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Principle-Based Reserves Update

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During the National Association of Insurance Commissioners' (NAIC) Fall National Meeting in Washington, D.C. several notable things happened, certainly not the least of which was the continuing crisis in the financial markets. The meeting took on a different tone than originally anticipated. Nonetheless, progress was made on certain proposals. I have summarized these below.

STANDARD VALUATION LAW

The Life and Health Actuarial Task Force (LHATF) discussed the proposed revisions to and amended the Standard Valuation Law (SVL). As a result, the amended version was exposed for adoption, which is one step closer than having exposed the SVL for comment. The industry may still comment using the usual channels. Opinions vary as to the importance of the NAIC's action since a critical component of the valuation package, the Valuation Manual (VM), remains a work in progress. If the revised SVL is adopted during conference calls following the fall meeting, the NAIC will have succeeded in meeting its Dec. 31, 2008 deadline for a revised law enabling principle-based valuations.

In contrast to prior exposed versions, this version has removed the specified statutory reserve floor from the SVL and empowered the VM to specify the statutory floor appropriate for the product or contract.

VALUATION MANUAL

LHATF received reports from subgroups on various portions of the VM.

- VM-00 Introduction, General, Procedures, etc. was amended and released for comment.
- VM-01 Definitions for Terms was amended and released for comment.
- VM-20 Requirements for Principle-Based Reserves for Life Products was amended and released for comment.
- VM-30 Actuarial Opinion and Memorandum Requirements was amended and released for comment.
- VM-31 Reporting and Documentation Requirements for Business Subject to a Principle-Based Reserve Valuation.

Amendments to VM-20 were integrated into the document during LHATF VM-20 subgroup conference calls during the months between the summer and fall meetings. These amendments are paraphrased below.

- The interest scenarios used in stochastic analysis will come from a prescribed generator (yet to be identified).
- The prescribed net spread on reinvestment assets shall be 4 percent of the appropriate Treasury spot path plus 0.25 percent. This item will remain on the issues list and a drafting note in VM-20 will indicate the 4 percent and 25 basis points are placeholders.
- The disclosure requirements for mortality assumptions were expanded and updated to reflect the recent changes incorporated in VM-20 dealing with the process to determine prudent estimate mortality assumptions.
- In demonstrating the impact of margins on the deterministic reserve, for assumptions that are prescribed (i.e., interest rate movements, equity performance and net spreads on reinvestment assets), the prescribed assumptions shall be deemed to be the prudent estimate assumption, and the equivalent of an anticipated experience assumption for these risk factors will be Scenario 9 (the base scenario) from the set of scenarios used in the stochastic exclusion test; 8 percent annual return for the path of S&P 500 returns; and actuarial judgment shall be used in determining the anticipated experience assumption for net spreads on reinvestment assets.
- The prescribed path of U.S. Treasury yield rates to be used for the deterministic reserve calculation shall be equal to the interest rate yield curves in Scenario 12 from the set of prescribed scenarios used in the stochastic exclusion test. The prescribed path of S&P 500 returns shall equal the 10-year treasury rate path in Scenario 12 plus the prescribed net spread added to each rate.
- The number of scenarios in the stochastic exclusion test has been updated from 12 to 16. The extra scenarios involve a wider range of interest rates in later years. The stochastic exclusion test is now based on anticipated experience rather

than prudent estimate assumptions. The test also appears in the C-3 Phase III proposal.

- Detail surrounding requirements for the demonstration supporting exclusion if the company elects to exclude policies from stochastic modeling but does not use the stochastic exclusion test.
- To pass the stochastic exclusion test, the ratio must be less than 4 percent. The 4 percent pass mark is expected to be continually reviewed for appropriateness by the NAIC once the valuation manual is adopted and companies submit their results of the stochastic exclusion test as part of the required documentation for a principle-based valuation.

C-3 PHASE III LIFE CAPITAL

Absent further input from NAIC's Life Risk Based Capital (E) Working Group, the American Academy of Actuaries' (the Academy) Life and Annuity Capital Work Group (C3WG), chaired by Peter Boyko, has completed their C-3 Phase III work. The Academy's Economic Scenario Generator Work Group continues to refine calibration criteria. The Academy's C3WG also provided updates to the NAIC instructions that would recognize the Phase III requirements included in the Academy's proposal. Items that have been added to the Academy's Phase III proposal that were provided to and reviewed by the NAIC Life RBC (E) Working Group are summarized below together with additional requests made by the NAIC to the Academy's C3WG:

- Language for the stochastic exclusion test has been added to the report. The Life RBC (E) Working Group expressed concern regarding the 4 percent threshold. Some members felt more testing of the concept is necessary. To the extent that any changes to the test or the benchmark are made within VM-20, the same changes would likely be reflected in the Phase III proposal.
- Language was added that required the stochastic modeling exclusion be re-analyzed at year end if the modeling had been done prior to year end and the company was within 110 percent of an action level. Whether 110 percent is an appropriate threshold for recalculation remains under review.

- The Academy was asked to provide a report specifying the differences between reserves and capital for both C-3 Phase III and Phase II.
- California and New York will provide further information to the Working Group regarding reinsurance issues.

The NAIC Capital Adequacy (E) Task Force then received and adopted the report of the Life RBC (E) Working Group. It appears as though, pending the additional requested items on economic scenario generator calibration, differences between reserves and capital, and more insight into the 4 percent exclusion benchmark, the concepts in the Phase III capital proposal are substantially complete. ■