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Regulatory Update for 2014

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This material is prepared as of Dec. 19, 2014. Since events in the insurance industry remain volatile and dynamic, readers are strongly encouraged to read email blasts from the Society of Actuaries (SOA), 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 SOA.

Principle-Based Reserving Implementation Task Force (PBRITF) This time, there was more intense discussion than at the preceding Life Actuarial Task Force (LATF).

-Small Company Exemption (SCE)

On an Oct. 28 call, LATF members approved the SCE amendment to the Valuation Manual, so it could be sent up to PBRITF. They left to PBRITF the decision whether to review the amendment in five years.

However, to my surprise, they also left to the parent the decision on whether to lower the premium threshold for exemption. Currently, it is $300 million ordinary life direct plus assumed premiums for a company and $600 million premiums for a group. One possibility suggested would be to lower the threshold to $200 million and $400 million for company and group, respectively.

With this proposed level of exemption, $300 million/$600 million, about 362 life companies out of 630 would be exempted from principle-based reserve (PBR) requirements. A table was provided, showing what companies fell into which one of defined premium buckets, starting with $10 million, going up to $300 million. Premium volume exempted would be from 4 to 5 percent of industry premium totals. Only companies with premiums greater than zero and with risk-based capital (RBC) levels at least 450 percent were included in the table.

As before, this would not affect exemption from mandatory experience reporting. There is still a $50 million premium threshold for this exemption, as well as the intention expressed in VM51 to include only 80 percent of industry premium volume for data calls on a given experience line.

Steve Ostlund of Alabama pointed out that some of these companies have $0 premiums; some are preneed, already exempt; some are partially preneed, etc. He proposed that, in a closed session, PBRITF review all 362 companies. Maybe in this way, regulators on PBRITF could be comfortable with the volume of exemption.

Based on 2013 Annual Statement data (from the National Association of Insurance Commissioners (NAIC)), several comparisons can be made between various premium thresholds. With a $600 million group premium threshold, 57.5 percent of total companies would be exempt. If the threshold was reduced to $400 million, the percentage would reduce only slightly, down to 55.4 percent. But based on total company premium volumes, the exempt amount at $600 million is 4.6 percent of total industry volume of $195+ billion. At a $400 million threshold, the percentage would reduce to 4.35 percent.

John Bruins of the American Council of Life Insurers (ACLI) reminded the task force that Oklahoma has already passed the Valuation Law with SCE included. In fact, Oklahoma's group premium threshold is even higher, at $1 billion premiums. Also, another state is close to passing the new law on the same basis. Several other states are considering such a move.

It was left that PBRITF would have a closed call as soon as possible. On Dec. 10, they announced a request for comments on a proposed reduction to the exemption thresholds down to $50 million premiums per company and $300 million for a group. Comments are due by Jan. 15, 2015. Several actuaries in industry have made inquiries of regulators who were on the call, but have not discerned any reason for this change. In my opinion, such an extreme reduction is sure to draw many comments.

-Captives and Actuarial Guideline 48 (AG48)

Although this topic does not directly affect most small companies, it is taking up the bulk of PBRITF members' time, and therefore taking their time away from SCE.

The guideline involves division of reinsured assets in a captive, covering preferred term and universal life with secondary guarantees (ULSG). Assets allocated to these products would be divided between "Primary Securities" and "Other Securities." Primary Securities would be regular admissible NAIC securities except for contingent notes and similar assets. However, if the reinsurance between the ceding parent and captive is funds withheld or MODCO, certain other assets can also be held (good-standing commercial loans, policy loans, and derivatives in the normal course of business).

Other Securities would often be evergreen letters of credit actually held as an asset, or other assets approved by the domestic department.

Total PBR reserves would be held. The amount of reserves that would determine the amount of Primary Securities would be calculated by a quasi-PBR threshold reserve (calculated according to the "Actuarial Method") that, at least initially, would be less than regular PBR reserves. This reserve would not be held in financial statements or shown in federal income tax returns. It would be based on updated deterministic or stochastic reserves, as described below, with a special floor, as described below.

