Society of Actuaries

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The Financial Reporter

The Newsletter of the Life Insurance Company Financial Reporting Section

Actuarial Analysis of Different Interpretations of SOP 03-1

Jay Vadiveloo, Ph.D., FSA and Richard Bass, Ph.D.

Introduction

This article analyzes two common interpretations of SOP 03-1 in determining the guaranteed minimum death benefit (GMDB) liability in a variable annuity contract, and it analyzes the resulting impact on the initial GMDB reserve and on the volatility of GAAP earnings as actual experience emerges. This analysis could be applied to the guaranteed minimum income benefit (GMIB), guaranteed minimum accumulation benefit (GMAB), guaranteed minimum withdrawal benefit (GMWB) and other guaranteed benefits in a variable annuity contract that are subject to SOP 03-1, and the conclusions would be similar.

Background

For the GMDB reserve, SOP 03-1 discusses calculating a benefit ratio (BR), which is defined as:

BR = (1) / (2)

where (1) = present value of total expected excess death benefit payments

(2) = present value of total expected assessments

SOP 03-1 goes further and stipulates that the BR should be determined using expected experience, and expected experience should be based on a "range of scenarios rather than a single set of best estimate assumptions." Most companies have interpreted this to mean generating scenarios stochastically. Since the GMDB volatility is mainly driven by the volatility in separate account returns, the stochastic scenarios are derived by projecting separate account returns stochastically.

It is at this point where companies deviate in their interpretation of SOP 03-1. The two common interpretations are as follows:

→**Interpretation 1:**

a. Stochastically generate separate account returns and for each scenario, calculate the present value of excess death benefit payments.

b. Take the mean of the distribution of the present value of excess death-benefit payments. Call this E(X).

c. Calculate the present value of expected total assessments, either deterministically using a long-term average separate account return, or as the mean of the distribution of the present value of total assessments using the stochastic scenarios. Call this E(Y).

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Chairperson's Corner

Tom Nace

2005 – A Year of Transition

This is my first article as chairperson for the Financial Reporting Section, having taken over that role as of the annual meeting. However, this is far from my first article for *The Financial Reporter*. In a former life, I was the editor for this newsletter. More recently, I served as a member of the Financial Reporting section council. So for me, 2005 is going to be a year of transition, as I take on the challenges of being section chairperson. I welcome the opportunity, and I am sure that my prior experiences with the newsletter and the section council have prepared me well to take on the responsibilities that lie ahead.

At this time I would like to thank Mark Freedman, the former section chairperson, for his time and leadership over the last year. Mark did a lot for our section, and I personally enjoyed working with him. I appreciate the opportunities he provided me as part of transitioning the responsibilities of section chairperson.

In a much bigger way, 2005 is also going to be a year of transition for our section and for the SOA as well. As many of you have probably heard, the SOA has adopted a new strategic plan, which will have a major impact on how the SOA is organized and also on the sections' overall responsibilities. One of my major goals for this year is to guide our section through this transition of responsibilities and also to communicate to our members, through this newsletter, the changes and how they will impact our section.

This first article will provide just a little background and also some of the steps taken so far by our section to address the reorganization.

Background

The SOA strategic plan document can be found on the SOA Web site, *http://www.soa.org/ccm/cms-service/stream/asset/?asset_id=8015079&g11n*. In effect, the thrust of the strategic plan is to improve the way in which the SOA provides support and services to its members and also to expand and strengthen the recognition of the actuarial profession.

One of the key principles recognized in the development of the new strategic plan is the unique advantage that sections have had in connecting with their members and responding to the section members' needs. As a result, one of the goals of the reorganization became obvious – not only is it important to maintain the grass-roots connection that the sections have developed over the years with their members, but it would be very advantageous to capitalize on this connection and expand the responsibilities of the sections under the reorganization.

One of the major byproducts of this initiative is to eliminate the practice areas and to have the sections absorb the responsibilities of the practice areas. Another byproduct of the reorganization is increased communications between the section councils and the Board of Governors. Also, all of the sections will be looking at the way in which they carry out their existing responsibilities to see if these processes can be improved. Increased communication amongst the various section councils will be facilitated by several meetings of the council chairs throughout the year.

Steps to Address the Reorganization

So how will we as a section determine what needs to be done in order to take on these new responsibilities? The first step in the process was to develop a transition plan, which will soon be posted on the Financial Reporting Section's Web site. In this document, we have defined various teams, each headed by a section council member, who will be responsible for various aspects of the transition.

>> *Chairperson's Corner from page 2*

The section's officers and the team coordinators are as listed below:

Section Role	*Council Member*
Chair	Tom Nace
Vice-Chair	Darin Zimmerman
Treasurer	Richard Browne
Secretary and Web Liaison	Kerry Krantz
Membership Value Team Coordinator	Yiji Starr
Communications & Publications Team Coord.	Tom Nace
Continuing Education Team Coordinator	Barbara Snyder
Basic Education Team Coordinator	Darin Zimmerman
Research Team Coordinator	Henry Siegel
Marketplace Relevance Team Coordinator	Howard Rosen
Professional Community Team Coordinator	Dan Kunesh

The goals of the Web liaison will be to review the Financial Reporting Section's Web site and to improve the level of information that is provided, as well to maintain the site by keeping relevant information up to date.

The purpose of the Membership Value Team is to focus on providing a sense of community for an area of practice or interest. Potential activities may involve member outreach, member research and volunteer management.

The Communications and Publications Team will focus on developing and identifying a publishing plan for section issues. This will encompass all media, including the newsletter, the Web site, blast emails, etc. The team will also develop a plan for communications with the Board of Governors.

The purpose of the Continuing Education Team is to identify and develop content for continuing education programs, including meetings.

The Basic Education Team will provide input into the basic education process, particularly reviewing the examination syllabus to make sure that critical financial reporting topics are addressed.

The Research Team will be responsible for identifying and overseeing research initiatives, as well as monitoring the experience studies undertaken by other sections.

The purpose of the Marketplace Relevance Team is to focus on advocating externally for actuaries who share an industry, type of employer or interest. Team activities may include: promotion/marketing, career encouragement, market research, surveys of practices, etc.

The Professional Community Team will attempt to establish and maintain external relationships with other (non-actuarial) organizations. Team activities may include: international relations (global actuarial community), academic relations, etc.

