Regulatory Update, First Six Months, 2014

By Norman E. Hill

This material is prepared as of June 22, 2014. Since events in the insurance industry remain volatile and dynamic, readers are strongly encouraged to read email blasts from the Society of Actuaries, its Smaller Insurance Company Section Council and other industry publications up to the date of *Small Talk* publication.

Opinions expressed in this article are solely those of the author, and not necessarily those of *Small Talk* or the Society of Actuaries.

Unclaimed Property

This topic is now sufficiently important to be covered in a separate working group under the A Committee. The issue is insurer use of the Death Master File (DMF) of the Social Security Administration. Since some companies used the file to check whether annuity recipients were still alive, state treasurers, attorneys general and other officials started to audit insurers for compliance of their life in-force with up-to-date benefit payments. For deceased policies with no available beneficiary, state escheat laws have been invoked for governments to take over proceeds.

Several of the largest life insurers have already been audited and have turned over substantial amounts to states. The American Council of Life Insurers (ACLI) has drafted a model bill that corresponds to terms of several of these settlements:

1. Ongoing matching of DMF against all in-force.

2. "Fuzzy" matching—that is, if almost all of policy numbers or names match, further investigation is required; inability to make final resolution is decided in favor of a match.

At the last National Association of Insurance Commissioners (NAIC) meeting, representatives from two trade associations objected to this approach. They want DMF matching only of new issues since the beginning date. Also, they want only exact matches to require payment. Finally, they demand better coordination of regulator efforts between insurance departments, state treasurers and attorneys general.

Captives and Principle-Based Reserves (PBR)

Today, 30 states allow captive insurers to be formed. Most new enabling legislation has been to allow reinsurance to captives on preferred term and universal life with secondary guarantees (ULSG). Key issues for captives are now under auspices of the PBR Implementation Task Force (ITF), with charges to be made to the Life Actuarial Task Force (LATF). Rector, a consulting firm, issued a report on captives in February 2014, and a Modified Recommendation report as of June 4, 2014.

With PBR legislation still pending, several writers of preferred term and ULSG have employed captives to obtain relief from perceived redundant statutory reserve requirements. Further, ACLI representatives have testified that these companies obtain 15 percent more reserve relief than available under the current version of PBR in VM20 of the new law/regulation package. In my opinion, their implication is that these writers will continue to use captives in some way, even after PBR final adoption.

Rector's first report concluded that the need for captives for these two products would disappear once PBR was adopted. But the above testimony during the March 2014 NAIC meeting strongly indicated otherwise. Rector emphasized that its main objective is achieving reserve uniformity among companies.

Rector's modified report implies that the reason for 15 percent extra reserve relief to writers is use of PBR VM20 methodology without the net premium reserve (NPR) floor. Previous indications from the NAIC's PBR Impact Study were that reserve floors served to increase PBR reserves noticeably. Of course, other modifications are also possible to obtain the 15 percent.

Rector seems to state that if NPR floor removal is allowed for these plans, some modification to PBR legislation will be required. However, as described below, this can be disputed.

A related proposal for captives to help achieve desired reserve relief is to allow use of letters of credit (LOCs) as admitted captive assets. Instead of just a bank promise to provide reserve security, part of the LOC would actually be included in the asset base, turned over to the captive by the ceding parent. My interpretation of the amount of LOC asset and workings of Rector's Actuarial Method is:

1. Reserves actually held by the captive = formulaic or current PBR, once the latter is adopted, with no change to methodology; less

2. Reserves calculated under a modification of PBR and VM20, which Rector's report calls the "Actuarial Method." Possibly, these reserves would be modified by removal of the NPR floor requirement, updated by the newest CSO2014 or other mortality, or other devices. With removal of this floor, the ACLI recommends straight use of deterministic reserves (GPV) for preferred term and stochastic reserves (SR), (or the greater of SR or GPV) for ULSG. Again, for this purpose, the Deterministic Exclusion Test (DET) would be eliminated, even while GPV and SR would correspond to full VM20 methodology.

3. Tests of the reserve method in #2's Actuarial Method would be required to see if the resulting asset allocation, LOC versus conventional, provides desired reserve relief. In #1, reserve comparisons under both formulaic and current PBR might be required.

In other words, the Actuarial Method is an internal method, aimed only at these two products. Assets allocated to these products other than the LOC would be conventional NAIC admitted assets. No change to reserve methodology in #1 would be called for. The Actuarial Method would use VM20 methodology, but not replace it. The method would not affect reserves actually held, NPR actually held, or effect on federal income taxes.

In the meantime, LATF will be committed to at least several calls to discuss captives and the June 4, 2014 Rector report. They would try to reach consensus on developing this Actuarial Method.