The net premium reserve (NPR) floor then would be based on a percentage of regular NPR, ranging from about 60 to 80 percent, depending on sex and smoking status. Eventually, the ACLI will re-compute NPRs for these products, to achieve the same percentage results. These recomputed NPRs will be proposed as an amendment to VM20 of the Valuation Manual, to replace current NPRs for preferred term and ULSG products.

The mortality table for deterministic or stochastic reserves would be based on 2014 CSO (equal to 2014 VBT with margins, which would be updated into the Valuation Manual anyway).

Several people on PBRITF and their consultant have stated that this approach would provide additional benefit to writers of preferred term and ULSG. With amended NPRs, these quasi-PBR reserves would soon become regular PBR reserves for these products. Captives could be integrated into their parent companies. Therefore, the need for captives should soon disappear. Others, during the meeting, stated that this view is much too optimistic.

After this contentious discussion, PBRITF voted to expose the Nov. 7 version of AG48 for further industry comments. As before, New York voted no. In the Dec. 17 NAIC NewsWire, the announcement was made that the NAIC itself (meaning both PBRITF and Executive Committee) had voted to approve AG48, effective for 2015. This approval includes standards for reinsurance itself between parents and captives, dealing with preferred term and ULSG products.

-PBR—State Adoption

Based on a Dec. 4, 2014 calendar, the legislative adoption process for the new Valuation Law has hardly changed since the summer NAIC meeting. Eighteen states comprising about 26 percent of national premiums have adopted the law and at least 10 others are considering it. From another source, I learned that California has agreed with the ACLI to adopt the new law—if they can assess companies for amounts that they need to hire consultants and staff to audit results. It remains to be seen exactly what companies would be assessed.

Oklahoma has already adopted the new law, but including SCE with \$1 billion group premium threshold. Of the 10 states considering adoption, Michigan and Illinois are including SCE—Michigan with \$500 million/\$1billion thresholds and Illinois with\$300 million/\$1billion thresholds.

Task force co-chairmen indicated that the most likely date for PBR implementation after necessary state adoptions is Jan. 1, 2017, with the optional three-year deferral for designated products.

-LATF

There was considerable discussion on new industry mortality tables, 2014 VBT and 2014 CSO. The former basic table is in the final stages of testing and should be available by June 2015. Adding margins for the CSO version is trickier. Instead of a complex quadratic equation, with the denominator based on expectation of life, the SOA group working on margins is considering flat percentage additions, varying by attained age.

LATF adopted several long-pending amendments and updates to VM20 of the valuation law. One is the Table of Spreads on interest rates as of Sept. 30, 2014, needed for the investment income assumption for certain products.

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This had been exposed at the November NAIC meeting. Second was a clarification, stating that assumptions for asset adequacy testing do not have to be the same as those used in PBR reserves.

New York objected to the pattern of spreads that reflected current low interest rates, but were projected upward in future years. The exposure was adopted with this pattern.

Also, LATF narrowly approved a change in the required threshold percentage in the Stochastic Exclusion Test from 4.5 percent to 6 percent. The main reason for a more liberal threshold is uncertainty over test results for non-par permanent products. However, because of the closeness of the vote, LATF asked the ACLI to provide additional test results before sending the amendment upstairs.

Larry Bruning of the NAIC announced that they intend to hire five to seven additional actuaries to handle reviews of new PBR reserve filings.

-State Insurance Department Letters

For some time, certain large states have issued letters, sometimes called "Halloween letters," outlining several provisions, analyses and data they wished to see in year-end Actuarial Opinion and Memorandum filings. All companies in the states, large and small, are affected. This year, New York, Illinois and California letters were mentioned in a communication from the Smaller Insurance Company Section of the SOA.

-Non-Variable Annuities

Several field tests have been continued, primarily on policies with guaranteed living benefits. The LATF subgroup for these products repeated that the goal for PBR is the greater of: a floor reserve equal to the cash value; and "model reserves" (deterministic reserves) whose assumptions must still be worked out.