We are still in the process of defining the specific tasks for each team that will need to be accomplished in order to transition to our new responsibilities.

Additional resources, over and above the section council, definitely will be needed once we have decided on all that needs to be done. So we will be recruiting "friends of the council" to assist the council members in carrying out their objectives. These "friends" will not be section council members, but will support the council members by heading up small working groups or taking on specific task assignments and then reporting back to the council member who is that team's coordinator.

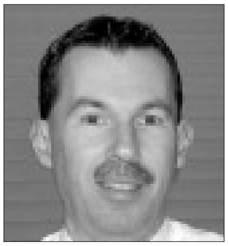
The Future

In future articles, I will provide more details in terms of specific activities our section is taking on and communicate to you the status of the transition.

In addition to the major changes discussed above, this year we will continue to provide the high level of support to various activities as we have done so well in the past, such as continuing education seminars, webcasts, financial reporting sessions at the spring and annual meetings and the newsletter, to name a few.

We will be soliciting member feedback during the year, but, in the meantime, if anyone has any suggestions for ways in which the section can better serve the members, please let me or any member of the council know.

There are a lot of challenges ahead of us in 2005, but I feel confident that with your support we can transition our section – and the Society – to a stronger, more efficient organization for many years to come.



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d. The benefit ratio is then:

$$BR1 = E(X) / E(Y).$$

→**Interpretation 2:**

a. Stochastically generate separate account returns and, for each scenario, calculate:

i. X = present value of excess death benefit payments

ii. Y = present value of total assessments

iii. X/Y = benefit ratio for the given scenario

b. The mean of the distribution of these benefit ratios is then

$$BR_2 = E\,(X/Y).$$

Analysis

The key question we shall analyze is the comparison of BR_1 with BR_2.

→**Theorem**

$$BR_2 > BR_1$$

→**Proof**

Define the random variables:

X = present value of excess death-benefit payments
Y = present value of total assessments

Note that X and Y are positive random variables and negatively correlated, i.e., high values of excess death benefit payments are associated with low fund values and correspondingly low total assessments.

If we set Z = 1/Y, it follows that X and Z are positively correlated:

$$O < COV(X,Z) = E\,(XZ) - E\,(X) * E\,(Z).$$

which implies that:

$$E\,(XZ) > E\,(X) * E\,(Z)$$
$$\text{i.e., } E\,(X/Y) > E\,(X) * E\,(Z).$$

Since the function g(y) = 1/y is convex (i.e., it has a positive second derivative), it follows by Jensen's inequality that:

$$E\,(Z) = E\,[g(Y)] > g\,[E(Y)] = 1/E\,(Y)$$
$$\text{i.e., } E\,(X/Y) > \frac{E\,(X)}{E\,(Y)}$$
$$\text{i.e., } BR_2 > BR_1.$$

Implications

In determining the initial SOP 03-1 reserves for GMDB, the benefit ratio is determined from contract issue, using historical actual excess death-benefit payments and assessments, together with projected excess death benefit payments and assessments. The benefit ratio is then determined using either Interpretation 1 or Interpretation 2.

Once the benefit ratio BR is determined, the opening SOP 03-1 reserves are calculated retrospectively by the formula:

(1) – (2)

where (1) = accumulated value of BR x (historical assessments)

(2) = accumulated value of historical excess death-benefit payments.

It follows then that the opening SOP 03-1 reserves are lower under Interpretation 1 than Interpretation 2. The magnitude of the difference is given by the formula:

accumulated value of ($BR_2 - BR_1$) x (historical assessments).

Impact

The impact of the two interpretations has been analyzed based on the following simplified example:

- Male age 45, 75-80 Basic Table ultimate mortality
- Initial deposit of $1,000,000 and annual deposits thereafter of $10,000
- GMDB benefit based on the roll-up method using a 5 percent guaranteed accumulation rate
- Equity returns generated using a normal distribution with a mean of 9 percent and standard deviation of 20 percent
- Net investment assessment of 100 basis points, net expense assessment of 35 basis points and mortality assessment of 15 basis points
- Surrender charges of 7 percent in year one and decreasing by 1 percent each year to zero in year eight and after
- Lapse rates are level 5 percent each year with a spike of 10 percent in year eight when the surrender charge goes to zero
- 8 percent discount rate

Based on 250 stochastic scenarios, the initial benefit ratio is 1.9 percent under Interpretation 1 and 3.2 percent under Interpretation 2, i.e., the initial benefit ratio under Interpretation 2 is 68 percent higher than under Interpretation 1.

In this simplified example, the end of the year expected retrospective GMDB reserve under Interpretation 1 is equal to $167, which is calculated as:

BR_1*(mean total revenue)*(1+discount rate) – (mean excess death benefit)

i.e. 1.9%*(mean total revenue)*(1.08) – (mean excess death benefit).

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New Editor Needed for *The Financial Reporter*

I am now into my third and final year as editor of *The Financial Reporter*. Now is the ideal time to find a successor. Finding a successor now would allow him or her to work with me on a few issues and gain some knowledge, experience and confidence before taking the reins.

Every editor brings different strengths to the position, which makes it very desirable to get a new editor periodically. Different editors undoubtedly approach the task differently. If you are willing to consider being the next editor, please call me at (765) 477-3220, and we can discuss what is involved. I am proof that the editor does not need exhaustive knowledge and does not need to be a consultant or belong to a large company.

If you think of someone who might be a good editor, please give that person a call and encourage him or her to consider the position and contact me. The section newsletters are one of the strengths of the SOA, and it is important that our section finds a good editor for the next three years. I hope that my phone will be ringing soon.

>> Actuarial Analysis of SOP 03-1 from previous page

This assumes revenues are collected at the beginning of the year and benefits are paid at the end of the year.

The same reserve under Interpretation 2 is equal to $383, which is more than twice as large as the reserve under Interpretation 1.

Correct Methodology?

In general, if the use of different methodologies gives relatively close results, the issue of which is the correct one to use is more of an academic discussion. When the results can be significantly different, as shown in our simplified example, then the choice of methodology has important financial implications.

To answer the question as to which is the "correct" methodology, one needs to go back to fundamental actuarial and reserving principles and try to understand what is the underlying risk that we are evaluating.

The basic deterministic prospective reserve formula states that the reserve at any duration equals:

(APV of future benefits) – (APV of future assessments),

where APV = actuarial present value.

