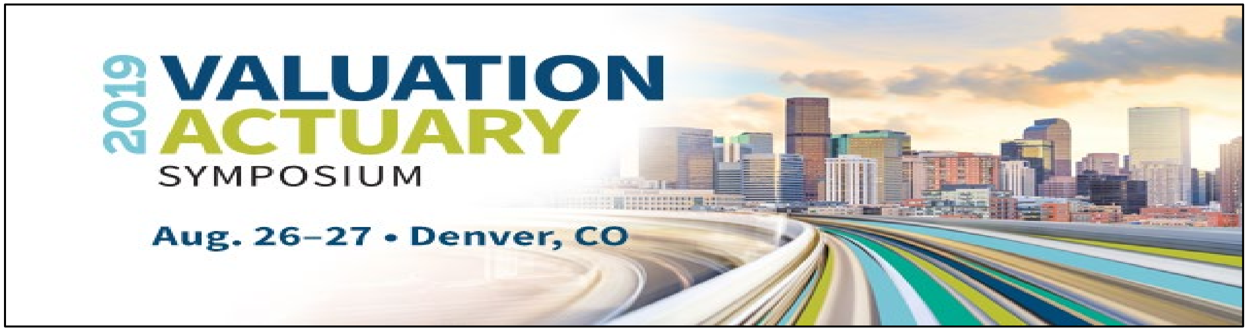

08 - Regulatory Role Play

2019 Valuation Actuary Symposium

PRESENTER NAME: JOHN ROBINSON

Session 08, Regulatory Role Play

August 26, 2019

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PUBLIC SERVICE

What is “public service”?

Wikipedia: Public service is a service which is provided by government to people living within its jurisdiction, either directly (through the public sector) or by financing the provision of services.

Public services are associated with fundamental human rights (such as the right to water).

Examples of public services (15): Courts, Electricity, Education, Emergency services, Environmental protection, Health care, Military, Public transportation, Public buildings, Social services, Telecommunications, Urban planning, Transportation infrastructure, Waste management, Water supply network.

THE ACTUARY AS A PUBLIC SERVANT

Who is a "public servant"?

Collins Dictionary: "A public servant is a person who is appointed or elected to a public office, for example working for a local or state government."

The essay "The Value of Public Service and Why" by Terrence R. Moore opens as follows:

"The famous quote by America's thirty-fifth president, John F. Kennedy, 'Ask not what your country can do for you, ask what you can do for your Country' well embodies and supports inspiration for entering public service."

Questions posed to 7 regulators and 3 non-regulators who work with regulators:

QR1. How is your motivation different from the company actuary's?

QR2. What is the impact of the political environment on our work?

QR1. How is your motivation different from the company actuary's?

Theme 1: Consumer Protection

"The foremost job of insurance departments is consumer protection in contrast to corporations whose primary interest is to maximize the value of their business."
"I am amazed at the extent to which those in public service are motivated by the desire to do the right thing for the policyholder and the public despite what sometimes seem like pretty major obstacles."

"Our tendency is to focus on fair and reasonable premiums that are not deficient such that solvency would be threatened."

"When I worked for a company, I don't recall specifically asking if something was in the interest of the public in general or for the common good. I ask that question frequently now."

QR1. How is your motivation different from the company actuary’s?

Theme 2: Understanding the Company Actuary

“Public service actuaries need to understand that company actuaries can be under pressure to make quarterly earnings look favorable. One lever for increasing quarterly earnings is lowering reserves. Public service actuaries need to add a layer to ensure that enough money is set aside to pay claims, as opposed to being available to pay shareholder dividends.”

“As a company actuary I was not generally concerned with a well-functioning market; rather I was looking to find any advantage for my employer over others.”

QR1. How is your motivation different from the company actuary’s?

Theme 3: Financial Incentives

“The primary motivation cannot be compensation, but rather must come from a desire to act in a just and honest manner.”

“Less incentive means less motivation. DOI’s generally do not set goals (exceeding, target, minimum) with monetary incentives for public service actuaries to shoot for. In a way, this allows public service actuaries to lead a more balanced life.”

QR2. What is the impact of the political environment on our work?

Theme 4: Impact of The Commissioner (aka Superintendent, Director)

"In states where the insurance commissioner is elected, there is a greater chance for political bias to have an influence."

