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The Actuarial Opinion Model Regulation (AOMR) Takes Center Stage

by Norman E. Hill

For a considerable number of years the common denominator in discussions concerning the Actuarial Opinion Model Regulation (AOMR) has been controversy and complaints. These objections have been voiced by both regulators and industry.

The AOMR began with the 1990 amendments to the Standard Valuation Law (SVL) and Model Regulation, providing for two separate actuarial opinions:

1. No statement of asset adequacy — Section 7 of the model regulation.
2. Statement of asset adequacy — Section 8 of the model regulation.

Opinions under Section 7 (labeled "Section 7 Opinion") would be allowed only for small companies (under $500 million assets) that met various statistical tests of product and asset mix and surplus strength. The asset adequacy approach was described in Section 8, and so the second type of reserve opinion was labeled "Section 8 Opinions." This section of the Regulation included descriptions of seven scenarios for interest assumptions in cash flow testing. Since these patterns had previously been included in New York's Regulation 126, the seven formulas were referred to as the "New York 7."

Most people accepted the requirement that all Section 8 reserve opinions must include full cash flow testing. This meant detailed projections of all elements of cash flow, such as interest, maturity, calls, and repayment/prepayment receipts from assets, and premiums, claims, and expenses generated from insurance liabilities.

Complaints about the AOMR came from several sources:

1. Industry — the required wording called for actuarial certification of compliance with the "state of filing." Many actuaries complained of substantial variances in state reserve requirements and their inability to keep up with constant changes in requirements. Mostly, these came from larger, widely licensed companies, including many licensed in New York (generally considered the toughest regulatory state).

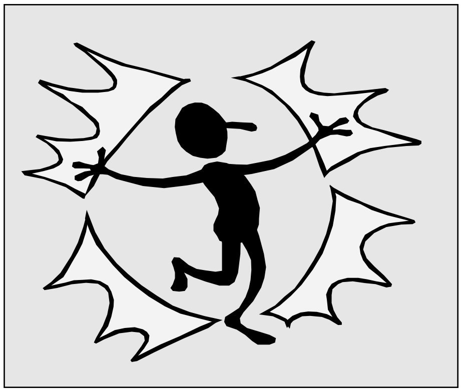
2. Regulators — their primary objection was that a Section 7 reserve opinion was mechanical. The actuary was attesting only to compliance of reserves with minimum statutory standards, not to reserve adequacy. Also, a second objection was that exemption criteria allowing small companies to file under Section 7 were too weak and did not cover many new types of innovative products and invested assets.

Attempted Modification

Throughout most of 1996, an American Academy of Actuaries Task Force studied state reserve requirements. This group was named the State Variations Task Force. They were to research establishment of a comprehensive regulatory compilation that would describe in detail each state's law, regulations, bulletins, and circular letters (written or unwritten), dealing with reserve requirements. In addition to the compilation, they were to make recommendations for its on-going maintenance, whether kept at the NAIC or some other suitable central location. The hope was that such a central depository would aid state regulators in evaluating reserve opinions from companies domiciled in other states.

In late 1996, this same task force made recommendations to modify AOMR, including the following changes:

1. Change asset adequacy opinions to compliance with state of domicile requirements.



2. Restrict Section 7 reserve opinions to companies under $100 million assets, instead of the current $500 million threshold.

3. Tighten exemption requirements for allowing Section 7 opinions, so as to measure reserves for Universal Life and participating life policies.

4. Further tighten exemption requirements to measure the extent of CMO invested assets.

5. Expand exemption requirements to measure liabilities for long-term care and non-cancelable disability. These products were normally not connected with the need for cash flow testing. However, several regulators wanted these included in measurement criteria, because of the lack of reserve standards.

The Academy's approach fulfilled the desire of at least one regulator. He wanted a "package deal" to present to the industry — relieve the valuation actuary of the burden of certification of compliance with each state's reserve requirements, in return for tightening exemption requirements for Section 7 opinions.

This proposal met with heated objections from many small companies, such as:

1. Not enough consideration was given to additional costs to small companies for asset adequacy testing. At this stage, most people in the industry tended to equate such testing with cash flow testing. This change could place extreme burdens on their scarce resources.

2. Wording in the proposal implied that cash flow testing for small companies would be relatively easy.

3. The rationale for including exemption criteria for participating life was unfounded.

4. The criteria for measuring the extent of CMO invested assets were far too broad, since only certain CMOs in segments known as "high traunches" exhibited volatile repayment patterns.

During the December meeting of the NAIC's Life and Health Actuarial Task Force (LHATF), these objections were part of a heated debate. One long-standing complaint about all Section 7 opinions was raised again; namely, that its reliance on mechanical calculations gave professional and indirect legal sanction to poor actuarial work.

The ACLI supported small company objections to the Academy's proposal. They did, however, request that regulatory desire for a "package deal" be eliminated, so that the goal of domiciliary state wording in reserve opinions could be considered separately. As a result, this proposal was not adopted by regulators and was sent back to the Academy for further study.