A scenario-based or stochastic prospective reserve formula is similar, except that the above formula is calculated for each scenario or stochastically generated variable.

Interpretation 1 is appropriate when the distribution of future benefits is uncorrelated with the distribution of future assessments. An example of this would be the typical situation in stochastic DAC unlocking methodology. Stochastic DAC unlocking formulas recognize that future margins can fluctuate with different market returns. However, future deferrals (if there are any) are generally not impacted in the same way. Interpretation 1 would thus capture the underlying risk obligation and appropriate DAC balance to hold, and would not provide materially different results from Interpretation 2.

The same is not the case for the GMDB reserve. Here, the distribution of future excess death-benefit payments is negatively correlated with the distribution of future assessments, i.e., equity return scenarios resulting in high excess death-benefit payments produce low assessments from the depressed fund balances. In fact, it is this very dependence between the excess death-benefit payments and total assessments that makes this product offering so risky. Interpretation 1 completely ignores this dependence and thus grossly understates the benefit ratio, while Interpretation 2 correctly recognizes and reserves for this dependency relationship.

Concluding Remarks

The authors hope that this article will generate further analysis and reflection on not just GMDB reserving under SOP 03-1, but also reserving for similar guaranteed benefits like GMIB, GMWB, GMAB, etc. In all these instances, the reserving formula shows dependence between future benefits and future assessments.

This article also has implications on unlocking methodologies under SOP 03-1. Interpretation 2, without any modifications, could produce greater volatility in earnings from the unlocking process than Interpretation 1. While Interpretation 2 more correctly captures the true risk of the GMDB product, it may make sense to incorporate it with some kind of corridor approach (similar to stochastic DAC unlocking methodologies) to avoid short-term fluctuations in earnings due to normal market volatility. $

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Aristotle Was Wrong:
or Formulas vs. Actuarial Judgment

Carol Marler

More than 50 years ago, a novel called *The World of Null-A* explored the idea of a world in which Aristotle's "law of the excluded middle" was rejected and the impact this would have on society. According to Aristotle, logic admits only two values, "true" and "false." Under non-Aristotelian logic, however, there are multiple values, or shades of gray. Indeed, there may even be unexpected results from logical combinations, like "both" and "neither."

I can't help thinking that this insight should be applied to the current debate between formula-driven reserves (with limited assumption flexibility) and the reserve principles approach (demonstrated by the proposed reserves and risk-based capital approach for variable annuity products with guaranteed minimum death benefits). A family story tells of a young lad offered his choice between mince pie and pumpkin, and he answered, lispingly but definitely, "Boze."

For reserve standards, we do seriously need **both**. That is, actuarial judgment grounded in reserving principles is essential in any reserving system, and restrictive formula methods (or safe harbors) are also necessary in appropriate circumstances. The purpose of this article is to identify how to proceed, based on actual conditions and circumstances. Conclusions are drawn regarding the current debate over guideline AXXX.

The first question to ask in any risk assessment is, of course, "What can go wrong?" With a required assumption/formula-driven approach, one risk is that the formula may be applied without a proper understanding of the potential for results that differ from the required assumptions. Another risk is that a reserve formula that is correct for the average or typical situation may be either inadequate or redundant in particular circumstances. There can also be significant differences among actuaries about the "best" assumption to use in given circumstances.

The long-running and often acrimonious debates over Actuarial Guideline 38 (also known as XXX) and its predecessors and successors, including AXXX now in progress, demonstrate quite clearly what can go wrong with the formula-driven approach. When the formulas and mandated assumptions fail to fit the nature of the business, problems arise. The symptoms include various attempts to circumvent the restrictive requirements, whether by use of offshore reinsurance arrangements or by "creative" product designs that exploit loopholes. In response, the defenders of the formula approach scramble to close loopholes, leading to further rounds of escalating disagreement.

With a principles-based approach, there is a risk of differing views about the appropriateness of the actuarial judgments. However, it has been my experience that most actuaries can agree as to the range of appropriate assumptions. For the exceptional situation it is extremely critical to provide an appropriate framework for validating those assumptions.

The principles-based approach also requires much more sophisticated computer support and considerable time and attention by highly trained actuarial personnel. On the asset adequacy front, as stochastic models replace the use of selected scenarios, the use of resources expands enormously.

The simplicity of the formula-driven approach does make it easy to implement and to audit. Many small companies cannot afford the costs of developing new methods and implementing new systems. Indeed, it would not be cost-effective for large companies to rework their methods on small blocks of business. While there are a few exceptions, most state insurance departments are staffed to handle the current methods and would be hard-put to make wholesale changes in their ways of doing things. Certainly any proposals for change would need to satisfy the test of whether a change provides benefits worth the costs and disruption involved.

There are also significant risks in any system with parallel requirements, including any safe harbor rules that allow current methods to continue while offering principles-based alternatives. For example, products could still be designed to exploit safe-harbor rules, starting again the spiral of loophole analysis.

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> ... the actuarial profession has taken a big step in developing principles-based approaches for reserves and risk-based capital.

Thus we see environmental change and product evolution leading to a need for more flexible reserving methods. But earlier generations of products are not extinct. These new methods may be impractical for such plain vanilla products, where traditional formula approaches are still appropriate. The method to use in a given situation depends on several considerations, such as product complexity, its sensitivity to environmental change and the degree of conservatism in pricing. Let us now look at each of these considerations.

First, Is The Product Simple?

The simpler the product, the more appropriate it is to use formulas and specified assumptions. However, the creativity of companies in developing complex products is evident. Reserves for products with more complex features, especially those that give policyholders valuable options and guarantees, require more flexibility. Sometimes these options are not fully appreciated. "Feature creep" happens when a product that initially met the simplicity test has additional benefits and choices added.

One example of change in product features over time is the variable annuity, which began as a straightforward way to allow policyholders to participate in equity returns, while taking on the corresponding risks. Guaranteed death benefits were added, and by analogy with fixed annuity death benefits, they were perceived as not requiring additional reserves. Soon living benefits became the competitive edge. It wasn't until disaster struck, in the form of a bear market, that the cost of these guarantees became widely recognized. In response, the actuarial profession has taken a big step in developing principles-based approaches for reserves and risk-based capital. It took a high degree of cooperation by the regulators and the industry to do this, and those involved in the process are to be commended for their work.

