for certain other invested assets). This proposal came about simultaneously with the solvency and image problems of banks and AIG. Therefore, any proposed surplus relief seemed to trouble some legislators greatly. They were concerned that last-minute reserve releases would make state regulation appear weak and inept, and give fuel to advocates of OFC. Most likely, they knew that several large companies supporting these changes were also strong advocates of OFC.

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Surplus Relief

As previously reported, the NAIC rejected the proposed surplus relief measures to be effective Dec. 31, 2008, However, the same package was reviewed again by NAIC groups for possible 2009 implementation. The portion dealing with reserves, that is, the term portion, was approved again by the LHATF in June. However, one contentious portion of this was a separate provision that, on heavily coinsured term insurance, direct versus ceded modal premium differences would cause negative reserves. This favorable reserve effect had to be removed. Otherwise, the 2001 CSO Preferred mortality tables could not be used for reserves going back to the original approval date for the 2001 CSO.

At the Life Insurance and Annuities Committee (“A” Committee), one of the parents of LHATF, other reserve changes from the latter group were confirmed by the parent. However, at the behest of one state and its actuary, the issue of restricting the above reserve effect of modal differences was reopened, for a subsequent conference call.

Principle-Based Reserves (PBR)

At the time this article was written, no new developments have occurred.

The proposed Net Premium Reserve (NPR) seemed to be on a fast track in December 2008. Since then, adoption appears to have been slowed by certain technical problems. NPR was supposed to be a floor for gross premium reserves on term policies. However, obtaining the desired balance between a floor and gross premium reserves otherwise held may be very treacherous.

A related proposal on PBR scope was presented to the LHATF before the June 2009 NAIC meeting. Several alternatives for excluding certain plans were provided, including deferring certain plans or deferring some plans at a company’s option. So far, LHATF has not reacted to this proposal.

The new Standard Valuation Law (SVL) proposal, including a Corporate Governance provision, was completed at the LHATF level. On July 28, 2009, a joint call was held by the A Committee, the PBR EX Working Group, and the Solvency Modernization Initiative (EX) Task Force (SMI). These groups approved the revised SVL. At the start of the meeting, Commissioner Thomas Hampton also reaffirmed the commitment to prepare a package of SVL and VM as the combined documents that would be sent to legislatures from the NAIC.

However, when the A Committee call tied in this topic with the Preferred Table/reinsurance modal premium controversy, the ACLI said they did have a few last-minute, fairly minor technical changes they would like to suggest for SVL. Therefore, there will be a Sept. 9, 2009 call held by the A Committee to go over this wording and, presumably, approve SVL. If the law gets changed this way, I believe that the other groups will revise their approval to reflect the changes.

Many small insurers and other parties hope they will retain the stated intent that only a package of SVL and substantially completed Valuation Manual (VM) will be submitted to state legislators.

Besides NPR, numerous contentious issues remain in life VM-20 exposure drafts. One is the discount rate. Although tentatively, the Academy's proposal for the investment grade portfolio earned rate was adopted; at least one state still wants a rate corresponding to a risk-free rate plus 50 basis points or so.

The Academy has also proposed a special approach to computing default rates, resulting in higher rates than normal actuarial methodology. This approach has not yet been exhaustively tested, but it appears very difficult to explain to Boards of Directors and to regulators for review purposes. One key question remains: If higher default rates are computed for this approach and are offset against portfolio gross rates, will the net result wind up comparable to risk-free rates reduced by normal default rates?

Other unresolved issues described before include:

1. The margin question for assumptions remains: Must separate margins be added to each assumption or should overall margins be relied on, so that effects on reserves remain reasonable?

2. Also with regard to margins, what methodology should be used for margins on lapse and expense rates? When company experience is partially credible, what techniques should be employed to blend company and industry experience?

3. On nonguaranteed elements, dividends and excess interest credits, some companies may pay additional amounts that were not included in original pricing or projections. Several companies want these amounts excluded from PBR reserve calculations.

4. For stochastic calculations, one technical point involves use of "working reserves." Currently, these amounts are not includible in projections. A related point is the required number of years for projections—until, literally, no events in the projection remain, no material amounts remain, or another alternative is available.

5. The Academy has presented to the LHATF the results from its interest rate generator program. Long-term Treasury rates have been studied. Most regulators want this program to operate on a prescribed interest assumption basis. In a conference call, they requested the Academy to test further to see if its program is biased towards high interest rates, as opposed to low or volatile rates.

6. Just as with RBC, the suitability of the Stochastic Exclusion Test 4 percent threshold for traditional nonparticipating products remains unresolved. There are significant differences between PBR and RBC as to how the test would be applied:

    a. Under PBR, only new issues after the PBR effective date would be tested. All issue years would require RBC testing.

    b. Under PBR, broad product groups such as term, UL with secondary guarantees and traditional nonparticipating products would be tested separately. For RBC, on the other hand, it appears that all products and issue years could be tested together.

7. So far, no definitive PBR proposals have been presented for nonvariable annuities and health insurance, including long-term care.

Summary

As always, there are a host of regulatory proposals and developments—at state and federal levels—that call for small insurer vigilance. Most of these will not be resolved soon, and will carry over to future years. ●

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