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Session 78OF
Current Statutory Reporting Topics for Life and Annuity Products

Track: Financial Reporting

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Summary: This session provides background and updates on a number of statutory reporting issues, including statutory codification implementation, Actuarial Guideline MMMM, Actuarial Guideline AXXX and implications of the movement to the 2001 CSO table. At the conclusion, attendees have a better awareness of the issues that will impact statutory financial reporting and are more prepared to address year-end statutory financial reporting matters.

MS. MEREDITH A. RATAJCZAK: Welcome to Session 78, Current Statutory Reporting Issues for Life and Annuity Products. There are two objectives for this session. The first objective is to provide a summary of and some comments related to a number of current statutory reporting issues for life and annuity products. We're going to talk about annuity and life reporting issues and cover a lot of topics in a short period of time. Our second objective, in light of the recent accounting scandals, is to provide an overview of the changes in public company oversight and how they might impact statutory reporting for us as an industry.

I am going to share the podium today with Harry Shissler. Harry has worked in the life insurance industry for 18 years. He's been a consulting actuary with Ernst & Young for 10 years. Prior to that, Harry worked as a company actuary, developing his expertise in product development and financial reporting. Harry's work at Ernst

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& Young involves advising clients with respect to financial reporting issues, actuarial modeling and pricing. Harry also advises Ernst & Young actuaries and clients regarding emerging life insurance regulatory issues.

I've been a consulting actuary with Milliman for 15 years. As a principal, I co-manage the Hartford Life Consulting practice. My areas of expertise include statutory reporting, cash flow testing, mergers and acquisitions, demutualization, pricing and product development.

I delivered a presentation similar to this one to the Milliman Life actuaries in September and moderated a session at the Valuation Actuary Symposium covering just this material. I learned that there are some pretty significant issues out there. As our economy continues to be in a state of turmoil, these issues will get even bigger.

The other thing that I noticed is there seems to be a renewed focus or interest in looking at statutory reporting from a longer-term perspective. We have some issues right now with the way our regulation works, so there are some longer-term projects on the horizon that may possibly address some of them.

I'm going to talk about the annuity topics and Actuarial Opinion and Memorandum Regulation (AOMR). Harry will cover the life topics and longer-term perspectives in relation to current events. These topics are those being considered by the NAIC, as well as current events. Specifically, we'll talk about variable annuities in the context of guaranteed benefits, reserving for those and calculating risk-based capital (RBC). We'll discuss GICs with bailouts, nonforfeiture for life and annuity products and some AOMR issues. We'll also cover possible updates of the standard valuation law, the 2001 CSO, some other mortality considerations, universal life (UL) secondary guarantees, the Liquidity Risk Report, policyholder dividend liability, the Long-Term Care Guidance Manual and the revisions to the Generally Recognized Expense Table (GRET).

On the annuity side, the topic is variable annuities with guaranteed benefits. In relation to reserving for these contracts I think it's fair to say that the old Actuarial Guideline MMMM is definitely dead. In the fall of 2002, the Life Insurance and Annuities (A) Committee will hold a conference call to consider adoption of the revised Actuarial Guideline MMMM. If adopted, it will go to the Executive Plenary Committee at the 2002 winter national meeting of the NAIC.

The October 17 draft—the most recent one—uses an accumulated charges approach to reserving for variable annuity guaranteed living benefits (VAGLBs). If there are no explicit expense charges, one needs to impute a charge to calculate the reserves. The old draft was quite complicated, and used a stochastic approach.

The draft, which defines reserves for contracts with variable annuity guaranteed living benefits, is composed of two pieces. The first piece is the aggregate reserve

for the VA contract, ignoring both future revenues and benefits related to the living benefits after comparison to the cash value.

The second piece is the VAGLB reserve, which is the sum of the accumulated aggregate VAGLB charges. You accumulate the charges for the in-force business with the living benefits at zero interest from the date of issue to the date of valuation. I will stress again that the second piece is on top of the reserve for the base policy, which has the cash value floor. Reinsurance is reflected in this calculation.

The other component of the revised guideline is that it will require a stand-alone asset adequacy analysis. This is where you talk about the adequacy of the VAGLB reserves that are held, based on the VAGLB benefit levels. This analysis should reflect all VAGLBs, expenses and charges. The VAGLB reserve is actually held in the general account. The asset adequacy analysis will reflect any reinsurance.

As I indicated, there will be a call in late October 2002. It's expected that this particular draft will be adopted and will go to the NAIC at the winter meeting. It will be effective for year-end 2002 for all business issued on or after January 1, 1981. This is expected to be an interim short-term solution, likely through the end of 2004.

