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Update on Regulatory Developments

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OVERVIEW

This is a quarterly update on developments at the National Association of Insurance Commissioners (NAIC), the International Association of Insurance Supervisors (IAIS), as well as other groups who may get involved in group supervision, with emphasis on those that may be important to members of the Financial Reporting Section.

The Life Actuarial Task Force (LATF) met at the NAIC Summer Meeting in August. At that meeting, Commissioner Julie McPeak (TN) recommended that the earliest date for principle-based reserving (PBR) implementation should be changed to Jan. 1, 2017, based on progress to date and the amount of work necessary to implement the PBR framework, but no final action was taken. We report below on a few other items that may be of interest to members of the section.

The Capital Adequacy Task Force (CATF) also met and heard a proposal for new risk-based capital (RBC) C-1 charges for corporate bonds.

On the international side, the IAIS issued two sets of principles to be used in the development of Insurance Capital Standards (ICS) for Internationally Active Insurance Groups (IAIG) and Higher Loss Absorption (HLA) requirements for Globally Systemically Important Insurers[1] (G-SII). In time, these will replace the current Basic Capital Requirements (BCR) formula.

LATF MEETING AT THE NAIC SUMMER MEETING, LOUISVILLE, KY., AUG. 14 AND 15, 2014

We report here only the highlights of the meeting; complete details are in the minutes produced by the NAIC and available on its website. There was also forward progress on many ongoing projects, but without notable landmarks; we do not report on those.

New Valuation Mortality Table

Mary Bahna-Nolan (American Academy of Actuaries (AAA) Life Experience Subcommittee) reported that the proposed 2014 VBT mortality table was proceeding more slowly than planned. Basic rates have been released, but the relative risk tables are still being worked on. The table is unlikely to be complete for 2014. There was discussion of the NAIC providing more support to the subcommittee so that the substantial volume of work needed to develop a new valuation mortality table would not be entirely borne by AAA volunteers.

VM-22 Working Group—Kansas Field Tests

Mark Birdsall (VM-22 Working Group) reported on the Kansas field tests. The group noted a practical need to limit the number of scenarios and is devising a representative scenario methodology with five key risk drivers (21 scenarios,[2] with weights to represent their relative probabilities). This work is not finished, but shows serious potential.

The working group had many practical observations based on (a) how valuable the benefits were compared to the price charged for them, (b) differences in experience based on tax qualified/non-qualified status, (c) the size of the business, (d) subsidies inherent in joint-life annuity options, and (e) in-the-moneyness of the guarantees. They asked LATF for guidance on whether or not these factors should be recognized in the reserve calculation.

Finally, they noted areas where VM-22 has not addressed basic issues, such as the valuation interest rate for very large contracts sold on one day (such as large longevity risk transfer transactions).

Small Company Exemption from PBR

Regulators remain generally favorable to a small company exemption, but think that $300 million of premium (the current American Council of Life Insurers (ACLI) proposal for a company to qualify) is too high. ACLI countered that lower levels may lead to PBR not getting the minimum support needed to become effective.[3] The chair asked ACLI to craft a compromise position with an exemption level of $50 million or $100 million, possibly with a sunset clause of about five years.

FRAMEWORK FOR CAPTIVE REINSURERS FOR XXX/AXXX BUSINESS

At its summer meeting, the NAIC adopted in principle the XXX/AXXX Reinsurance Framework recommended in the June 2014 report written by Rector & Associates. There are many details to be worked out, but the immediate steps are three:

1. Develop an XXX/AXXX Reinsurance Supplement to be filed by insurers starting with the 2014 annual statements. The current proposal would require schedules setting out the following information for each transaction:
    a. Assuming insurer
    b. Reserves ceded
    c. Reserve credit taken by the ceding insurer
    d. Summary of assets for the assuming insurer
    e. Securities and collateral
    f. Affiliate or parental guarantees.
2. Develop a *Financial Analysis Handbook* section on review of XXX/AXXX transactions to be used starting with the 2014 year-end.
3. Develop the actuarial method for PBR, including (a) a definition for the level of primary security (a concept similar to economic reserves, which are backed by admitted assets, whereas statutory reserves over that level may be backed by alternative assets, such as letters of credit meeting certain standards), (b) incorporation of changes in mortality tables developed by the AAA, and (c) a clear statement about whether the net premium reserve (NPR) is kept as a floor (possibly in a modified form) or eliminated.

