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Are YOU Ready? A PBA Implementation Guide

By Tim Cardinal and Steve Stockman

A principle-based approach for determining reserves is coming your way. The Valuation Manual VM-20 describes requirements for principle-based approach (PBA) reserves for life products but does not set forth resources, changes in processes and workflows needed by insurers to implement VM requirements. The Financial Reporting Section of the Society of Actuaries, joined by the Smaller Insurance Company Section, engaged Actuarial Compass, a consulting firm, to develop a PBA Implementation Guide for Life Products, based on the Valuation Manual passed by the NAIC in Dec. 2012.

The Guide offers companies/actuaries some “play-by-play” tactics for developing a “champion” implementation strategy for PBA. The Guide outlines a series of steps to translate VM-20 requirements and company business requirements into an implementation plan. The Guide contains templates and six Case Studies vetted through a series of interviews with a diverse group of 15 insurers that will help companies in forming a successful PBA strategy to help you get to the “end zone.”

The Guide parallels travel guide books designed to help tourists plan a successful trip, such as to Paris or Rome. First you leaf through the travel guide, skimming sections based on your interests in historical sites, cultural and sporting events, restaurants, transportation and lodging. There are sample itineraries for one-, two- and three-day visits. Based on your initial scoping you make a list of potential things to see and to do. You then read more carefully and continue to re-read as your list narrows and final choices

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are made along with priority must-do's and optional and contingency plans. The Implementation Guide can be used in a similar fashion.

A Road Map indicates a company's goals, starting points and ways to achieve the goals. PBA implementation is in essence performing a gap analysis and bridging the gaps. Determine where you are (current framework), where you want to be (future PBA framework) and why (requirements), what (initiatives), how and when to get there (Map). Sounds simple, yet could be overwhelming.

GUIDE OVERVIEW

In addition to the Case Studies, the Implementation Guide contains an Executive Overview, a Scoping Guide, and a Road Map Guide.

The Executive Overview links VM requirement implications with business requirements and company strategy and is intended for company management charged with implementation responsibilities and developing company PBA strategy. For each Case Study, a company profile outlines requirements and considerations for that company and a Road Map outlines the PBA

initiatives the company will undertake. Project scale reflects the magnitude and complexity of the implementation and the case studies range from minimalist to enormous. Flow charts visually capture VM-20 requirements such as exclusion tests, deterministic and stochastic reserves and prescribed assumptions to aid users in forming a view of their future PBA framework.

The Scoping Guide outlines a precursory gap analysis including steps to identify business requirements and financial reporting requirements, to form a view of your future PBA framework and a template to evaluate the current framework versus PBA framework. The Road Map Guide steers users to ask more substantive questions, explore alternatives and evaluate and implement competencies, capabilities, activities and processes that could collectively be called practices. A VM requirement overview, implications and PBA implementation considerations are provided for categories organized as assumption setting, inputs, model platforms, outputs, technology and systems and actuarial organization. The Road Map Guide concludes with potential initiatives (i.e., action items) to implement PBA. The Guide also contains lessons shared by the participants and provides literature resources on numerous issues pertinent to a PBA framework.



EXECUTIVE GUIDANCE

Three frequently asked questions are,

- 1) "Where should we start?"
- 2) "What are others doing?" and
- 3) "What do we need to do and what don't we need to do?"

First, start by using the Guide to develop a plan and plan now. The benefits of doing so and the downsides of not doing so are numerous. Constructing your Road Map (plan) now does not necessarily mean the Map is frontloaded with large expenditures of time, effort and money. Numerous companies are concerned with having enough resources or the cost of procuring additional resources to implement and operate in a PBA paradigm. Spreading out the imple-

mentation work allows management more choices. Constructing a Map now permits some of the transition from the current framework to the future PBA framework to occur incrementally in manageable sub-steps and to be coordinated with other actuarial or company projects as a marginal increase in resources.

REQUIREMENTS, FACTORS AFFECTING SCOPE

The second and third frequently asked questions consider project scope and focus. Project magnitude and complexity are related to several dimensions including business strategy, products and features, business requirements (e.g., financial close schedule), staff size, management philosophy (conservative/aggressive), policy count, existing framework, recent and ongoing activities, organizational structure and asset/company size. Significant factors impacting project scope and which VM requirements are applicable will be product features and risk profiles. The Guide contains a Product Decision Tree and Potential Reserve Applicability table to assist with these determinations.

Perhaps the most significant factor affecting project scope is the degree to which statutory financial intelligence is incorporated into business decision making. The Guide makes a sharp distinction between the usage of the words information and intelligence. For example, the PBA financial statement reserve is information and the explanations of PBA earning variances are intelligence. The degree of resources invested in activities should reflect the degree to which they support business strategy and drive value creation. Information is costly, intelligence more so. The magnitude and complexity in implementing PBA reflects if, why and how decision makers accept, interpret and implement PBA intelligence.

PRACTICES FOLLOW REQUIREMENTS

The Guide explores practices in a PBA future framework in four areas:

... is more always better and is most/all always best?