What drives this as a short-term interim solution is that on the flip side, you look at calculating RBC for these contracts. An independent group is currently looking at the RBC requirements related to these contracts. Take a step back and look at where we are today on RBC for minimum death benefit guarantees and variable annuity guaranteed living benefits. There's no specific explicit provision related to RBC for guaranteed minimum death benefits (GMDBs) and a factor approach for VAGLBs. Looking at the aggregate reserve for these contracts and the nature of the guarantees, whether they're considered high-risk or medium-risk determines which factor to apply to the reserve to calculate the RBC.

The current approach to RBC is not considered to be the best approach, so the C3 Phase Two Committee is looking at a more appropriate RBC calculation methodology for GMDBs and VAGLBs. This particular approach looks at a stochastic way of doing the calculations and is based on a test with the modified conditional tail expectation.

Starting off with zero surplus, you will project profits or loss under each one of these stochastic scenarios. Then, take the present value of the profit or loss. Using the actual 90 percent number, take the worst 10 percent and calculate the arithmetic average. Then, take the difference between that amount and what is being held as reserves for those benefits, and the difference is the RBC.

The C-3 Phase Two Committee's work is expected to be ready for year-end 2003. The reserving requirements in Actuarial Guideline MMMM are considered to be an

interim short-term solution. The work being done by the C-3 Phase Two Committee looks at a more robust approach for calculating RBC on these benefits. Given that information, a new committee has been formed, which has put both of those committees together.

They're taking a longer-term look at the appropriate reserving for contracts with these benefits and trying to come up with a methodology that not only covers reserving but also covers RBC. They want it to be a longer-term solution that reflects the innovative nature of the contract and benefits that are being developed each and every day.

Some of the issues with Actuarial Guideline MMMM may include the fact that people are developing new and different benefits with special features that didn't quite fit into some of the stochastic methods they originally discussed. They are looking at the approach that incorporates both RBC and reserving requirements.

Turning to GICs with bailouts, the most recent draft that I've seen for this particular actuarial guideline was from March 2002. It's written in response to the issues related to GICs that have downgrade and put provisions. The NAIC is concerned about the liquidity risk associated with these benefits, so I believe this guideline is up for adoption.

It says that if your contract has these particular options, then you should be using plan type C for valuation purposes; and if the valuation actuary uses something higher than plan type C rates, he or she had better have a solid explanation of why it's appropriate. Given that you will be using lower valuation interest rates on these contracts, the reserves will be higher on contracts that offer these options.

Regarding nonforfeiture on annuities, at one point last year, if you talked about looking at nonforfeiture both on life and annuity products, you'd say, "Oh no, not again." Both the life and annuity committees have actually been very active, holding conference calls at least once every couple of weeks.

Given today's interest environment the push is to lower nonforfeiture rates for annuity contracts. The norm is three percent, which is high in relation to what rates can be earned today.

The ACLI said approximately 15 states have adopted the 1.5 percent minimum interest rate guarantee on a temporary basis, based on the ACLI proposal. I stress that this is on a temporary basis.

The Academy has issued a draft report to look at a couple of things such as finding the right interest rate basis for annuity contracts. They've also been having discussions to determine the appropriate expense loads to reflect. They are questioning the six-month deferral on paying out nonforfeiture benefits.

At the last NAIC meeting the ACLI shared a proposal that tied the minimum interest rate to a five-year Treasury rate less 2.5 percent, subject to a minimum and a maximum. The most recent draft that I saw of the annuity nonforfeiture law was from October 4, 2002, and there was a subsequent conference call on October 10, 2002 to talk about that. The current draft will give companies a choice of two interest rates, either the lesser of three percent or the two-year constant maturity treasury rate, or 2.25 percent.

In that conference call there were discussions about providing for a maturity period longer than two years. There were some discussions on the part of the ACLI about looking at the history of the two-year Treasury rates in down interest environments. They have determined that it is not favorable enough from a nonforfeiture perspective. They are considering the appropriate expense loads and the six-month waiting period to pay out surrender benefits.

There has been a lot of interesting discussion related to the revisions to the Opinion and Memorandum Regulation, which were adopted by the NAIC. The substantive changes were the elimination of Section 7 opinions. They did not necessarily mandate what interest scenarios are used, but left it up to the appointed actuary to determine the right interest scenarios. The NAIC is also talking about allowing states to accept a state of domicile actuarial opinion.

Some states are taking action, most of which is in a discussion related to codification, the AOMR and the fact that states need to adopt it. There was a conference call in October 2002 related to this issue. I don't know what the buzz is in all of the states, but I heard that New York will require all category C companies (those with $100 million-plus in assets) to do a Section 8 opinion at the end of 2002.