As a result, LATF is developing two new actuarial guidelines:

1. AG47, to require the Appointed Actuary to qualify his/her opinion on XXX/AXXX reserves subject to a financing transaction unless the transaction complies with the framework. This has met with resistance from the AAA, who points out that the purpose of the qualified opinion is to certify reserves, not deal with regulatory issues that are not directly reserve-related.
2. AG48, to provide guidance to actuaries on calculating the Level of Primary Security.

INDEXED UNIVERSAL LIFE (IUL) ILLUSTRATION REGULATION

At the Summer Meeting, LATF heard a proposal from ACLI on regulations for IUL policy illustrations. The task force also heard a request from a group representing four companies (the G4)—New York Life, MetLife, Northwestern Mutual Life and OneAmerica—that LATF defer exposing the ACLI proposal until they could submit an alternative proposal. The G4 believe that the ACLI proposal did not go far enough in remediating problems with IUL proposals, and they wanted LATF to expose both proposals at the same time. The chair agreed.

At a phone call on Sept. 18, the G4's proposal, together with ACLI's amended proposal, were discussed. ACLI's amendments from its previous proposal were to:

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- Require an alternative illustration with values midway between the guaranteed and illustrated values, as an example of what could happen if illustrated returns were not achieved.
- Cap the return illustrated in any one year at 10 percent.[4]
- Require an alternative illustration with the cap coming down to minimum levels evenly over four years.
- Add instructions on what to do if 25 years of historical returns are not available.[5]

ACLI stated that its new proposal was approved by a super-majority of member companies and by the ACLI board. It expressed reservations on the analysis underlying the G4's "risk-neutral" approach (see below).

Bobby Samuelson (MetLife) stated that his company did not sell IUL, not because it finds fault with the IUL product, but because it did not want to operate in a market where it found serious fault with the way IUL products were illustrated. He gave five examples of ways in which IUL illustrations can be misleading:

- IUL is not VUL. The investment earnings credited to the policyholder are the general account return (possibly less a spread), converted into an equity option strategy. Illustrations that look back 25 years are based on general account returns that average roughly 8 percent, compared to the current 4 percent. Whatever means is used to convert those returns into the equity option strategy return, the starting point overstates (by a factor of two) what can be expected in the immediate future.
- The assumption that an equity option strategy returns more than investing in the equity market directly is viewed by many as flawed. (Ed. Note: This is the point that ACLI is disputing). He cited research showing that buying calls does not add value over time. CalPERS' recent announcement that it was getting out of hedge funds (because they don't add value) was also given as an example. Historical research from the 1990s (when options were seriously underpriced and markets rose sharply) has turned out to not be sustainable.
- Some illustrations are calculated using leverage, which produces better returns on mean equity returns, but can seriously reduce performance in years when equity returns were negative. An example was mentioned where if the actual earnings had been zero in only one year, the policy would have lapsed.
- The illustrations don't show the customer the opportunity cost of not investing directly in the equity market (essentially the comparison between VUL and IUL). That makes for an incomplete comparison.
- The structure can be easily gamed. For example, a company could construct an index by looking at historical data and choosing the asset strategy that performed the best over the 25-year look-back period.

Both proposals were exposed for comment.

The factors that were exposed appear generally a bit higher than the previous, but they are more granular. …

PROPOSAL TO REVISE CORPORATE BOND C-1 CAPITAL CHARGES FOR RISK BASED CAPITAL (RBC)

The NAIC has been overhauling its C-1 capital factors for RBC.

At the summer meeting, the AAA, working with Moody's Analytics, proposed a new set of charges for bonds. The factors that were exposed appear generally a bit higher than the previous, but they are more granular and should result in a sharper distinction between portfolios with different rating distributions (even if all bonds are investment grade).

In 2013, the AAA, also working with Moody's Analytics, had proposed a new set of charges for commercial mortgages. Those factors were materially lower than the previous factors. In addition, they made provision for common items such as mezzanine financing, which had heretofore been relegated to the dreaded "all other" category with the maximum charge of 30 percent.

At the 2014 Valuation Actuary Symposium, Colin Devine (Jefferies LLP), an equity analyst, commented that the first version of RBC had forced many life insurers out of the real estate market by increasing the capital costs on real estate investments. He added that the new C-1 factors greatly reduce the capital costs, and should allow life insurers to return to real estate, a natural investment class because of their long liabilities.