Some have complained about the amount of time and effort devoted to these two products outside of PBR. The original intent of PBR was primarily to provide reserve relief through VM20, not through alternative devices.

Small Company Exemption (SCE) and Oklahoma

In December, the ACLI promised that it would soon provide a proposed amendment that would exempt small companies from PBR reserve calculations (although not mandatory data collection). At the March meeting, it fulfilled this promise. The premium threshold for exemption would be $300 million, and $600 million for a group. RBC ratios would have to be at least 450 percent, and a clean actuarial opinion would be required.

Although the amendment was adopted for a 45-day exposure period, no action at all by LATF has been taken since March. The American Academy of Actuaries stated that it could only support exemptions based on product risk, not company size. At least three LATF members have voiced opposition to the amendment. Although there are emphatic differences of opinion, an increasing number of observers believe that its final adoption by LATF is in doubt. If it is rejected and then revived at a higher level NAIC committee, further action could extend well into 2015.

It should be noted that Oklahoma adopted a version of PBR that includes SCE. The version is even more liberal in one respect, providing for a group premium threshold of $1 billion. Time will tell whether this provision will encourage some small insurers to re-domesticate to Oklahoma. In recent years, two large companies re-domesticated from California to other states. One even kept its administration in the original state. This seems to demonstrate that re-domestication is a viable tool.

PBR Adoption Status

So far, 18 states have adopted the new Standard Valuation Law (SVL)/PBR package, including two where legislation is on governors' desks. These 18 comprise a little over 26 percent of nationwide 2008 premiums. The required total remains 75 percent of these premiums. ACLI lobbyists seem to be moving aggressively in promoting adoption. Since the SCE amendment mentioned above may be stalled, some have questioned these aggressive efforts.

In both December and March, one prominent commissioner at the NAIC expressed support for small company concerns over PBR effort and expense. However, no effort has been made since to pressure LATF to move on the key SCE amendment.

Other ACLI Amendments

ACLI also proposed two other amendments. For those using the Stochastic Exclusion Test (SET), the passing threshold had been 4.5 percent. However, little test work

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had been completed for certain products. The proposed 6 percent threshold should provide some cushion.

Second, VM20 requires detailed procedures for computing reserve mortality, involving margins and credibility. For asset adequacy tests, computed reserves are for testing only. Many have felt that VM20 mortality procedures for these test reserves are too onerous. This amendment proposal clarifies that, for asset adequacy purposes, the degree of VM20 precision is not required.

VM22 and PBR for Non-Variable Annuities

A Kansas field test is being made for one type of annuities, those with guaranteed minimum benefits. The eventual PBR objective would be for reserve options with election probabilities, rather than current 100 percent election rates under CARVM. Spokesmen for the Annuity group have stated several times that they intend to take small company concerns about PBR simplicity into account.

Actuarial Opinion Model Regulation

Key changes will be made to the process for communicating actuarial findings. As a minimum, a summary actuarial report must be presented to the board of directors and discussed with them. If an outside consultant prepares the report, he won't necessarily have to appear before the board in January and February peak workload months. The entire Actuarial Memorandum, containing formulas and tables, won't have to be read by the board.

New Statutory Mortality Table, 2014 VBT

This new table is almost complete, but some work remains on the question of mortality rates at very high ages. These have a key impact on reserve levels, due to their relations with still-improving younger age mortality. Related reserve problems with 2008 VBT reserve levels should not be repeated.

The VBT plus margins will result in the 2014 CSO. Hopefully, these will be completed in the summer of 2015.

Work on separate mortality tables for pre-need and guaranteed and simplified issue is in process, but stalled by the margin project for the 2014 CSO.

Experience Reporting and Data Collection—Expenses

New York has long desired to receive industry splits of expenses not included in pricing or current reserve calculations, due to lack of critical company mass or other reasons. Therefore, they have gone ahead with emphasis on expense compilation and reporting, including required splits not found in Annual Statements. The ACLI has objected to this type of data reporting, partly on grounds that data on policyholder behavior should be a higher priority.

Statutory Accounting

So far, there have been no 2014 proposals that would endanger current statutory accounting.

Other Amendments and Updates Adopted or Discussed by LATF

It was agreed that the Valuation Manual's governance section could be amended at LATF conference calls, not just the three NAIC on-site meetings.

Updated asset spreads for VM20 to reflect year-end 2013 data were adopted.

A due premium proposal from the American Academy of Actuaries had been discussed for some time. The amendment that required inclusion in cash flows was finally adopted.

A proposed guideline for indexed universal life (IUL) was discussed. The ACLI will work further with some regulators who had comments and concerns.

Summary

Even with the new SVL/PBR package adopted by the NAIC in December 2012, there seems no end to complexities that must be faced by small insurers. The author recommends that small insurers continue to stay alert and stay informed. ●

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