I also heard that Pennsylvania will not adopt the AOMR changes; however, they view them as part of the codification. Therefore, they fall under the disclosure requirements, so if an actuary files a Section 7 opinion, he or she will have to disclose the implications. The only way that somebody can quantify the impact is to do Section 8 type of testing. So, there are still a lot of questions in the air. After we're done I welcome any regulators in the audience to step up to the podium and provide us with insights regarding how your states are looking at the differences between codification and the confusion related to the AOMR changes.

My last discussion point is related to revisions to the standard valuation law. A new committee has been formed to look at longer-term changes to the standard valuation law, which will hopefully simplify regulation and provide a better framework for the innovative products that companies are developing today. They say that it's going to look at not only reserving, but also at solvency.
This is RBC and reserving, so they'll probably start with unified valuation system (UVS) principals, because a lot of good work was done when the UVS team was looking at this a few years ago. Given the timeframe on that project and what it

took to get people on board, I view that as a very long-term project, and a necessary one. Now I will turn the floor over to Harry.

MR. HARRY R. SHISSLER: Thank you Meredith. I remind everyone that this is an open forum and the answers to questions may well lie somewhere in the collective knowledge of this room, so I encourage everyone to ask questions as well as answer them.

As anyone who has ever dealt with regulations knows there are two levels. The top level looks at the fundamental or spirit of the regulation and the detailed level is intended to close the loophole. The devil is in the details and my hope is that we can capture the spirit without raising the devil.

As Meredith mentioned, I've been asked to keep in touch with the regulatory issues. Meredith has already covered the annuities and the AOMR, so I'm going to cover the life insurance current events. Then I will move on to some of the more global current events and relate them back to a more localized regulatory arena.

The hot regulatory topics in life insurance that I'm going to discuss are developments with respect to the 2001 table and issues concerning updated inter-company mortality, as they affect all types of actuarial models. Nonforfeiture issues regarding secondary guarantees are probably the most controversial topics on the agenda. The NAIC has taken some measures to address the liquidity risks and we'll mention what they have done. Finally, we'll turn our attention to demutualized companies with closed blocks of policyholder dividend obligations (PDOs).

The 2001 table seems to be finally destined to become a reality. This is a result of a commendable effort on the part of the good actuaries of participating companies, the Society of Actuaries, consultants and The Life and Health Actuarial Task Force (LHATF) who drafted the model regulations to implement the table. LHATF and its parent, the Life Insurance A Committee, adopted it during the fall NAIC meetings, so it's a safe bet that it will be adopted during the winter meeting of the NAIC. This means that states may begin to put it into their regulatory books in 2003 and companies may start to file new products on this basis. It will become mandatory in 2009.

A very interesting and useful document that discusses implementation issues was drafted by the Academy. It's available on their Web site (http://www.actuary.org), and it's an excellent starting point for those actuaries who are asked to price new products on this basis, as well as those with valuation concerns.

In order to use this table you will have to do a Section 8 opinion. This was championed by the Illinois department. It's not without basis, and the table won't be adequate for about 25 percent of the companies.

There is a legitimate concern that companies without stringent underwriting standards could develop inadequate reserves. Another somewhat late revision or deletion was to remove the requirement that in order to use the table you had to contribute experience. This was something that some regulators wanted, given that the number of companies contributing to the experience base was dwindling.

Secondly, regulators wanted to gain confidence that the table would be adequate. We've heard that some regulators will ask for your experience, so you should at least retain this in the level of detail required by the Society of Actuaries in case they ask.

Also worth pointing out is that although this loading scheme is consistent with the 1980 CSO, since the mortality has improved and the base mortality is therefore lower; the margins, which are a function of the base rates, will be reduced. Another concern has to do with nonpreferred classes, since preferred classes are in effect skimming the cream off the top. The 2001 table may not be appropriate in all cases. Although you might be okay in the aggregate, if you are if not in the preferred market, you may get selected against.

What this all means for AOMR reviews is that you will have to put more emphasis than is appropriate on arguments with respect to mortality assumptions. You should see reduced adequacy in reserves because of the mortality margins that will put a strain on the results. That's an area in which regulators are going to keep an eye, particularly where mortality margins are significant or there is a significant proportion of profits such as term insurance.

You may say that now we have the answers. For pricing, there are the '90/'95 tables. They are materially flatter and have nice improvements that are embedded in the 2001 table. That is not exactly so. Mortality doesn't get better just because of a new release in the table, and regulators know this as well. The moral of the story is that the mortality shouldn't get any better just because you use a new experience table. If anything, the reserves in AOMR demonstrations will be less strong as the 2001 table emerges.

