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Revisions to the Actuarial Opinion and Memorandum Regulation

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The NAIC has already adopted the revisions to the Actuarial Opinion and Memorandum Regulation (AOMR). Now, it is up to the individual states to approve the new regulation. This article provides a summary of the four major revisions to the AOMR, the changes to the Actuarial Standards of Practice and the different methodologies for asset adequacy testing.

Major Revisions to AOMR

Elimination of Section 7 Opinions

The most controversial change to the AOMR is the elimination of Section 7 opinions. The prior AOMR split companies into two groups based on whether their assets exceeded $500 million. Those with assets of at least $500 million were required to perform asset adequacy analysis, while those below were further split into subgroups by asset amount. Each of these subgroups was exempted from performing this analysis as long as certain additional criteria were met. For those exempted from asset adequacy analysis, Section 7 of the AOMR described what form the actuarial opinion was to take. In the revised AOMR all actuarial opinions must be based on asset adequacy analysis.

The second major change to the AOMR is to provide for restricted use of actuarial opinions based on the law of the state of domicile.

Restricted State of Domicile Opinions

The second major change to the AOMR is to provide for restricted use of actuarial opinions based on the law of the state of domicile. The original AOMR required a statement to the effect that the reserves and related items meet the requirements of the insurance laws and regulations of the state in which the statement is filed or of the state of domicile, and are at least as great as the minimum aggregate amounts required by the state in which the statement is filed.

This satisfied each state's desire to remain independent and free to set insurance regulations that they considered to be in their best interest and to impose solvency standards for companies domiciled in their state without giving unfair advantage to companies domiciled elsewhere. However, the insurance industry preferred a state of domicile filing, because of the added expense of trying to understand and comply with all of the individual states' regulations. A compromise was reached to permit a state to accept a company's state of domicile opinion.

The revised AOMR allows the commissioner to make one or more of the following approaches available to the opining actuary:

1. A statement that the reserves "meet the requirements of the insurance laws and regulations of the state of domicile and the formal written standards and conditions of this state for filing an opinion based on the law of the state of domicile."

2. A statement that the reserves "meet the requirements of the insurance laws and regulations of the state of domicile and I have verified that the company's request to file an opinion based on the law of the state of domicile has been approved and that any conditions required of that request have been met."

3. A statement that the reserves "meet the requirements of the insurance laws of the state of domicile and I have submitted the required comparison as specified by this state."

Regulatory Asset Adequacy Issues Summary

The third change is the requirement that a "Regulatory Asset Adequacy Issues Summary" be prepared. This will increase the efficiency with which the actuarial opinion and memorandum are reviewed. The required content of the confidential summary is detailed in Section 7 (C.) of the AOMR. The summary should include a description of the scenarios tested, the sensitivity tests, changes to prior year assumptions, amount of reserves, results, methodology and that the actuary is satisfied that the options whether explicit or embedded in any asset or liability have been appropriately considered.

Required Interest Rate Scenarios

The fourth major revision to the AOMR was to eliminate the required interest rate scenarios. The new AOMR allows the appointed actuary to exercise judgment, guided by the Actuarial Standards of Practice.

ACTUARIAL STANDARDS OF PRACTICE

Along with the revised AOMR, actuaries received revised Actuarial Standards of Practice (ASOP) No. 7 and No. 22. ASOP No. 14 (*When to Do Cash Flow Testing for Life and Health Insurance Companies*) was eliminated. The changes to the standards of practice coincide with the changes to the AOMR.

ASOP No. 7 — *Analysis of Life, Health or Property Casualty Insurer Cash Flows* provides guidance to actuaries analyzing asset and liability cash flows. The standard of practice lists reasons for cash flow testing, how to perform the analysis and offers guidance on documenting the analysis.

ASOP No. 22 — *Statements of Opinion Based on Asset Adequacy Analysis* provides guidance to actuaries and offers statements of actuarial opinion relating to the adequacy of a life or health insurers' reserves and other liabilities in light of supporting assets when providing statements of opinion to satisfy applicable law. The standard of practice lists the main steps in asset adequacy analysis and discusses the different methodologies.

ANALYSIS METHODS

The available methods have not changed from the original AOMR, but since some companies will be completing the asset adequacy analysis for the first time it is worth noting them. Cash flow testing is the most widely used method of asset adequacy analysis, but there are other possible methods that may be appropriate. These other methods can be used when moderately adverse deviations in the investment rate-of-return risk assumptions are not likely to have a material effect on the prescribed value of the combined asset, policy or other liability cash flows.

The five additional methods are as follows:

1. A gross premium reserve test where the policy and other liability cash flows are sensitive to moderately adverse deviations in the actuarial assumptions underlying the cash flows. The example given is a block of term insurance backed by noncallable bonds.

2. Demonstration of great conservatism in the reserves and other liabilities such that moderately adverse deviations in the actuarial assumptions underlying the policy and other liability cash flows are covered. The example given is a block of AD&D insurance.

3. Demonstration that product risks have been limited by policy design and investment strategy such that these risks are not subject to material variation and that moderately adverse deviations in actuarial assumptions underlying the policy and other liability cash flows are covered. The example given is a block of variable annuities with no guarantees and no unamortized expense allowance.

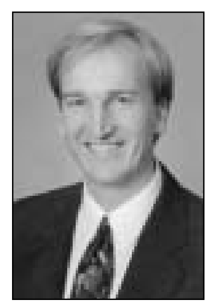
4. Use of risk theory techniques, namely testing the effect of a small number of large individual claims over a short-term period, to measure the risks in short-term products backed by short-term assets.

5. Loss-ratio methods when the asset and liability cash flows are all of short duration. An example of where this may apply is short-term health insurance contracts.

The appointed actuary will need to weigh carefully the responsibility to use an appropriate method against any desire to avoid full-blown cash flow testing.

CONCLUSION

In summary, for some companies the most significant effect of the new AOMR will be the requirement to perform asset adequacy analysis. For other companies the biggest adjustment will be coping with various requirements to provide an opinion based on requirements of the state in which the statement is filed. For most companies, preparation of the Regulatory Asset Adequacy Issues Summary will not be a challenge. The elimination of the required interest rate scenarios will provide opportunities for some companies. For all companies, the new Actuarial Opinion and Memorandum Regulation means that it will not be "business as usual" for valuation actuaries.



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