



SOCIETY OF ACTUARIES

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PBA Corner

by Karen Rudolph

(Editor's note: Karen Rudolph has agreed to supply the Financial Reporter with regular updates on PBA activities. Thanks to Karen and watch for future updates in the PBA Corner.)

Activity surrounding the principle-based approach (PBA) to statutory reserves and minimum regulatory capital is gaining momentum. The regulatory community, actuarial profession and insurance industry in general have contributed significant effort to fuel the progress to date. As the deadline for this issue of *The Financial Reporter* nears, the NAIC's Life and Health Actuarial Task Force (LHATF) scheduled an unprecedented number of days combing through the documents included in the proposed Valuation Manual (VM), as well as endeavoring to adopt the revisions to the Standard Valuation Law (SVL-II) that recognizes the VM as the repository for statutory accounting reserve requirements. This article will allow those readers who are not as close to this initiative to quickly become familiar with the landscape of the movement and where it stands today.

The work products have been many and varied. At this stage, all reserving requirements, both principle-based and formulaic methods, will be found in the VM. Following is an overview of the six sections of the VM and some important elements of each. The first five sections refer to one or more minimum standards found in the final, sixth section. Much of the content in these sections is in draft form and subject to change.

I. Introduction. The reserve requirements found in the VM satisfy the minimum statutory valuation requirements of the SVL. These requirements are applicable to life, annuity, deposit-type contracts and health insurance business. The operative date of the VM is January 1 following the date that: (1) the VM (or a change thereto) is adopted by at least 75 percent of the NAIC executive and plenary members; and (2) at least 39 states have adopted the revised SVL. This section also includes the process for updating the VM.

II. Reserve Requirements. This section lays out the scope of the VM and maps any particular business type to the appropriate requirements. For example, for life insurance contracts in force on the operative date of the VM, this section specifies applicable state

requirements as the minimum standard. For life insurance contracts issued on or after the operative date, the minimum requirements found in VM-20 are applicable. VM-20 is the Requirements for Principle-Based Reserves for Life Products and is found in a later section of the VM. Whether a contract qualifies as a life contract is specified in VM-2.

III. Reporting Requirements. Companies are subject to each of two types of reporting requirements: the Actuarial Opinion and Memorandum (VM-30) and the Principle-Based Reporting Requirements (VM-31).

IV. Annual Principles-Based Review Requirements. The scope and responsibilities of the reviewer and the company are found in VM-40. At the winter NAIC national meeting however, this section was removed from the manual. The disposition of peer review requirements for principle-based valuations is to be determined. Review requirements found in VM-40 will likely be retained in some way, whether by inclusion in the Financial Examiner's Handbook or some other state-specific requirement. The frequency of the review is also unknown and may be at the discretion of the state.

V. Experience Reporting Requirements. The scope and content of experience reporting is still under development. VM-50 and VM-51 outline these requirements and the associated formats for submissions.

VI. Valuation Manual Minimum Standards. This is where the detailed content resides. Sections I through V point the reader to a document in Section VI for detail on specific requirements. These include:

- VM-0 Introduction, General Information and Table of Contents
- VM-1 Definitions for Terms in Requirements
- VM-2 Definitions for Types of Contracts
- VM-3 PBR Applicability to Contracts
- VM-5 NAIC Model Standard Valuation Law
- VM-20 Requirements for Principle-Based Reserves for Life Contracts.
- VM-21 PBR Variable Annuity (VACARVM)
- VM-22 Requirement for Principle-Based Reserves for Non-Variable Annuity Contracts
- VM-25 Health Insurance Reserves Minimum Reserve Requirements



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- VM-26 Credit Life and Disability Reserve Requirements
- VM-30 Actuarial Opinion and Memorandum Requirements
- VM-31 Reporting and Documentation Requirements for Business Subject to PBR
- VM-40 Review Opinion Requirements for a Principle-Based Valuation
- VM-50 Experience Reporting Requirements
- VM-51 Experience Reporting Formats

Recent Developments

With respect to PBR for life insurance, developments between the September and December NAIC meetings include definition of a test for sensitivity to economic scenarios (formerly the Material Tail Risk Test) and reconstruction of the guidance for determining the valuation mortality assumptions.

The purpose of the test for sensitivity to the economic conditions is to provide the practitioner a safe harbor test to demonstrate a group of policies as qualifying for the stochastic modeling exclusion. This test is under review by LHATF, but all indications are that it will approve the general methodology. The test is performed on a limited number (12) of proposed economic scenarios, one of which is considered baseline, and focuses on a ratio of (A-B)/C where:

- A = highest scenario reserve amount among the 11;
- B = baseline scenario amount; and
- C = PV of benefits and expenses, determined on baseline scenario.

A, B and C use prudent estimate assumptions and follow the definition of scenario reserve found in VM-20. Regulators would need to determine a threshold level for policies to qualify for the stochastic modeling exclusion. A group of policies for which there is a clearly defined hedging strategy is viewed by the regulators as a group of policies ineligible for the stochastic modeling exclusion regardless of the type of hedging being used.

The mortality section of VM-20 (Subsection 6) has been updated to include a clarified methodology for arriving at valuation mortality rates. The objective

of the rewrite was to provide companies with little or no credible experience a simplistic way to find the appropriate valuation mortality table. A credibility criterion has been introduced. This criterion has yet to be determined, but can be thought of as a threshold credibility level. If the company's credibility falls below the credibility criterion threshold, the company uses its underwriting and risk-classification procedures (through a scoring procedure) to map into a VBT and its corresponding CSO mortality table.

If the company's experience mortality credibility falls above the criterion, the company would use a more complex path to determine the appropriate valuation mortality assumption. This path includes the underwriting scoring procedure, determination of the appropriate VBT industry table and a method for blending the industry table with company experience rates. A margin is added to the blended rates. Finally, the company would select the CSO mortality table that provides a seriatim reserve closest to, but not less than, a seriatim reserve based on the blended rates with margin. §

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