Moving on to Actuarial Guideline AXXX. As some astute actuaries quickly noticed about Regulation XXX, there were some potential loopholes in it. Actuarial Guideline AXXX was born out of the perceived loopholes, which are derived from the literal interpretation of regulation XXX. Some examples are spelled out in AXXX policies that essentially have an n-year guarantee period, but contract language alleviates the guarantee when interpreted in the literal sense.

An example is that an initial premium rate is guaranteed for 10 years, followed by increased guaranteed premiums for an additional 20 years. However, the company cannot increase premiums after 10 years. That is, unless the initial premium continues being charged, or some specified event occurs. Other things are reinsurance deals that transfer the guarantee risk to the reinsurer, guaranteed

dividends or guaranteed refund scales and universal life with shadow account values.

Basically, the idea of AXXX is that you can't dress up a product in order to disguise or evade XXX. The draft was adopted in 2002 by the A committee. It's on its way to approval by the end of 2002. Since it's a guideline, we'll have to abide by it.

There's only one provision, as I understand, that has a prospective application only in nature. I think it relates to Case 8. In all other cases we're dealing with retrospective as well. Of course, it wouldn't go back to the prior financial statements, necessarily.

Actuarial Guideline XYZ is on the radar screen, and although it is not as imminent as Actuarial Guideline AXXX, until recently there was quite a lot of disagreement and controversy about this guideline. This might be an oversimplification, but there are really two camps here. Camp A believes that you shouldn't be able to write term to 100 with a universal life contract and Camp B says that you can do anything you want with a universal life contract. That's what the policyholders are demanding.

At the fall meeting, an interested party approached the NAIC, i.e. LHATF, and proposed a compromise regulation. It's now being considered and my understanding is that it has a much better chance than the prior version.

The next area we're covering is liquidity risk, and this is an issue that would thrust itself on to the regulators as a result of overaggressive provisions afforded by institutional GICs. The Academy issued a white paper discussing the issues. Basically companies that write these liabilities will have to provide information on the activities to regulators. Also there are some additional schedules to fill out if you're engaged in this market.

The codification working group asked LHATF for advice with regard to whether a policyholder dividend obligation (PDO) should be established. The task force said yes. The excess of the closed block book value of assets over the closed block book value of the liabilities should be established as they are basically committed to the closed block policyholders.

A couple of other things have been put out recently. The B committee has adopted the Long-Term Care Guidance Manual. It takes the position that minimum loss ratio requirements are inappropriate and rate filings need to take an approach that is more appropriate. This really puts the onus on the actuary responsible for rate filing to demonstrate that the rates will be reasonable and will work.
Finally, the 2003 GRET is of interest. No one really wanted to do it, or had time to work on it. Eventually it was completed. The basic conclusion is that the expense factors are somewhat higher. This will have illustration actuary implications.

Now, shifting gears and turning to the big picture, none of us are immune to the

recent events and the fallout from the accounting controls gone awry. If nothing else, we all had to face the fact that something like this could happen to any one of us. To categorically say no is to kid ourselves. We need to re-think some things, which is the positive side that we can take from this.

Of course, there will be more scrutiny. Accounting practices and financial reporting must be re-engineered. There needs to be more disclosure. New requirements have emerged in public accounting in the form of SEC proposals. These will impose new financial requirements. The Sarbanes-Oxley Act mandates that management certifies the accuracy and completeness of financials. Things must be done at a faster pace; additional disclosures must be more timely.

To a greater degree than companies in other industries, insurers are faced with making numerous significant accounting estimates. Several of these estimates could meet their criteria for disclosure under the SEC proposal. The rule proposal does not set a minimum or maximum on the number of critical accounting estimates to be discussed. The SEC believes that few of the companies' accounting estimates would be considered critical, but that very few of them would have none at all. The SEC expects the number to vary, but notes that the vast majority of registrants would have three to five critical accounting estimates.

In essence, the disclosures amount to the reason different estimates would have been reasonable. Quantification of the sensitivity of financial results to reasonably possible changes in the most material assumption underlines the estimate. There is quantitative and qualitative information about material changes in the estimate during the period for which financial statements are presented. Also, a statement is made as to whether or not management discussed the development, selection and disclosure of the estimate with the audit committee.

How can companies respond? In recent years, many insurers have made improvements to their financial statements' closing process. However, the accelerated GAAP filing deadlines will require companies to further streamline and automate their actuarial evaluation and financial reporting process. The ultimate solution may require a combination of initiatives, such as technology and process automation solutions, process improvement, re-engineering efforts, additional staffing at peak times, moving up the cutoff dates and greater reliance on estimates.

