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AVR, IMR update

by James F. Reiskytl

The mandatory securities valuation reserve was replaced at the end of 1992 by two reserves — the asset valuation reserve (AVR) that now covers the default risk on all assets and the new interest maintenance reserve (IMR).

Several changes recommended by the Industry Advisory Committee in 1992 were approved by the National Association of Insurance Commissioners (NAIC) for implementation in 1992 and 1993. Other issues are being considered for introduction in 1994 or later.

Changes effective in 1992

The most significant change made in 1992 was the approval of a new public common stock maximum factor (effective in 1992) for the AVR of either (1) 20% adjusted up or down by the average beta of the company's portfolio or (2) 30%, if the company elects not to do the beta calculation. (Beta measures the risk of the portfolio relative to that of a standard — Standard and Poor's 500 or other appropriate index for non-U.S. portfolios.)

Changes effective in 1993

Noteworthy changes made in 1992 that will be effective in 1993 include:

- Refining the exemptions for the IMR to include the release of any existing IMR, whether positive or negative, at the time of sale of a block of business (The earlier exemption only covered gains or losses on assets at the time of sale.)
- Clarification of AVR/IMR treatment of most separate account products with guarantees
- Permitting transfers between AVR

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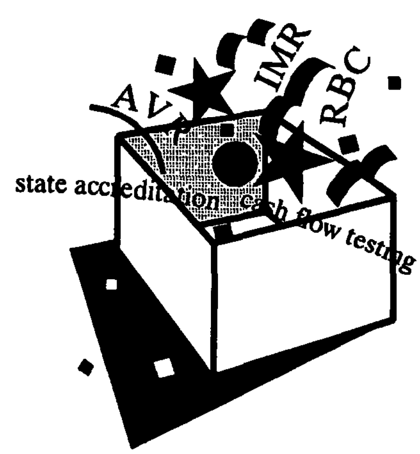
RBC standards part of new regulation package

by Thomas K. Gross



The new risk based capital (RBC) standards adopted by the National Association of Insurance Commissioners (NAIC) at its December meeting ushers in a new era of scrutiny and control by state insurance departments. The standards are just one part of a package of new requirements that will allow the insurance departments to regulate more effectively. Other enhanced regulatory features are cash flow testing, state accreditation, the asset valuation reserve, and the interest maintenance reserve. Together, these should help the regulators do their job better and should serve as a cornerstone to help improve the industry's public image.

Features of RBC standards formula

The risk based capital standards involve calculation of a company's exposure to the classical categories of risk: asset default, pricing risk, interest rate risk, and general business risk. The formula, an evolution of

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Cash flow testing cont'd

on the company's bottom line. This points out the importance of testing the product when it is originally priced to discover what the profitability of the product is particularly sensitive to (e.g., expenses, mortality, morbidity, lapse rates, earned rates, or mix of business). These items can be monitored, and corrective actions can be taken as necessary.

Communication between the actuaries and investment people and periodic updating of cash flow testing also are important.

Testing alone not a solvency cureall
Will asset adequacy testing prevent all company insolvencies? Of course not. Asset adequacy testing is not solvency testing, which includes company surplus and expected future business. However, it can help. Cash flow testing is a lot of work. As long as it is viewed, however, as an integral part of the management of the company and not just another bothersome requirement that must be complied with, it can improve the solvency of the insurance industry.

Donna R. Claire is president of Claire Thinking, Inc.

Calling U. of Michigan alumni and friends

The University of Michigan and the Alumni Advisory Group are working to revitalize the actuarial program. The goals are to continue the Mathematics Department undergraduate program, which recently has been graduating about 30 actuarial students annually, and to develop an improved master's program in cooperation with the Business Administration School and other units of the university.

To update the alumni list and to receive future notices, those who were not in the actuarial program while at the University of Michigan and all who graduated after 1979 are requested to send address and phone number to: Susan Smith, 48439 Meadow Ct., Plymouth, MI 48170-3256. Other friends of the program also are encouraged to send similar information.

AVR and IMR cont'd

subcomponents (that is, within the default component or the equity component) up to one-half of the positive subcomponent balance
- Classifying certain money market funds as class 1 investments

A proposal to extend the transition period from three to five years and a small company proposal to defer implementation of the IMR to October 1 received considerable discussion but were not adopted.

The advisory committee prepared answers to commonly asked questions about the implementation of these new reserves. This document is available from the Securities Valuation Office of the NAIC.

Possible changes in 1994 or later
The advisory committee is considering more than 30 items for possible implementation in 1994 or later. The most significant of these items (not in any order of importance) are:
- Implementation of the full actuarially based IMR, likely only with a supporting actuarial opinion. In other words, negative values for the IMR will be permitted under appropriate conditions. It may be useful to recall that the IMR is designed to protect surplus from purely transitory changes created by the events lacking economic substance. These so-called losses are transitory and should have no impact on surplus, since the proceeds can be reinvested at higher yields. Restricting negatives does impact surplus.
- Modification of the formula for the AVR contribution to require (a) a basic contribution equal to the expected defaults for each asset type and (b) an additional contribution that amortizes to a target reserve level instead of a maximum. That is, each year the beginning reserve would be increased by the basic contribution (for expected defaults), reduced by actual defaults, and then amortized by 20% toward the target level. Since over the long run actual losses should be about equal to expected losses, this new reserve should approach the target level. This change, if it can be accomplished, should improve consistency. You are likely to be hearing more about this later this year and, although less likely, about possible similar changes in the equity component.
- Recalculation of the mortgage loan default factor by an ad hoc committee to reflect both the delinquency and foreclosure rate and the amount of loss, as well as possible other refinements
- New bond factors — adopt the risk based capital factors as AVR maximums
- Wherever possible, adjust factors or definitions to provide consistency with the risk based capital structure
- New real estate and mortgage factors, reflecting the latest Society of Actuaries studies to be released soon, any other emerging data, and the optional use of appraised values in the calculation of the real estate reserve
- Further possible refinements of exemptions for either reserve based on product risks or other considerations. Specifically, the committee has been asked to review the IMR requirements for assets backing various lines of business, such as surplus, term insurance, or variable products.
- Recognition of the new mortgage loan/real estate classifications introduced in the 1993 annual statement
- Recognition in the AVR of lost interest on mortgage loans, as well as the actual writedowns at the time of default. Whether this is done or not, the AVR factors then must be developed to be consistent with the final treatment of these losses.
- Treatment of investments in investment subsidiaries as though they were investments of the parent, treatment of derivatives after the accounting for them is clarified and established, and further IMR refinements for indemnity reinsurance

The advisory committee welcomes your questions, suggestions, and comments as it completes the implementation of these two reserves. A complete list of current items being reviewed is available from the American Council of Life Insurance to its members or from me at my *Directory* address.

James F. Reiskytl, Chair of the Steering Committee of the NAIC Industry Advisory Committee, is Vice-President, Secretary, and Treasurer of the Society of Actuaries. He is vice president, tax and financial planning, at Northwestern Mutual Life Insurance Company.