"As with private-sector actuaries, our role is to inform our boss (in this case the commissioner) on things he/she needs to make decisions. It's possible that the political environment will occasionally come into play when the commissioner makes the ultimate decision."

"A new commissioner will certainly bring along different management philosophy, different priorities, different policy preferences."

"There is far more turnover at the commissioner and policy maker level of most insurance departments compared to the actuaries and other regulators. That can make it challenging to consistently apply politically sensitive regulations."

QR2. What is the impact of the political environment on our work?

Theme 5: The Impact of Change

“There are many gray areas in regulation. Laws and regulations are somewhat fixed when enacted, but products and markets continually evolve. It becomes difficult to apply the static regulations to evolving products and situations.”

“Part of the role of the actuary has always been to ‘substitute facts for appearances’, but it seems like more and more public opinion is entering into the mix. This is especially true in health insurance.”

QR2. What is the impact of the political environment on our work?

Theme 6: Job Security

“I honestly don't think the political environment has much of an impact on me. Perhaps that may be why I lose my job some day?!?”

“The political environment can result in all sorts of issues such as change in responsibilities, change in goals and objectives of the work, change in amount of support for the actuaries, loss of compensation/recognition, and sometimes loss of job.”

Organizations: NAIC

https://www.naic.org/index_about.htm

National Association of Insurance Commissioners

- Standard-setting organization for US insurance industry
- Comprised of insurance regulators from all 50 states, the District of Columbia, and five US territories
- Develops insurance model laws, regulations, etc. to be promulgated to the states
- Includes standards for statutory reserves, nonforfeiture, and Risk-Based Capital

Organizations: Academy

https://www.actuary.org/content/about-us

American Academy *of* Actuaries

Objective. Independent. Effective.™

American Academy of Actuaries

- Sets US actuarial qualification, professional, and other standards
- Provides objective analysis to assist policymakers with risk and financial matters
- Comprised of actuaries across all actuarial fields and all professions
- Assists the NAIC with development of reserve and capital standards
- Provides comments to pressing issues at the NAIC and other organizations

Organizations: ACLI

https://www.acli.com/About-ACLI

Financial Security...for Life.

American Council of Life Insurers

- One of several trade organizations advocating on behalf of the insurance industry
- Comprised of members from 280 member companies
- Advocates for policy that supports the insurance marketplace and the families that rely on insurance products for their financial and retirement security
- Provides comments and recommendations to the NAIC and other regulatory bodies regarding emerging issues

THE END

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2019 Valuation Actuary Symposium

PRESENTER NAME JOHN ROBINSON

Session 08, Regulatory Role Play: Vignette #3, VM-22 Rates

Date August 26, 2019

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Regulatory Role Play Vignette #3: The Development of VM-22 Valuation Interest Rates

Cast:

LATF Chair

AAA Representative

ACLI Representative

VM-22 Subgroup Chair

NY Regulator

CT Regulator

IA Regulator

KS Regulator

MO Regulator

NE Regulator

NJ Regulator

UT Regulator

VA Regulator

MN Regulator

Background:

The original goal was to develop principle-based valuation method for non-variable annuities, to right-size reserves and recognize benefits of hedging. This was to be used when deterministic/formula-based methods don’t work well. Six methods were reviewed, three eliminated and three remained under consideration.

Background cont’d

Separately, revising valuation interest rates was seen as an area needing attention, for the following reasons:

1. Mis-match between “spot” rates used for pricing SPIAs and “moving average” index used for valuation.

2. Review appropriateness of 3% floor.

3. The Moody’s bond index used as basis for valuation interest rates has eroded in quality over time, reducing margins for risk and expenses.

4. Current methodology did not consider the duration of the liability.

The Academy’s SVL Interest Rate Modernization Work Group (SVLIRMWG) addressed this issue, starting in May, 2015. Specifically, LATF gave the Academy work group the following charge:

Review the current methodology, and if appropriate, recommend changes to the current methodology for establishing “dynamic” valuation interest rates in the Standard Valuation Law (SVL).

Act 1: Meeting of LATF, April 15, 2015 (NAIC Spring Meeting)

LATF Chair: "Welcome to the April 15, 2015 open meeting of LATF. At today's meeting, we will discuss a proposal to modernize the process for determining valuation interest rates for annuities. The following weaknesses in the current system have been identified:

1. There is a mis-match between the spot rates that companies are using for pricing and the moving-index rates prescribed for valuation.