At this point Arnold Dicke, FSA, then an Academy officer, made a conceptual point that carried substantial weight in subsequent discussions. The extent of reserve testing and asset adequacy testing should be consistent with each company's "risk profile," i.e., the risks and volatility of its products and assets in term of Cl, C2, and C3 components.

In the meantime, after the December debate, the State Variations Task Force returned to its original charge. Eventually, they concluded that a central source for reserve requirements would be very unwieldy and time consuming for regulators to study. Therefore, no final recommendation in this area was made to the NAIC.

Recent Developments

Over the next few years, regulators and the Academy Task Force wrestled with various issues of a revised AOMR:

1. One new proposal for allowing a Section 7 opinion would require a Gross Premium Reserve (GPR); i.e., a projection of future cash flows at an appropriate discount rate. This rate should reflect projected asset performance, but not be tied directly to the incidence of each year's interest, maturities, repayment defaults, etc. The discount rate should not be mechanically tied to current yields from asset portfolios. For example, high yielding junk bonds should not result in higher discounts and artificially low GPR liabilities. Instead, the discount rate should reflect the degree of risk, so that it would actually be lower for riskier portfolios and liabilities.

2. Debate ensued over the degree of required conservatism in GPR assumptions. Should there be margins in assumptions, and, if so, how should they be expressed? Should each component have a margin, or should one over all margin be included? Some degree of regulatory support was reached for adding a final margin of 7½ % to the initially computed GPR. This would be considered a margin for "moderately adverse" conditions.

3. A proposed approach for allowing reserve opinions based on state of domicile was tied to new NAIC statutory codification requirements. The opinion would refer to separate reserve calculations based on codification standards. Basically, this called for reserves that conformed to NAIC models. A host of questions and controversy arose over this proposal:

(a) Should all models be followed, even if not widely adopted by the various states?

(b) Should such codification reserves be shown, but without actuarial certification?

(c) Should such reserves be shown in total, or in various, defined segments?

(d) Instead of totals, should only the difference between the company's reserves and codification reserves be included in the opinion?

4. Other Section 7 exemption criteria were developed as follows:

(a) For long-term care and non-cancelable disability, regulators added one for a new product, equity-indexed or equity-linked annuities.

(b) Participating life was removed from any exemption criteria.

(c) Maximum exemption limits on CMO invested assets were limited to those with high "flux scores" (measuring the extent of asset volatility) determined by the NAIC to be over 7.

(d) The $500 million asset threshold was retained.

These various proposals all seemed to lack the necessary degree of regulatory support and enthusiasm. Some members of LHATF called for abandoning the entire AOMR project.

Current Proposal

During 1999, still another proposal was structured. This newest approach to amending the AOMR seemed to enjoy considerable support among industry and regulators. It contained several fairly radical changes:

1. Under certain conditions, the state of domicile rather than state of filing would be allowed as the basis for actuarial reserve opinions. These conditions included either of the following:

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(a) The domiciliary state makes available a complete written list of its valuation standards.

(b) By the previous March 31, the company requests that the filing state rely on its domiciliary opinion and the filing state makes no objections by October 1.

(c) The company submits for specific products a comparison of nationwide reserves on domiciliary state standards versus NAIC codification standards.

However, any Insurance Commissioner could still request a given company to report on compliance with his own state's reserve requirements.

2. All companies, large or small, would file reserve opinions based on asset adequacy.

3. The extent of asset adequacy testing would largely be left to actuarial judgment, by requiring the certification to state compliance with revised Actuarial Standards of Practice (ASOP) 7 and 22.

> ***"There are two very significant implications of these latest proposals. Actuarial judgment would play a greater role in setting reserves. Mechanical compliance with statutory limits on assumptions and methods could no longer form the sole basis for an actuarial reserve opinion."***

4. These two ASOPs are being redrafted to include specific statements that cash flow testing is not automatically required in all cases. Asset adequacy is not synonymous with cash flow testing. During the years of discussion and debate since 1996, several prominent actuarial regulators had made the same point.

5. To be consistent with actuarial judgment described in the above #3 and #4, the New York 7 scenarios for cash flow testing were removed from the AOMR draft.

Implications

There are two very significant implications of these latest proposals. Actuarial judgment would play a greater role in setting reserves. Mechanical compliance with statutory limits on assumptions and methods could no longer form the sole basis for an actuarial reserve opinion. Also, each company's risk profile of liabilities and investment assets would play a dominant role in determining reserve levels.

March 2000 NAIC Developments

When the latest proposal was discussed, small company objections were still vehement. The NALC representative objected to the additional expense and work inherent in asset adequacy opinions. They stated that if LHATF approved these revisions, they would fight it at higher NAIC levels and also on a state-by-state basis. Also, the ACLI reported that its survey of its own small company membership indicated that most of them were similarly opposed. This trade organization did not change its long-standing support of the Section 7/Section 8 split opinions.

Summary

The Actuarial Opinion Model Regulation has been controversial throughout its life. At this point, it is uncertain whether the newest proposal for an update can work its way through the torturous process of review and discussion by regulators and all industry segments, large and small. However, revised ASOPs 7 and 22 will probably be adopted. Even under the current AOMR, more actuarial reserve opinions may deal with asset adequacy testing and risk profile considerations, without automatic ties to company size.

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