1. Capability: Can and How
2. Automation
3. Centralization
4. Robust versus Flexible

Key decisions throughout the implementation will reflect choices in these four interrelated areas critical to operating a PBA framework. Addressing gaps and deficiencies will be integral components of any Road Map. The considerations are to what extent, when and how a company should implement capabilities, full automation, a centralized input database, model or output database and fully or partially flexible and robust infrastructures. Two questions are, is more always better and is most/all always best? Our opinion is sometimes and no.

Practices should be aligned with company strategy. For example, five business-level strategies are cost leadership, differentiation, focused cost leadership, focused differentiation and integrated cost leadership/differentiation. Each strategy will have different requirements. The right capabilities, activities and processes including actuarial practices are not identical across all strategies. The competencies and leading practices to support a cost leadership and differentiation strategies have similarities but have important distinctions.

What you need to do will be significantly impacted by requirements. For example, the Guide explores whether it is critical to supplement company data with external sources in setting assumptions and margins. The Guide

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PBA will push ... processes and frameworks to their limits. ...



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provides a narrative and visual overview of VM-20 requirements. The adage, “measure twice, cut once,” can be recast as, “form requirements twice, implement once.”

ONE AND MANY

Many frameworks and processes exist to meet current requirements. PBA will push these processes and frameworks to their limits due to a significant increase in volume such as more scenarios, more sensitivities and more model runs to quantify assumptions and margins. A simple question to ask is, if your cash flow testing had to meet the same timeline as current statutory reporting and other demands such as governance, audits, accuracy, granularity and explanations to management, what would break? What if cash flow testing were run dozens of times? What would it take to make it work? The current framework may be sufficient if a process is run one time but insufficient in a PBA framework if the process will be run many times. Thus it is important to not only ask can it be done but how. The how can be measured in terms of cost and resources.

LEVERAGE EXISTING COMPETENCIES

A PBA framework is more than a model and spans processes, culture and business strategy. A company will want to leverage competencies from both financial reporting and cash flow testing functions. Each serves different needs and each has different strengths. Stochastic analysis, assumption setting and dynamic formulas, and non-premium/benefit cash flows includ-

ing assets have historically been the domain of cash flow testing. However, cash flow testing may have been in non-production environments under moderate time constraints with pass/fail outcomes using models with approximate and conservative methods and assumptions. Financial Reporting exists in Sarbanes-Oxley or Model Audit Rule environments with standards and rigors of being precise, auditable, timely and insightful. Reporting receives the attention of management, auditors and analysts regarding earnings, explanations, planning, decision making and constant comparisons of forecasts to actual results. However, reporting may lack the infrastructure and capabilities required to gather experience data, set assumptions and model and explain stochastic results.

YOUR MOVE—PBA STRATEGY

Bridging gaps leverages internal core competencies. An internal-only view does not provide a complete perspective necessary to formulate a PBA strategy and decide your moves (i.e., construct your Road Map). Road Map choices regarding capabilities or when to sequence PBA implementation activities must also reflect anticipated competitor actions such as launching new products. How and when will you respond? Will you be a first mover? How will your distribution channel react? These are questions senior management should ponder today. Internal strategic discussions between management, marketing, operations and accounting are critical to formulate your PBA strategy. Besides product development another item to incorporate into your PBA strategy is the impact on capital and risk management strategies including actions by both direct writers and reinsurers.

MOVING TARGET

Another frequently asked question is, “why begin now—VM-20 will be changed and has numerous proposals under discussion such as aggregate versus individual margins.” We remain steadfast in our advice—construct your Road Map now. Your business



requirements and PBA strategy should be high level and flexible to have much the same look now as in a few years. The conclusions, sequencing and details of the implementation activities may change considerably but your strategy on why and when to adopt, launch products, reflect PBA in business plans and incorporate VM-20 into managing the business will not. Your Road Map will be comprised of many foundational improvements to your current work activities that will have immediate benefits with or without VM-20. Other changes such as a delay in VM-20's effective date will stretch out your timeline of when you begin, work on and complete implementation activities, but your strategy should be able to adapt to changes in details.

ONE GUIDE, MULTIPLE PLANS

Will one shoe (Guide) fit all sizes? Wherever a company may be on the spectrum of today or tomorrow's demands, challenges, resources and capabilities there are common elements in implementing and operating a PBA framework. The scoping and road mapping exercises will be fairly similar across a broad range of

companies. Potential considerations and questions to ask are similar, but which considerations are important or even applicable, and the answers to the questions will be unique. Thus, the frameworks, practices and maps will be unique as well.

Yes, one Guide fits all sizes, and yes, the Guide will lead companies down divergent paths. By rearranging templates, redefining categories, renaming labels, modifying considerations, reducing and adding detail, adjusting timelines, resources and sequencing, the tools and templates are transformed into something useful to the only company that matters—yours. And like if you were going to Paris or Rome, enjoy a successful trip. ■

References

Cardinal, Tim and Stockman, Steve. 2013. *PBA Implementation Guide*. Society of Actuaries.