On the other side of the coin, universal life products are complex products that feature extensive options for the policyholder in terms of both premium flexibility and death benefit choices. The industry does not have a good way to recognize the effect of this flexibility in setting reserves.

The formula approach to universal life reserves cannot be described as simple. Much of the difficulty in understanding, interpreting and applying the rules comes about because the product simply does not fit the approach that is being applied. Formula-driven reserves implicitly assume a fixed pattern of future premiums and benefits. They do not address the range of policyholder actions to increase, decrease or suspend premium payments or the corresponding flexibility in benefit levels. And the addition of secondary guarantees and shadow accounts merely exacerbates that lack of fit.

Second, How Sensitive Is The Product to Environmental Change?

No formula can adequately address the truly unexpected. However, the conscientious actuary will consider which environmental changes may put a product at risk. For quite some time, the focus has properly been on the investment risk. In the 1980's disintemediation was the issue, and asset adequacy analysis was developed to help identify and manage this risk.

Now that interest rates have fallen to historically low levels, the new concern is spread compression. This problem occurs when a significant element of pricing is the investment return. Spread compression is a problem, whether or not the credited interest design allows the company to adjust the rates provided to the policyholder's account, since the credited rate is subject to contractual minimums.

For smaller companies that have recently become subject to asset adequacy analysis, it may not be necessary to perform full-fledged cash-flow testing. However, simpler alternatives such as gross premium valuation must be supplemented by sensitivity testing to determine the extent to which reinvestment of existing assets at these low rates could produce loss scenarios. As Albert Einstein once said, things should be made as simple as possible, but not simpler.

Turning from investment issues to mortality issues, the impact of environmental change has not yet been properly recognized. The specified mortality assumptions now required for term insurance include provision for mortality far worse than experience has shown. While it is necessary to consider what changes may occur in mortality in the future, an overly conservative approach may not be the right solution.

Standard and Poors published a report, "Evaluating the Effect of Regulation XXX on Insurers' Capital" dated March 29, 2004. The report explained the issue this way:

>>

> Regulation "Triple X" is creating some pressures for life insurance companies because of the substantial amount of redundant reserves that now are required for term and universal life insurance writers. [...] In the meantime, differences between economic and statutory reserve differences continue to grow, creating a substantial reserve redundancy, pressures in the prices of these insurance products, and lower statutory profits.

This leads us to the final issue.

Third, How Competitive Is The Pricing?

Products with conservative pricing can generally support the conservative assumptions that are a part of the formula-driven approach.

Conversely, products that attempt to pass through to policyholders the benefits of improved experience face serious limitations. For example, careful underwriting, especially for business that qualifies for "preferred" classification, cannot be fully recognized in pricing because of reserve requirements.

Conclusions

Consider that valuation mortality tables are updated at about a 20-year interval. There is also a time lag in collecting and analyzing the data, and by the time a new mortality table is adopted, the experience it is based upon is at least 10 years old. Given the way mortality has improved over time, this methodology incorporates a bias toward overstated mortality. On top of that, the valuation tables always incorporate additional margins.

Recognition of factors that could improve mortality experience is very limited. Non-smoker policies had been available for more than 10 years before non-smoker mortality was made available for valuation purposes. Research is now being begun to quantify the value of underwriting tools in improving mortality experience. This is, however, a long-term project, and it does not solve the current problem.

Meanwhile, much actuarial expertise that could be addressing this important issue is being wasted on battles over how best to apply an inappropriate methodology to an environment and a product that have changed substantially since the early days of the standard valuation law. I would suggest that a great deal of the effort and creativity that have been expended on both sides have nevertheless not done much to improve things for policyholders and their beneficiaries.

With each round of revisions to the regulatory guidance comes another round of product enhancements, such as the UL shadow accounts, leading to further attempts to close the loopholes. In my opinion, it is time to "stop the insanity" and develop an approach that allows the actuary to use professional judgment in setting reserves for products that do not fit the formula approach.

Interestingly, pricing mortality is permitted for the modeling work done as part of asset adequacy analysis. And Actuarial Guideline 38 does allow a limited adjustment to mortality by means of the x-factor. But the approach is still driven by a mentality that relies on specified assumptions and explicit formulas.

I find it particularly interesting that guideline AXXX includes language requiring actuaries to follow "the spirit" of the law, not merely the letter thereof. As I interpret this, it means that actuarial judgment is found acceptable for determining whether the complex product provides similar benefits to other complex products. Yet that same actuarial judgment is not allowed in identifying the appropriate assumptions for mortality and persistency. We need to rely on actuarial judgment in **both** cases. We need to make this interrelationship between product design and experience assumptions much more explicit.

The new reserve and required surplus approaches give a good method, I think, for maintaining discipline and for limiting the opportunity to "game" the system. They are integrated by a common set of principles, with different confidence levels driving the value of each.

When using actuarial judgment for reserve assumptions on life insurance products, the risk-based capital rules need to explicitly address the risks of understating mortality. The current C2 risk formula focuses primarily on the risk of statistical fluctuation. This is probably adequate and appropriate for business that uses formula-driven reserves.

For products with aggressive mortality assumptions, additional modeling is required to determine the amount needed to cover scenarios in which mortality is less favorable than pricing. Setting up additional risk-based capital is an appropriate tradeoff for more flexibility in setting the underlying reserves for business that does not fit the formula methods.

Work needs to be done to structure the process to give an appropriate level of confidence in the results. The industry and the regulators need to agree on a way to deal with the flexible nature of the current generation of products. Scenario testing is probably appropriate, including analysis of interaction between persistency and mortality antiselection.

Yes, I think that Aristotle was wrong. This is not an either/or situation. On the one hand, it is important that appropriate levels of reserve and surplus be held to avoid insolvency. On the other hand, excessive reserves have led to bad results, including a more restricted availability of low-priced term insurance. Only those companies that use the perceived loopholes are able to sell this business. However, these creative approaches may hide the true level of risk, in order to minimize the use of scarce capital. A more explicitly look at the actual risks, and greater transparency in the product design could be to everyone's benefit. I say, let us have both kinds of pie, formula-driven and principles-based. Let us use actuarial judgment in choosing our methods and assumptions to fit our products in the world as it is today and as things change in the future. $

Council Changes with Election

With the annual election, the section council had four members complete their terms and four members join the council.

