2018 Investment Symposium

Session 1A: NAIC Capital Framework: AG43 and C3 Phase 2 Developments

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Actuarial Guideline 43 - Update

SOA Investment Symposium
March 8, 2018

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I’m the auditor, I’m here to help …

Goals of AG43 Update

AG43 is a highly prescriptive Guideline. However, regulators and the industry recognize the challenge of applying a uniform reserve standard to contracts in scope and in particular some of the guaranteed benefit structures. This continues to be true as more complex products are introduced to the marketplace.

- Valuation requires assumptions about product design, contract holder behavior and economic relationships and conditions.
- The economic volatility seen over the last few decades, combined with an increase in the complexity of these products, have made attempts to use these approaches for measuring economic related risk less successful.

Goals of AG43 Update

In 2015, the NAIC undertook an effort to identify changes to the statutory valuation framework for Variable Annuities (VAs) that could remove or mitigate the motivation for insurers to engage in captive reinsurance transactions for VAs

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Goals of AG43 Update

Oliver Wyman issued a report in 2015 identifying motivations based on an industry survey for captive usage:

- Mitigate non-economic volatility in statutory capital ratios
- Align market risk profiles of the funding requirements and the insurer hedge program
- Mitigate funding requirement in down scenarios (net of hedging strategies)
- Optimize exposures across legal entities, taking advantage of potential diversification benefits
- Avoid significant discrepancies between tax reserves and capital requirements that can result in concurrent large tax obligations and increases in funding requirements

Goals of AG43 Update

Subsequently the NAIC commissioned a Quantitative Impact Study ("QIS") to develop recommended revisions to the existing statutory framework

The QIS noted the following observations:

- Extensive hedging often increases total statutory funding requirements
- Full hedging is often penalized while partial hedging produces more optimal results
- Significant surplus erosion can occur from hedge losses in upside scenarios
- Market risk capital is disconnected from actual amount of market risk retained
- Companies' effective funding requirements, i.e. the assets needed to maintain a target capital ratio are difficult to manage

Goals of AG43 Update

In August 2016, Oliver Wyman presented to the NAIC and the VAIWG a set of recommended structural revisions to the existing framework, centered around:

- Mitigating the asset-liability accounting mismatch between hedge instruments and statutory liabilities
- Removing non-economic volatility in statutory capital charges and resultant solvency ratios
- Facilitating greater harmonization across insurers and products for greater comparability

Goals of AG43 Update

With recommendations from Oliver Wyman and industry, the NAIC undertook a second QIS ("QIS II") in 2017 in order to evaluate and parameterize the recommended structural revisions further

QIS II spanned from February to October and comprised two primary work-streams:

- Evaluation and parameterization of the revised framework, excluding Standard Scenario assumptions
- Industry-aggregate experience study aimed to refine prescribed Standard Scenario actuarial assumptions

Findings from QIS II re-affirmed most of Oliver Wyman's CTE-related recommendations, but also led to:

- Significant refinements in the proposed Standard Scenario construct
- Fine-tuning of several parameters in the revised framework

Goals of AG43 Update

Actuarial Guideline 43 has had a principles based element to it.

Principles speak to the ultimate goal of establishing sufficient liabilities to meet the company's contractual obligations. Management should exercise appropriate prudence in assumption setting and modeling techniques. Management is allowed to consider offsetting risks inherent in an aggregate view. However, Management should also step back for a big picture view as to whether risks are appropriately considered and accounted for in the valuation.

These principles are still a part of the updated Guideline.

Goals of AG43 Update

With the underlying principles in mind, updates to the guideline have considered the following themes:

- Maintain robust funding requirements
- Maintain reasonable and appropriate level of risk management
- Promote comparability of results across products and insurers in the industry
- Maintain the current statutory framework where reasonable
- Minimize implementation and operational complexity

The Audit Focus

Understanding the goals of the updated guideline, audit focus is expected to look at four main areas:

- Model design
- Assumption Setting
- Scenario Generator
- Disclosures and Reporting

Model Design

Need to assess:

- Scope of the model, products covered
- Degree of grouping of contracts
- Modeling of guaranteed benefit structure

Assumption Setting

Focus:

- Persistency
- Maintenance expense

Consider:

- Level of conservatism embedded in the assumptions
- Sensitivity testing

Scenario Generator

Scenario Generators

- Allow use of the VM-20 generators for interest rate scenarios
- Allow use for Separate account returns if appropriately calibrated
- Can use a proprietary generator if TAR is not reduced

VM-20 generator is on the SOA website. Always simpler to use the recommended thing.

If alternative is used, consideration will be given to the range of scenarios, level of volatility. How much do the scenarios stress the product guarantees and supporting assets

Disclosures

- The amount and level of required depth of disclosures is expected to increase.
- The actuary will be expected to support the construct of the model and the assumptions chosen.
- Stated goals for the update include improved risk management. Explain how the valuation sufficiently addresses the risk of the underlying products and the assets that support them.
- Goals also include comparability of products across companies. Disclosure will require sufficient transparency