IAIS INSURANCE CAPITAL STANDARD PRINCIPLES FOR IAIG AND G-SII

The IAIS is due to release the specifics of the BCR formula by the end of 2014. This is the first step in developing group-wide global ICS. The second step is developing HLA capacity requirements for G-SII, scheduled for 2015, and then group-wide risk-based ICS, in 2016. The risk-based ICS are expected to replace the BCR, whose factor-based approach was described in the September issue.

The failure of a G-SII could result in significant costs to the financial system and to the overall economy. The HLA is designed to make the G-SII "internalize" some of those potential costs. Put another way, the higher capital held by the G-SII serves as a cushion to absorb losses that would have been absorbed externally, up to the level of the HLA requirement. Reports from observers at the International Actuarial Association[6] meeting in London are that the HLA could increase capital requirements by about 20 percent.

The IAIS comments that "the HLA should be set at a level that offsets any advantage that may be expected to arise from the G-SII designation. Through internalizing external costs, HLA may lead to a reduction in systemic activities as they become more expensive and therefore less attractive." Your author interprets this as follows: The higher capital requirements for G-SII create both a reputational advantage and a higher cost of capital (which ultimately leads to higher premiums or charges to the customer).

As a first step, in September 2014, the IAIS released the principles to be applied in developing ICS and HLA requirements. They are summarized below; the full set of principles can be found on the IAIS website, iaisweb.org.[7]

ICS Principles

1. ICS are consolidated, group-wide standards for capital adequacy. The definition of capital required and capital resource reflect the risks of the entity regardless of its location. They incorporate (a) consistent valuation principles for assets and liabilities, (b) a definition of capital resources, and (c) a measure of risk-based requirements.
2. ICS have two objectives: policyholder protection and enhanced financial stability.
3. ICS are the foundation of HLA for G-SIIs. Until ICS are defined, the BCR is the foundation.
4. ICS reflect all material risks of the IAIG. ComFrame will address non-quantifiable risks.
5. ICS are designed for comparability of outcomes across jurisdictions, to enhance understanding and confidence, to create a level playing field, and to minimize capital arbitrage.
6. ICS are designed to promote sound risk management.
7. ICS promote prudent behavior and minimize procyclical behavior (e.g., high sales of high-risk products in economically good times).
8. ICS are designed to be granular enough to reflect risks, but simple enough to be practical.
9. ICS produce transparent results.
10. The ICS capital requirements are calibrated to a level deemed appropriate by the IAIS.

HLA Principles

1. Outcomes should be comparable across jurisdictions. For example, different HLA requirements are allowed to reflect different reserve standards in different jurisdictions.

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2. HLA requirements should address the specific risks that caused the entity to be designated a G-SII. They need not be limited to those risks.
3. HLA should cause some "internalization" of the risks they pose to the financial system. IAIS recognizes that internalization may make G-SII more expensive and less attractive.
4. HLA requirements should work, and remain valid, across a variety of economic conditions, including stressed conditions.
5. HLA requirements are based on a "going concern" assumption.
6. HLA requirements must be met by high-quality capital.
7. HLA requirements are designed to be granular enough to reflect risks, but simple enough to be practical, and communicable to external parties.
8. HLA requirements should be consistent over the range of insurance and non-insurance entities they will cover over time.
9. HLA requirements should be as transparent as possible.
10. HLA requirements will be refined with experience developed in field testing. ■

ENDNOTES

[1] As of early October 2014, nine companies are designated G-SII by the Financial Stability Board of the G-20: Allianz SE, American International Group, Inc., Assicurazioni Generali S.p.A., Aviva plc, Axa S.A., MetLife, Inc., Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc. and Prudential plc.

[2] Base scenario, plus four alternative scenarios (+1, -1, +3, and -3 standard deviations) for each of the five key risk drivers.

[3] PBR can only become effective if it is approved by 42 of the 55 NAIC jurisdictions and if it is approved by states that account for 75 percent of premiums written.

[4] By comparison, variable universal life (VUL) policies may illustrate up to 12 percent in any one year.

[5] This modification was in response to an AAA comment, not related to the G4's views.

[6] Courtesy of Tom Herget.

[7] The ICS principles are at *http://www.iaisweb.org/db/content/1/23178.pdf*, and the HLA principles are at *http://www.iaisweb.org/db/content/1/23179.pdf*.