The section owes a debt of gratitude to the following four members who completed three-year terms in October. Our section council works hard and devotes considerable time and skill to the section.

Mark J. Freedman	*Ernst & Young LLP*
Mark D. Peavy	*NAIC*
Deborra M. Poorman	*Bankers Life*
Simon R. Curtis	*Manufacturers Life*

The section welcomes the following four new members of the council. They arrive at an important time of change in the SOA and in the section.

Richard H. Browne	*KPMG LLP*
Henry W. Siegel	*New York Life*
Yiji S. Starr	*John Hancock Financial Services*
Howard L. Rosen	*ING US Financial Services*

Finally, we acknowledge the council's officers for 2005.

Chairperson	Thomas Nace
Vice-Chairperson	Darin G. Zimmerman
Secretary	Kerry A. Krantz
Treasurer	Richard H. Browne

Erratum

In the December 2004 issue of *The Financial Reporter*, we incorrectly reported the biographical information of John Morris, author of "Don't Miss This Second Chance." The biographical information should have been:

John D. Morris, FSA, MAAA, is principal consultant at PricewaterhouseCoopers in Philadelphia, Pa. He can be reached at john.w.morris@us.pwc.com.

We apologize for this error and also for omitting his photograph. *–The Editor*

Highlights of the December 2004 NAIC Life and Health Actuarial Task Force Meeting and Other NAIC Topics

Ted Schlude

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I attended the NAIC Winter Meeting held December 2-6, 2004, in New Orleans, La., including meetings of the Life and Health Actuarial Task Force (LHATF) and selected meetings of the NAIC. Summarized below are the activities that took place at these meetings.

LIFE AND HEALTH ACTUARIAL TASK FORCE

The LHATF met on Thursday and Friday and discussed the following topics:

1. C-3 Phase II – Actuarial Guideline VACARVM: The following discussions took place related to Actuarial Guideline VACARVM, about reserves for variable annuities with guarantees:

- *Update on C-3 Phase II RBC:* LHATF first received an update from Bob Brown, representing the Academy, on the status of the C-3 Phase II RBC project. Bob indicated that the Academy has prepared an updated report, dated December 2004, which includes slight changes from the September 2004 report. The hope is that the Capital Adequacy Task Force would adopt the RBC diskette specifications at its meeting here in New Orleans and that a set of instructions would be completed by June 2005, in order for the methodology to be applicable at December 31, 2005. Bob noted that the scope section was clarified further and that, with respect to revenue sharing, the Academy's intention was that all aspects of revenue sharing, both revenues and expenses, would be considered in the C-3 Phase II testing model. The RBC project is discussed in more detail later in this report.

- *Academy Report on Actuarial Guideline VACARVM:* Tom Campbell, representing the Academy, went over various aspects of the Academy's December 2, 2004 report, which includes Actuarial Guideline VACARVM, along with various comment letters that were discussed at this meeting. Items identified as refinements to Actuarial Guideline VACARVM included: 1) clarification of prudent best estimate, which is associated with deterministic assumptions, 2) revenue sharing, which is discussed below, 3) reinsurance ceded, 4) GMIB annuitization rates, 5) the required memorandum and confidentiality, 6) standard scenario calculations, 7) the alternative methodology for GMDB benefits, 8) modeling of hedges, 9) certification requirements and 10) guidance on modeling contract-holder behavior.

Specifics are discussed below.

- *Revenue Sharing:* Refinements to language include stipulation that revenue sharing must be received and controlled by the company, agreements must be signed, and revenue must not be counted elsewhere. The actuary is required to review the revenue sharing agreements and verify the appropriateness of the handling of revenue and expenses.

  A small subgroup will be formed to work on issues related to disclosure, conflicts of interest, and what constitutes valid revenue for these purposes (nature of guarantee to company, its successors, etc.).

- *Alternative Methodology for GMDB Benefits:* New York proposed that the 65 percent of 1994 GMDB Table inherent in the alternative methodology for GMDBs be increased to 85 percent, but this motion was defeated by LHATF. It was noted that an SOA mortality study on GMDB is in progress. Some regulators are concerned that there could be an underreporting of death claims on policies that were above water at time of death, because the decrement (mortality vs. lapse) becomes less important when there is not an explicit death benefit being provided on a claim.

  It was noted that the alternative methodology for RBC purposes has been modified to adjust mortality from 100 percent of

1994 GMDB to a prudent best estimate level based on company experience. This approach, though, causes some issues from a tax reserve standpoint, where a floating mortality table might not be acceptable to the IRS. It was also noted that the lack of aggregation under the alternative methodology results in conservatism, and that mortality is just one of many assumptions going into a complicated calculation.

- *Modeling Analysis and Standard Scenario:* Next, the Academy reviewed the results of the testing that has been performed to date. Problems continue to be seen by the industry with the standard scenario and the lack of aggregation effect, which causes reserve levels that are much higher than what would be generated by the detailed modeling process. Next, the Academy outlined a December 2, 2004 letter to LHATF that highlights six reasons why the Academy does not support the standard scenario reserve proposal. Most of the objections have as a theme the fact that the standard scenario undermines the stochastic testing modeling approach that has been developed and thoroughly tested by the Academy and appears to be the appropriate methodology to evaluate reserve and capital levels for variable annuity products with guarantees. Objections include: limitations placed on revenue items, conservative surrender rate assumptions for in-the-money benefits, and no credit being provided for hedges other than those currently held, even though a clearly-defined hedging strategy might be in place. In addition, the standard scenario is not consistent with the AG33/AG34 integration of benefits approach. Finally, the largest problem with the standard scenario is the lack of aggregation benefit inherent in the approach.

  The ACLI has supported the standard scenario for reserves because it sets a benchmark for tax reserves. The industry generally does not support the standard scenario for capital purposes.

LHATF exposed the current Actuarial Guideline VACARVM for comment and will have several conference calls to discuss outstanding issues. A subgroup was formed to study issues related to the standard scenario.

2. Model Regulation and Other Topics Related to Implementation of the New Non-forfeiture Law for Individual Deferred Annuities: LHATF considered various comment letters, but ultimately made no changes to the October 14, 2004 draft model regulation implementing the new Non-forfeiture Law for Individual Deferred Annuities, which was re-exposed for comment. An interim conference call will be scheduled to discuss this document further.