2. The Moody's index traditionally used as the basis for the valuation rates has eroded in quality over time, reducing margins for risk and expenses.

3. The current methodology does not consider the duration of the liability.

Do regulators have any comments or any further aspects that should be reviewed?"

UT Regulator: "We agree that those important aspects should be reviewed. However, we would like to add a fourth: currently, the valuation interest rate has a 3% floor. Considering the current low-interest rate environment, we think this floor should be re-considered for the future."

LATF Chair: "Thank you, Utah. Any comments from Interested Parties?"

Act 1 cont’d

AAA Rep: “This is _______ representing the American Academy of Actuaries. We have formed a working group, the SVL Interest Rate Modernization Work Group, to provide LATF technical assistance on this matter. We have met to conduct a preliminary review of how we might go about it. We think the first step should be to develop a new approach for SPIAs. We understand the point made by Utah, and we are willing to include this in our assignment if LATF so wishes.”

ACLI Rep: “This is __________ representing the ACLI. On behalf of our members, we support the direction proposed by LATF, including the review of the 3% floor mentioned today. We expect to have a lot to say on this matter. How long a timeline will apply here?”

LATF Chair: “I believe we should be able to get this into the 2017 edition of the Valuation Manual, but I suggest we make that a soft deadline for now. Does that seem reasonable to the Academy?”

Act 1, cont'd

AAA Rep: "Yes."

LATF Chair: "… and Interested Parties?"

ACLI Rep: "Yes, that will be fine."

LATF Chair: "Thank you. Here is the charge that has been accepted by the American Academy of Actuaries: *Review the current methodology, and if appropriate, recommend changes to the current methodology for establishing "dynamic" valuation interest rates in the Standard Valuation Law (SVL).*

I thank the Academy for accepting this charge and LATF looks forward to offering any guidance that may be needed along the way. Let's move on to the next topic."

END Act 1.

Act 2: Meeting of VM-22 Subgroup, February 16, 2016

Act 2 Background: SVLIRMWG presents framework to VM-22 Subgroup, and VM-22 Subgroup exposes for comment ending April 20, 2016. VM-22 Subgroup starts developing process for calculating the rates and drafting the text.

Act 2 cont'd

VM22SG Chair: "Welcome to the February 16, 2016 meeting of the VM-22 Subgroup. Our colleagues at the Academy have been working for several months on developing a new valuation interest rate regime for SPIAs. The purpose of this meeting is to hear a final report on the framework that they propose for the future, to expose it for public comment, and to initiate the drafting of new language for the Valuation Manual. Is anyone representing the Academy's working group on the call?"

AAA Rep: "Yes, this is _______"

VM22SGChair: "Thank you, ______. Please proceed."

Act 2 cont'd

AAA Rep: "Thank you. Following the LATF Meeting of April 15, 2015 and after months of development work, we are pleased to present a framework which we believe will serve the industry well. We thank the chair and other regulators for their input along the way.

The new framework addresses all four concerns discussed at the April 15 meeting. I will discuss the important features.

The valuation rate structure is based on a notional portfolio in which an insurer might invest in to match the liability at hand. Underlying this notional portfolio is the following Credit Quality Distribution:

5% Treasury bonds

15% Aa bonds

40% A bonds

40% Baa bonds

Act 2 cont'd

This Credit Quality Distribution should be reviewed periodically, as insurers' preferences change.

Valuation interest rates will be determined on a quarterly basis, and on a daily basis for jumbo contracts. "Jumbo" refers to contracts with premium of at least $250 million.

Now for the rates.

A quarterly valuation rate I_q will be determined by Formula A in the Appendix, which has four components:

> R, the Reference Rate, is the reference rate selected from the appropriate Valuation Rate Bucket;
>
> S, the spread rate for that Valuation Rate Bucket;
>
> D, the default cost rate for that Valuation Rate Bucket, and
>
> E, a constant spread factor which we have set at 10 basis points.

Act 2 cont'd

The Valuation Rate Buckets are designed to reflect the duration of the liability. There are four buckets, labelled A, B, C and D. The Valuation Rate Bucket depends on the Reference Period and, for life-contingent contracts, the Initial Age of the contract. The Reference Period is essentially a measure of the period certain in the SPIA, and the Initial Age is essentially the Issue Age. Tables VRB 1 and VRB 2 in the Appendix show the mappings to the Valuation Rate Buckets for life-contingent and non-life-contingent contracts, respectively.