While a number of companies have made progress in accelerating the closing process, there has not been much progress to date in accelerating, automating and improving the management reporting and performance analysis process. It is critical that management understand the profitability drivers and the sources of profit, as well as the variances from expectations and the root causes of such variances.

Let's bring this back to the context of the statutory framework. It's really no

different than the GAAP framework. You must make timely and significant assumptions and use methods that are appropriate. We must assess the economic scenarios that are the most material under the circumstances of the company.

We must know which sensitivity tests are most appropriate and actuaries' work must be available for peer review, both internal and external. Finally, it is critical that this gets into the hands of management and is presented in a way that's meaningful to them. The parallels to codifications goals were uniformity, speed-to-market and the preservation of state-based roles. However, there are some realities such as additional disclosures, the enforceability issues and the self-regulatory character. There are gray areas.

The future of statutory reporting should also be considered. We are moving away from a world in which everything is captured by a formula and is explicit in the SVL. Nonformulaic approaches are being developed and clearly have strength in that they allow for a better assessment of risk. They do, however, expose the valuation actuary to risk, since he or she is responsible for the assumptions and must do everything possible to see that they're appropriate. Also, he or she must speak in a way that management understands the conclusions. That's the end of my remarks.

MR. WILLIAM J. SCHREINER: I'd like to make a couple of observations. First, this regulation would require adoption by each of the states to be effective.

With respect to AOMR, Meredith, I've been told the same thing by the New York State actuaries, that they will require Section 8 opinions for companies over $100 million. Also, there's one other aspect with respect to the implications of codification. Codification requires that disclosure only if it's a material difference on business written since 2001. So, it may well be that an actuary concludes that the difference between a Section 7and a Section 8 opinion may not be material and therefore does not have to be disclosed.

MR. SHISSLER: The issue, though, is how does one know it's not material?

MR. CHRIS I. NOYSE: Which would take precedence, the AOMR or the new CSO regulation? I ask because the new CSO regulation says if you're using a table you have to do asset adequacy analysis to put that in the opinion, and you have to do an opinion. Then the AOMR says you obviously have to do an opinion as well. Neither one is officially adopted yet. Do you have any ideas on that?

MR. SHISSLER: Ultimately the AOMR will start to go into effect. I'm not sure of the timing, but it does sound like both of them are pushing toward a Section 8. There will be some limited single state exemptions, which what they're saying is if that's the case and you use the 2001 table, you'll have to do a Section 8 opinion. That's the intent of the language in the 2001 regulations.

MR. NOYSE: We could meet a situation in which a company could be still using the 1980 CSO, but if the AOMR goes into effect, its actuaries couldn't point to the 1980 CSO and say they are not using the table yet, therefore they don't have to do an opinion. Then AOMR would take effect.

MR. SHISSLER: If AOMR has been adopted by the state, then it would be in effect.

MR. MARK J. FREEDMAN: Meredith, I'm curious about your feeling on some of the moving parts in the guaranteed minimum income benefit (GMIB) reserves. For example, which CTE level do you think companies will use for reserves and what approaches do you think they will use for mean and standard deviation? If there are any regulators in the room, I'm curious what your take is on this.

MS. RATAJCZAK: From a reserving standpoint, and looking forward to what the committee is reviewing, if you're looking at it from the type of testing that they're talking about or related to the C-3 Phase Two, from the standpoint of looking at reserving as opposed to RBC, I hear the number 65 percent CTE for reserves and 90 percent for RBC.

MR. FREEDMAN: How about mean and standard deviation? The Canadian approach uses a historical look at that. Where are the actuaries headed here?

MS. RATAJCZAK: I haven't seen anything related to specific numbers regarding mean and standard deviation.

MR. ROD L. BUBKE: Was there any discussion of a possible RBC C-3 Phase Three? In Phase One, certain businesses were subject to cash flow testing and if you're subject to that requirement and go through that process, first of all, not all business is subject to the testing. However, the results of the testing are then applied to all business.

For example, if the testing implies that you have to double your C-3 component, it not only applies to the components that are tested, but everything else as well. To me, this does not sound quite logical. I wonder if there were any discussions about not only including more business, such as equity-indexed annuities and removing the requirement that the result be applied to all C-3 components, including, for example, the life reserve component.

MS. RATAJCZAK: The focus related to RBC is the C-3 Phase Two work. I'm sure that those issues have been topics of discussion. However, I can't specifically say that I've seen anyone look at a "Phase Three," but I suspect that when they get done with Phase Two their work will not be done.