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Principle-Based Reserves Update

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Looking back to progress made during the NAIC Summer National Meeting, much of the meeting agenda was devoted to the Standard Valuation Law (SVL) and little to the proposed Valuation Manual (VM). My update in the June 2008 issue focused on a series of amendments, none of which were specifically addressed during the summer meeting. As a result, many interim conference calls are being held during the months of June, July and August with the objective of completing the review and consideration of these amendments.

SVL

Progress has been most notable on the evolution of principle-based requirements within the law itself. The timeline of the regulatory community is to pursue discussion and resolution of remaining issues during the period between the summer and fall meetings. It is hoped that by year end 2008 the revised SVL will be formally adopted by the NAIC and on its way to state legislatures during 2009. To that end, these remaining critical issues need to be agreed upon and finalized in the coming months.

1. Confidentiality: The current SVL language provides a level of confidentiality around the appointed actuary's actuarial opinion and memorandum. Under a principle-based regime, the Commissioner has the authority to call for an examination of the principle-based reserves of the company to determine the appropriateness of any reserve assumption or method used by the company. To accomplish this, the Commissioner may engage a qualified actuary to perform an examination of the principle-based reserves or compliance with the VM. In the course of such an examination, the qualified actuary will have made available to them confidential materials. Industry representatives would like the benefits of confidentiality extended to this examination process and its associated materials.

2. Statement of Principles: The SVL includes, in Section 12, six conditions that must exist for a valuation to be considered a principle-based valuation. Generally speaking, regulators agree these principles belong in the SVL, as opposed to the VM, but the exact description of the principles remain under discussion.

3. Minimum Floor: In general, regulators agree a minimum floor is necessary for reserves calculated under a principle-based environment. In the current draft dated May 31, 2008, the floor is stated as a per policy or per contract amount not less than the greater of (i) zero; (ii) the cash surrender value; or (iii) the present value of cash flows associated with or allocated to the policy or contract, where the present value calculation is based on the appropriate interest rate or rates as specified in the VM. Whether such language should reside in the SVL or in the VM is still up in the air. Some regulators feel strongly this language should appear in the SVL and thus be enshrined in the law rather than in a document like the VM which can be modified through an NAIC process rather than a state legislative process. If in the SVL, then questions arise from other regulators about the applicability of items (ii) and (iii) to all policies within scope of the law.

These are not trivial issues and need to be given an appropriate level of consideration when it comes to finalizing the language of the SVL. As a law, the parameters laid out in Sections 11, 12 and 13 will need to service valuation well into the future without the bother of re-opening and again adopting this law through legislative measures.

VM

Although little time was spent covering amendment proposals to the VM, the fact that the VM-20 subgroup has a fairly concise list of outstanding issues is encouraging. Six hours of conference call time has been scheduled to discuss remaining amendments. In addition, the following items require resolution before this group can consider themselves ready to submit the manual to the full LHATF.

1. The absolute level of CTE for the stochastic reserve needs to be determined as well as

whether such level should vary by product type or not. The current VM-20 draft refers to varying CTE level by product type. Arguments have been given for setting a single level for all products. The CTE metric captures variability by nature of its calculation. All other things being equal, scenario reserves in the tail of the distribution of scenario reserves for a product with greater variability with respect to interest or equity returns will produce a higher CTE value than will a product without such variability.

2. Products without exposure to interest rate or equity return risk may be exempted from stochastic analysis through the use of a stochastic exclusion test. The pass level of this test needs to be determined. LHATF has requested from the Academy a recommended pass mark. The Academy's LRWG has preliminarily established the mark and will be providing a supporting argument to LHATF before the NAIC September 2008 National meeting.

3. The concept of establishing margins around valuation assumptions is a wide open area. The regulators and the actuarial profession realize the need for more guidance on this piece of the requirements. Though it may not require amended language in VM-20, it is recognized that an Actuarial Standard of Practice may need to be formed in order for practical implementation of the PBR requirements.

4. A fundamental principle of PBR is recognition, in the valuation exercise, of a company's risk management methods, models and techniques. In other words, a company's valuation approach should by synched up with their risk management approach. However, when it comes to aggregating liabilities within a stochastic analysis in order to produce an aggregate stochastic reserve, the regulators are hesitant to allow for offsetting liability risks. Allowing aggregation in the stochastic analysis is under consideration.

5. The inclusion or exclusion of federal income tax cash flows is on the outstanding issues list. This would produce circularity in the calculations, since taxable income depends on changes in reserve levels.

6. Revenue sharing arrangements in separate account fund offerings, for example, have not typically been guaranteed. Though nonguaranteed, these arrangements are a critical source of income for the companies offering these products. The company provides a valuable service to the fund itself, which in turn offers a portion of its profit in return. Some regulators would rather see these arrangements ignored in the projected cash flow streams if not guaranteed.

7. Credit for a company's dynamic hedging risk mitigation techniques are currently allowed as long as the hedging program qualifies as a clearly defined hedging strategy. Suggestion that credit for such risk mitigation techniques should be capped at something less than 100 percent in the cash flows is under discussion. Implementing a cap would arguably be in conflict with the fundamental principle of reflecting a company's risk management strategies. The concern of regulators is primarily rooted in the uncertainty of how well these strategies play out in relation to their original design and under extreme scenarios.

8. Whether a minimum number of scenarios should be required for the stochastic reserve and if so, what that number should be.

9. The discount rate used in the determination of the stochastic reserve is last on this list of nine issues, but certainly not the least important. There are several amendments currently proposed that alter the nature of derivation of the discount rate. These amendments arise primarily for two reasons: (i) a company should not be encouraged to invest in securities with higher risk profiles in order

to effect lower reserves, and (ii) there is a question regarding the appropriate discount rate for points in a projection where the asset balance is zero. Another concern is general auditability of the calculations from an examination perspective. I expect this issue will receive attention in coming conference calls.

Regulator concerns not listed above include establishing a credibility methodology for assumption setting and the concept of scenario generators. Regulators have suggested using pre-determined scenarios of interest rates and equity returns during the initial years of principle-based valuations. Once a comfort level is established, the requirements could begin to allow for a company's generator, if calibration criteria are met.

I will mention a few more key items here. VM-00 no longer includes a VM-22 section for non-variable annuity contracts. The work on non-variable annuities will follow on the heels of the life insurance work, since regulators feel that initial PBR efforts should be focused on life insurance. VM-00 points to current statutory requirements as minimum requirements for these contracts. VM-00 allows a company a five-year transition period starting after the operative date of the VM. During this five-year period the company may choose to value newly issued policies using principle-based methods. After the five-year period, new issues must recognize the requirements of VM-20. VM-50 establishes the experience reporting requirements mandated by the SVL. The current version would require submission of experience data for all policies rather than just those policies subject to principle-based requirements. ■