For each Valuation Rate Bucket, the Reference Rate is a weighted average of average rates for two-year, five-year, ten-year and thirty-year Treasuries. The weights used in this calculation are based on specified annuity forms that are deemed to match the corresponding reference period ranges.

The spread rates are based on recent spreads for two-year, five-year, ten-year and thirty-year corporate bonds, relative to Treasuries. They also incorporate the credit quality distribution.

The default cost rates are based on those developed for VM-20, and incorporate the credit quality distribution. They are updated annually.

With that, I will take comments and questions. Thank you."

Act 2 cont'd

VM22SGChair: "Thank you, ___. Do regulators have any comments or questions?"

NY Regulator: "We do not support the notion that the valuation rate should depend on how companies invest. We would prefer something closer to a risk-free rate, such as 5% Treasuries, 45% AA and 50% A, and that it remain unchanged."

VM22SGChair: "Thank you. I suggest you comment on it during the exposure period. Are there any other comments from Regulators?

Hearing none, any comments or questions from Interested Parties?"

ACLI Rep: "This is ________ for the ACLI. We and our member companies have been following the development of this framework. We are generally comfortable with the direction."

Act 2 cont'd

VM22SGChair: "Thank you, ___. We will need a team to assist me in drafting the language for the Valuation Manual. If anyone on the subgroup wishes to volunteer, please let me know. [Academy Rep]____, is your report in a format that is fit for exposure?"

Academy Rep: "Yes, it is."

VM22SGChair: "Then I would like to expose it for a period of 30 days. Is 30 days acceptable to regulators? Interested Parties?"

ACLI Rep: "We request that the exposure be 60 or not less than 45 days, to allow us and our member companies to review this in detail."

VM22SGChair: "Thank you _______. Do regulators object to an exposure period of 60 days? [Pause] Hearing no objection, the Academy's draft report and supporting calculations will be exposed for a period of 60 days.

Is there any new business for the committee?

Hearing none, this meeting is adjourned." END Act 2

Act 3: Meeting of VM-22 Subgroup, November 18, 2016

Act 3 Background: VM-22 Subgroup hears comments from ACLI and CT.

Act 3 cont'd

VM22SGChair: "We are continuing our discussion of the new valuation interest rate regime for SPIAs. We have received comment letters from the ACLI and the Connecticut regulator. I will ask each of them to briefly explain their comments, starting with the ACLI representative.

ACLI Rep: "Thank you, ___.

ACLI supports the general direction of the proposed framework. However, we request consideration of the following:

1. Since not all states have adopted the Valuation Manual, we might not have a level playing field, since some companies may be permitted to use the Model #820 rates, which have been demonstrated to be higher than these new rates.

2. Since this work is only in partial completion of the goals for nonvariable annuities, we need proper alignment with the rest of the Valuation Manual and also with the Actuarial Guidelines IX-A, IX-B and IX-C that affect SPIAs. In particular, we find some inconsistency between the guidance in AG IX-B and VM-22.

3. We need clarity around the NAIC's role in the production and communication of the valuation interest rates.

Act 3 cont'd

4. As I mentioned earlier, the new rates have been demonstrated to be lower than the Model #820 rates. This will cause reserves to increase, and may, in turn, cause consumer prices to increase.

5. There needs to be more clarity around the selection of the Premium Determination Date. We recommend a principle-based approach, whereby the qualified actuary sets the decision rules.

These are the highlights. Our letter goes into much more detail on each point. Thank you."

VM22SGChair: "Thank you, ___. Comments from Connecticut?"

CT Regulator: "Thank you, ___.

1. We find the new structure overly complicated. We think the problems with the Moody's rates can be solved by making a few minor adjustments.

Act 3 cont'd

2. We think that reserves using these rates may still be found to be inadequate under cash flow testing and would prefer to make adjustments to avoid that possibility.

3. We think the Credit Quality Distribution is too liberal and would prefer limiting it to AA and A bonds only. The criteria should be based on what companies **should** invest in, not what they **might** invest in.

4. The 10-basis point deduction is too low to cover investment expenses.

5. The document is silent on the question of what to do when the assets that initially backed the contract have matured, have been called away or have been otherwise replaced.

We ask for further consideration of these issues."