3. Possible Areas of Revision to the Standard Valuation Law (SVL II): David Sandberg, representing the Academy, provided an update on the SVL II project. This is a three to five-year project initially focused on liability categories that are harder to measure. The ultimate goal is to provide a principles-based framework for incorporating stochastic cash flows into an accounting balance sheet structure. Initial product focus includes C-3 Phase II products, UL products with secondary guarantees, and long-term care.

Regulatory oversight in such a framework will be a challenge. The group will work on the principles of accountability and disclosure, with reliance on professional standards to provide discipline to the process. A conference call will be scheduled to discuss the role of peer review in such a framework.

4. Actuarial Guideline ABC: This draft actuarial guideline has been developed to provide a valuation framework for CARVM under the new annuity non-forfeiture law, where the future non-forfeiture interest rate is not always known. The September 9, 2004 draft remains exposed for comment and will be considered at the March 2005 LHATF meeting.

5. Referral on Accounting for Life Reinsurance Credits: One company brought a proposal to the Statutory Accounting Principles Working Group related to reinsurance agreements that fall somewhere between coinsurance and YRT reinsurance, where the accounting and reserving guidance might not be clear. The illustration deals with reinsurance products similar to YRT, but where there is a multi-year premium rate guarantee provided by the >>

reinsurer. The company believes that the ceding company should be entitled to more than a YRT reserve credit to recognize the benefits of having the multi-year premium rate guarantee and the risk management implications of such a guarantee.

Sheldon Summers of California suggested that LHATF expand its charge to discuss further other reinsurance vehicles that do not fall directly under the current reinsurance model regulation, which was developed more than 10 years ago and did not contemplate many of today's products or reinsurance vehicles.

6. Universal Life Work Group: The Academy's Universal Life Work Group is considering a long-term approach to reserving and capital for certain products, such as UL with secondary guarantees, term insurance and variable universal life. Two possible approaches are being considered by the work group: (i) a purely stochastic approach or (ii) a deterministic approach with a provision for adverse deviation to generate a similar result to (i) but also to address tax deductibility issues that might be associated with a purely stochastic approach. Regulators expressed a desire to eliminate the distinction between primary and secondary guarantees and rather simply focus on valuing all guarantees provided within a product structure.

7. Actuarial Guideline 38 Revisions – UL Products with Secondary Guarantees: A variety of material was discussed, both pro and con, related to the application of Actuarial Guideline 38 to universal life policies with secondary guarantees. The first item is the current draft of Actuarial Guideline 38, which was modified somewhat by LHATF and re-exposed for comment. Regulators are still divided with respect to whether or not there should be a revision to Actuarial Guideline 38 (10 states voted for re-exposure, five states against, and one abstained).

A variety of industry comments were heard related to the Actuarial Guideline 38 revisions. Most of LHATF feel as if the spirit of general language contained in Actuarial Guideline 38 is being violated. Certain companies feel that their traditional products are at a competitive disadvantage with respect to the apparent difference in reserves that can be present in traditional and UL secondary guarantee products that contain what are viewed as similar guarantees. They argue that reserves should reflect basic principles inherent in a present value of future benefits less present value of future net premiums valuation methodology.

UL secondary guarantee companies believe that they are computing reserves consistent with the model laws, regulations and Actuarial Guideline 38, and many companies have gone directly to their domiciliary regulator to confirm that the reserve methodology is appropriate for their product. As a stop-gap measure, these companies propose a stand alone asset adequacy requirement, pending future activities of the Academy's Universal Life Work Group in this area. Opponents of this temporary solution point out that an asset adequacy requirement introduces discounting for lapse as well as introduces best estimate assumptions for mortality and interest rather than conservative statutory assumptions.

Other NAIC Developments Related to AG 38 Revisions: The Emerging Accounting Issues Working Group dropped its tentative position INT 04-16 on AG 38 from its agenda, because the actuarial guidelines are the responsibility of LHATF and get automatically swept into the *Accounting Practices and Procedures Manual* based on procedures already established by the NAIC. The Life (A) Committee, which is composed of insurance commissioners from various states, expressed its frustration with the AG 38 process during its meeting on Monday, December 6, 2004, which I was unable to attend. Certain members of the Life (A) Committee would prefer that LHATF work toward a long-term solution along the lines of that contemplated by the Academy's UL Work Group rather than by making a temporary change to the guideline, which has proved to be very contentious and controversial. Other regulators would like to fix the actuarial guideline first to address what they believe to be an unlevel playing field that exists in the life insurance marketplace as well as provide for reserve levels that they believe the existing guidance made clear.

A two-hour conference call will be scheduled by LHATF in February to discuss this topic further.

8. Accident and Health Working Group (A&HWG): The A&HWG discussed the following topics that may be of interest.

- *Medicare Modernization Improvement Act Impact Project:* A&HWG continues to discuss issues related to premium rate re-determination on policies that no longer have drug benefits because of policyholder elections made under Medicare with respect to drug coverage.

- *Long-Term Care Working Group – Issues Referral:* A&HWG considered draft changes to the Long Term Care Guidance Manual and Model

... regulators view PDRs as satisfying short-term sufficiency issues, while the gross premium reserve analysis provides for long-term financial solvency.

Regulation related to contingent benefit on lapse for limited pay LTC policies. The material discussed included both Frank Dino's initial proposal as well as an ACLI comment letter. The original proposal was exposed for comment as well as keeping the ACLI's comments on the table. The trigger for the RPU benefit depends on issue age and the relative magnitude of cumulative premium increases (i.e., the higher the issue age, the lower the level of premium increase needed to trigger the contingent benefits). The magnitude of the RPU benefit depends on how many of the limited pay premiums have been paid by the policyholder.

- *Premium Deficiency Reserves:* The A&HWG discussed the goals of premium deficiency reserves (PDR) and gross premium reserves as part of a document prepared by Katie Campbell on this topic, which includes a basic principles outline as well as certain modifications to the health reserves model regulation for premium deficiency reserves and reserve adequacy sections. It was noted that regulators view PDRs as satisfying short-term sufficiency issues, while the gross premium reserve analysis provides for long-term financial solvency. Because the document had not yet received review by A&HWG, it was not exposed formally for comment; rather a conference call will be scheduled to discuss it further.