-Illustrations for Indexed Universal Life

This topic is probably of minimal interest to small companies, but it is worth noting that it has caused a division within the ACLI. There is a mainstream ACLI recommendation for these illustrations and an opposing view, made up of giant companies such as Northwestern Mutual and New York Life (known as the "Coalition"). Most of one morning's meeting was devoted to these discussions.

-Revisions to Reserves for Synthetic Guaranteed Investment Contracts (GICs)

This topic is also of minimal interest to small companies, but LATF spent a fair amount of time discussing it.

-Potential Increases in C1 Bond Factors

The American Academy of Actuaries (the "Academy") has gone further in its recalculation of bond factors. Indications are that these would substantially increase life company RBC charges for the C1 component. They will probably have definite recommendations by the summer of 2015.

The ACLI has reviewed the Academy's preliminary assumptions and modeling and indicated they question some of them. John Bruins from ACLI pointed out that total C1 charges for life insurers, before co-variance adjustments, comprise about 60 percent of total industry RBC. Therefore, Academy calculations affect the entire industry.

Bill Weller of America's Health Insurance Plans (AHIP) pointed out that the average duration of bond investments for health companies may be only about half of that for life companies. Therefore, revised C1 factors for life insurers may not be appropriate for health writers.

In a Dec. 1, 2014 conference call, Weller added that the Academy representative had informed him that a change of bond duration would require restructuring the model from scratch.

-International Negotiations

The main NAIC working group here is the "Comframe Development and Analysis Working Group" (pronounced "sea-dog"). They are actively working with the International Association of Insurance Supervisors (IAIS) on insurance regulatory matters. So far, these discussions only affect large companies that deal in several countries ("Internationally Active Insurance Groups," or IAIGs) One indication of NAIC difficulties is that IAIS has decided to keep all its meetings closed.

Key issues discussed include global capital requirements, not just RBC for weakly capitalized companies, and various accounting bases, such as U.S. GAAP, international GAAP (IFRS) and GAAP for several other countries. As indicated, there is no move yet to expand any such requirements to small companies or to threaten U.S. statutory accounting.

-Executive and Plenary Developments

The last session at the fall NAIC involved approval of a significant Model Law and Regulation. Starting in 2016, due by June 1, 2016, all companies must file with their domestic departments a plan of group corporate governance and management procedures.

The Executive Committee approved new GRET factors for unit expenses for 2015, completing the approval chain that

had started with LATF. This year, the SOA made a significant change from 2014 by redefining official distribution channels. New categories are Independent, Career, Direct, Niche (applying to products like preneed, final expense and home service) and Other. This change could cause difficulties in adjusting from the seven categories previously used (Branch Office, Direct Marketing, Home Service, Career General Agency, Brokerage, PPGA and Multiline).

In a subsequent closed conference call, the Executive Committee approved revisions to the Insurance Holding Company System Regulatory Act. It clarifies group-wide regulatory supervision for defined classes of IAIGs. Also, it defines the lead state in regulation of such domestic IAIGs.

In this same call, the Executive Committee approved three new nations (besides four previously approved) eligible for reduced collateral involving reinsurance with U.S. companies—Japan, Ireland, France, and, earlier, Bermuda, Germany, Switzerland and the United Kingdom.

At the fall session, one commissioner stated that the NAIC may develop its own Model Law on Unclaimed Property. This would be compared to an existing bill prepared by the National Conference of Insurance Legislators (NCOIL) already adopted with various amendments in 15 states. No actual session on this topic was held at the fall meeting.

As stated before, the issue involves required insurer matching of the Death Master File (DMF) of the Social Security Administration against its in-force file. So far, at least 40 of the largest life insurers have been audited by special firms hired by secretaries of state or state attorneys general, rather than state insurance departments.

Two issues that have concerned some small insurers involve:

1. So-called "fuzzy matching"; when Social Security numbers or names on the DMF are close, but not exactly equal to those on the insurers' file, the matter should always be resolved in favor of the policyholder; in many cases, this would mean turning over the claim to state escheat files.

2. Each year, matching the entire insurer in-force against DMF, instead of matching only new entrants to DMF.

Summary

Each time, new and old complex issues and new wrinkles on each combine to require close attention of small insurers.

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