Act 3 cont’d

VM22SGChair: “Thank you, ___. The Subgroup will continue to consider these comments, but there is one that I think we can address today. In light of the comments about having less liberal credit quality criteria and about investment expenses, I would like to propose that we increase the E component from 10 basis points to 25 basis points. Will someone make a motion to this effect?

Utah Regulator: “Utah makes the motion.”

Nebraska Regulator: :”Nebraska seconds.”

VM22SGChair: Thank you Utah and Nebraska. Since this has been somewhat controversial, I would like a roll-call vote.

Iowa?”

Iowa Regulator: “Yes”

VM22SGChair: “Kansas?”

Kansas Regulator: “Yes”

Act 3 cont’d

VM22SGChair: “Missouri?”

Missouri Regulator: “Yes”

VM22SGChair: “New Jersey?”

New Jersey Regulator: “yes”

VM22SGChair: “Nebraska?”

Nebraska Regulator: “Yes.”

VM22SGChair: “New York?”

New York Regulator: “No, this is insufficient”

VM22SGChair: “Utah?”

Utah Regulator: “Yes”

VM22SGChair: “and Virginia?”

Virginia Regulator: “Yes”

Act 3 cont’d

VM22SGChair: “Thank you, the proposal is adopted. Any other matters?

Hearing none, the meeting is adjourned.”

END Act 3

Act 4: LATF Meeting, Dec 8, 2016

Act 4 Background: The VM-22 Subgroup has discussed all the comments and incorporated the new 25 basis point value for E and other changes agreed upon. The VM-22 Subgroup presents final draft to LATF. LATF exposes for public comment.

Act 4 cont'd

LATF Chair: "Welcome to the Fall, 2016 Meeting of LATF. At this time, I would like to call on the VM-22 Subgroup Chair for their report."

VM22SGChair: "Thank you, ___. The VM-22 Subgroup is pleased to present our final draft of VM-22 for public exposure. Starting with the foundation laid by the Academy, the draft has undergone several rounds of comment and revision, culminating in what we have today.

The process of calculating the rates is somewhat complicated, and I am very pleased that the NAIC will be calculating and publishing both the quarterly rates and the daily rates, for all users.

I would like to mention that New York has expressed concern at the underlying Credit Quality Distribution, and I would like LATF to make a final determination. The target implementation date is January 1, 2018. This concludes my report, and I make the motion that it be accepted."

Act 4 cont'd

LATF Chair: "Thank you, ____. Is there a second to the motion?"

Nebraska Regulator: "Nebraska seconds."

LATF Chair: "Thank you, Nebraska. Any discussion? Hearing none, those in favor say 'Aye'".

Regulators: "Aye"

LATF Chair: "Those opposed, say 'Nay'"

LATF Chair: "Motion passes. Unless there is an objection, I would like to expose this document for 45 days, ending January 24, 2017. Following that, we will consider New York's concern and any other comments that are submitted. Regulators, any objection?

Hearing none, the document will be exposed for 45 days. Let's move on to the next topic."

END Act 4

Act 5: LATF Adopts VM-22, April 6, 2017

Act 5 Background: At the NAIC Spring Meeting 2017, LATF makes all final decisions and votes to accept the document.

Act 5 cont'd

LATF Chair: "Welcome to the Spring, 2017 Meeting of LATF. At this time, I would like to call on the VM-22 Subgroup Chair for their report."

VM22SGChair: "Thank you, ___. The final issues pertaining to VM-22 have been settled, and I recommend adoption. I would like to thank the members of my Subgroup for their participation, the American Academy of Actuaries for their technical support, and all Interested Parties who helped to produce this guidance.

LATF Chair: "Thank you, ___. I understand that there are no more comment letters to discuss, correct?

VM22SGChair: "That is correct."

LATF Chair: "I need a motion to adopt this final version of VM-22."

VM22SGChair: "Minnesota so moves."

Act 5 cont’d

LATF Chair: “Thank you, Minnesota. A second?”

Nebraska Regulator: “Nebraska seconds.”

LATF Chair: “Thank you, Nebraska. Any discussion?”

New York Regulator: “New York finds too many flaws with this approach.”

LATF Chair: “Thank you, New York. Any other comments? Hearing none, those in favor, say ‘Aye’”

All but NY Regulator say ‘Aye’.

LATF Chair: “Those opposed say ‘Nay’”.

NY Regulator: “New York says ‘Nay’”.

LATF Chair: “The motion passes. Thank you all for your contributions to this important achievement.”

THE END

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