- *1985 Cancer Tables:* The 1985 Cancer Table is viewed by regulators as obsolete and in need of revision to reflect current products and more recent experience. A project plan for revisions to the 1985 Cancer Tables will be submitted to the Society of Actuaries in January 2005. The data request to various companies has been drafted and will also be sent in January 2005. The Society expects to be finished with its analysis by late 2006.

- *Rate Regulation in Individual Medical Marketplace (Closed Block Problem):* A&HWG continues to consider ways to address the closed block death spiral problem in the individual medical marketplace. A conference call will be scheduled to discuss this topic further.

CAPITAL ADEQUACY TASK FORCE ("CADTF")

The following topics were discussed at the CADTF meeting.

1. C-3 Phase II Project: CADTF received an update report from Bob Brown representing the American Academy of Actuaries. Bob went over recent modifications to the Academy's work product, including a summary document as well as the complete December 2004 Academy report. Areas of refinement include: 1) GMIB purchase rate margins, 2) definition and requirements for inclusion of revenue sharing income in the cash-flow model, 3) use of 100 percent of the 94 MGDB Table or an experience based assumption using the prudent best estimate concept under the alternative methodology (for GMDB benefits) to put the assumption on a consistent basis with companies doing the detailed modeling, and 4) guidance has been added with respect to applying the concept of prudent best estimate to static and dynamic contractholder behavior assumptions.

2005 RBC Formula Changes: The CADTF adopted recommendations with respect to changes needed for the RBC formula to be able to implement C-3 Phase II by 2005 year-end. Formula changes must be completed by the prior year-end to allow for the programming necessary to implement a change. CADTF has until June 2005 to develop the instructions related to the RBC formula.

The C-3 section now has a separate line for Total Market Risk (C3c) and the RBC Covariance Formula would work as follows:

$$C0 + C4a + \sqrt{(C1o + C3a)^2 + (C1cs + C3c)^2 + (C2)^2 + C3b^2 + C4b^2}$$

Where

C0	=	Asset Risk – Affiliates
C1cs	=	Asset Risk – Unaffiliated Common Stock
C1o	=	Asset Risk – All Other
C2	=	Insurance Risk
C3a	=	Interest Rate Risk
C3b	=	Health Credit Risk
C3c	=	Total Market Risk
C4a	=	Business Risk
C4b	=	Health Administrative Expense Business Risk

Much work remains to draft appropriate instructional language by June 2005, if the C-3 Phase II capital methodology is to be effective for December 31, 2005.>>

It was noted that the smoothing mechanism that blends the prior yearend C-3 Phase II capital level held with the theoretical calculation could lead to inconsistent results when hedging is used, because the RBC requirement is being smoothed, while the asset valuation is not. It was also noted that weighting the existing requirement with a theoretical calculation may have some deficiencies, because there is currently no C-3 requirement for GMDB benefits, while there is a 1-2 percent of account value C-3 requirement for VAGLBs.

2. P&C Trend Test: The CADTF discussed developments since the September 2004 proposal for a two-tiered trend test in the P&C RBC formula, which is illustrated below.

P&C Proposed Trend Test	
RBC Ratio (% Regulatory Action Level)	Combined Ratio
200% to 300%	Greater than 120%
300% to 350%	Greater than 134%

Since the original proposal, some work has been done on the RBC formula modifications. Issues that are currently being addressed include clarifying the definition of combined ratio, and whether the second tier provides a useful test or rather generates too many false positives. Ultimately, a change in the model law will be required to implement the trend test for the P&C RBC formula.

3. Long-Term Care C-2 Proposal: The CADTF exposed a proposal from New York that is a blend of premium and claims-based approaches to C-2 risk for LTC products. This proposal was well-received by the industry and addressees some of the issues raised by a premium-only or claims-only based formula. The hope is that this can be adopted into the formula by December 2004, to be effective for December 31, 2005 RBC filings.

Long Term Care C-2 Risk				
		Recommendation		
RBC Component	Current Formula	Premium Based	Claims Based	New York Proposal
% of EP: 1st $50 million	25%	20%	N/A	10%
Above $50 million	15%	6%	N/A	3%
% of IC: 1st $35 million	N/A	N/A	37%	25%
Above $35 million	N/A	N/A	12%	8%
% of Claim Reserves	5%	5%	5%	5%
Additional Charge for Non-can	N/A	10% Charge	10% Charge	10% Charge

4. New York Proposal for C-3 Phase I Testing: A New York proposal had been discussed that would eliminate the exemption criteria for C-3 Phase I Testing. The ACLI submitted a document opposing extending the C-3 Phase I testing beyond those companies currently required to do the testing, because they believe there is no apparent problem or deficiency in the existing framework that needs to be fixed.

5. Other Academy Projects: CADTF received a brief update from the Academy on two projects described below.

- *Modco Treatment and Dividend Liability:* A report will be provided by the Academy in March 2005. This issue relates to treatment of the dividend liability credit (one-half) inherent in the Total Adjusted Capital calculation for modco reinsurance treaties where the dividend liability has not been physically transferred to the reinsurer.

- *Unauthorized Reinsurance:* A report is expected from the Academy at the June 2005 CADTF meeting. This issue was raised by New York and relates to whether or not security should be provided for RBC credits resulting from unauthorized reinsurance similar to reserve credit requirements.

Finally, the CADTF will suggest to the Financial Condition (E) Committee that they go back to formal meetings of the life, health and P&C subgroups rather than consider all matters at the CADTF level in order to focus on the specific needs of each formula.

ACCOUNTING PRACTICES AND PROCEDURES TASK FORCE

I attended several meetings of working groups reporting to the Accounting Practices and Procedures Task Force as described below.

1. Emerging Accounting Issues Working Group (EAIWG): The EAIWG discussed the following topics that may be of interest.

- *Form B Filing on AG 38 (UL with Secondary Guarantees):* EAIWG deleted this tentative position from its agenda, since the actuarial guidelines are the responsibility of LHATF and get automatically included in the *Accounting Practices and Procedures Manual* via Appendix C.

- *EITF 03-01:* EAIWG issued tentative guidance with respect to "non-interest related" other than temporary declines in value, in order to allow time for the FASB to finalize its own guidance related to other than temporary impairment in the context of changing interest rates or changes in credit rating as it pertains to EITF 03-01.

2. International Accounting Standards Working Group (IASWG): The following projects were discussed.

- *IASB Insurance Contracts Project (Phase II):* It was noted that the IASB favors discounting of non-life liabilities, but that the non-life user community does not support discounting in practice. One industry representative expressed frustration with the IASB process, which appears to settle on individual issues rather than focus on an entire accounting standard for insurance contracts.

- *IASB Timeframe:* A brief outline of the anticipated timeframe for an insurance contracts standard was discussed. A joint IASB/FASB project on insurance contracts is planned in 2005-2006. A discussion draft may be exposed in 2005, followed by 12-18 months of analysis, a standard by mid-2008, and adoption in 2009 – at the earliest. This project is referred to as a modified joint project where the IASB would be involved initially, followed by more active FASB participation. The ACLI continues to express concerns related to the narrow perspective and lack of focus on the fundamental issues related to insurance contracts.

3. Statutory Accounting Principles Working Group (SAPWG): Highlights of the Hearing Agenda and Meeting Agenda are discussed below.

- *Hearing Agenda:* SAPWG incorporated Model Regulation No. 818, "Determining Reserve Liabilities for Credit Life Insurance," into the Accounting Practices and Procedures Manual, which specifies the 2001 CSO Male Composite Ultimate Table as the standard mortality table for credit life insurance. SAPWG deleted Appendix A-825, "Guideline Concerning the Commissioner's Annuity Reserve Valuation Method," because it is already included in Appendix C, "Actuarial Guidelines" of the Accounting Practices and Procedures Manual. Revisions to Model Regulation A-010, which include items related to DI claim reserve revisions in the area of company experience recognition and revisions to the health model in the area of Long-Term Care reserves (morbidity improvement, lapse rates, mortality table, provision for moderately adverse, etc.), were referred back to LHATF for some technical review items.

  Finally, the SAPWG discussed recently emerging FASB Staff Positions (FSPs) and where these papers would fall in the NAIC's accounting hierarchy. FASB Board-directed FSPs have the same prominence as FASB technical bulletins and would be NAIC Level 1, while FSPs issued by FASB staff would be treated as NAIC Level 5.

- *Meeting Agenda:* Several items were discussed as outlined below.

  a) *Stress Liquidity Disclosure:* The Blanks Working Group referred to SAPWG the proposed revisions by LHATF related to stress liquidity disclosure for GIC/institutional business in the notes to the financial statements. If endorsed by SAPWG, then they will consider developing a disclosure requirement as part of SSAP No. 51, "Life Contracts."

  b) *Permitted Practices Disclosure Update:* Executive and Plenary adopted the revisions to the preamble of the Accounting Practices and Procedures Manual related to disclosure requirements for permitted accounting practices by a state. The Form A describes what was adopted which requires notice to be provided by the domiciliary regulator generally with 30 days advance notice with a description of the practice, quantification of the effect of the practice, and the effect on any parent or affiliated companies of the practice.

     A Q&A draft that had been developed as states deliberated the *Accounting Practices and Procedures Manual* changes will be reviewed and refined by NAIC staff for exposure prior to the SAPWG meeting in March 2005.

4. NAIC/AICPA Working Group: This working group continues to work on incorporating certain >>

provisions of Sarbanes/Oxley into the NAIC Model Audit Rule. Some progress has been made with respect to Title II (auditor, auditor rotation, etc.) and Title III (corporate governance items), but a substantial amount of work remains on Title IV, Section 404 management's internal self-assessment and its application to insurance companies. Issues raised include application to insurance companies that are not publicly traded, corporate level application of SOX, as opposed to the insurance entity application, in the Model Audit Rule, and the auditing process and expense related to the internal self-assessment.

It was also noted that some of the material in the Risk Assessment Working Group's revisions to the Examination Handbook contain references related to the Sarbanes/Oxley. The NAIC would like to get issues related to SOX resolved by the NAIC/AICPA Working Group before anything gets incorporated into the examiners' handbook.

Next, the AICPA provided a brief update of insurance-related projects, which include: 1) DAC on internal replacements—a draft was re-exposed with a comment period ending January 7, 2005, which would be applicable to fiscal years beginning after December 15, 2005, and 2) a technical practice aid was issued by the AICPA related to AICPA Statement of Position 03-01, which provides a Q&A discussion related to certain key questions.

VALUATION OF SECURITIES TASK FORCE

One item of note, which was discussed by the VOS Task Force, is a proposal by the state of New York that would include a requirement for more information with respect to the fair value, type of asset, and investment strategy related to Schedule BA assets.

OTHER MATTERS

Several other meetings that I attended are highlighted below.

1. Risk Assessment Working Group: This working group continues to consider revisions to the Examiners' Handbook, with a focus on risk assessment. In addition, they are working on a risk assessment best practices supplement that would highlight both best insurer practices as well as best state insurance department practices. Several site visits to certain states have been scheduled by NAIC staff as part of the state best practices project.

The Risk Prioritization Subgroup is developing a prioritization system for companies. Specifications have been completed and implementation will be released in March 2005.

The NAIC staff will begin the Risk Focused Surveillance Framework Training Program, which is intended to train state examiners in a risk-focused examination process.

Finally, it was noted that there will be a financial summit sponsored by the NAIC in February in Orlando, Fla. to update regulators and the industry on the activities of the NAIC with respect to financial regulatory developments.

2. Reinsurance Task Force: This task force continues to work on issues related to the Hague Convention in the area of enforcement of foreign judgments as well as to consider the reinsurance working trust that has been offered as one partial solution to the 100 percent collateralization requirement for foreign reinsurers operating in the United States. The foreign reinsurers view the working trust as only a partial solution to the collateralization problem.

Finally, the task force heard a presentation from the ACLI related to the life reinsurance marketplace. The discussion included recent consolidation of the life reinsurance market, changes in the industry in terms of products, capital market solutions and advances in valuation principles, as well as the potential for proposing modification to the Reinsurance Model Regulation to allow ceding companies to transfer risk in the current environment as efficiently as possible.

3. Insurance Holding Company Working Group: This working group continues to work on insurance holding company issues with a focus on making regulation and examination by various states as efficient as possible in a holding company framework.

4. NAIC Executive and Plenary: As previously noted, the Executive and Plenary Committee adopted minutes of the Financial Condition (E) Committee related to requirements for domiciliary state notification to other states of permitted accounting practices for any domestic companies. $

The next NAIC meeting will be held in March 2005 in Salt Lake City, Utah.