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Highlights of the December 2005 NAIC Life and Health Actuarial Task Force Meeting and Other NAIC Topics

by Ted Schlude



I attended the NAIC Winter Meeting held December 1-5, 2005, in Chicago, including meetings of the Life and Health Actuarial Task Force (LHATF) and selected meetings of the NAIC. Summarized here are the activities, which 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 – Update (AG VACARVM): The agenda for this meeting was to first receive the Academy's comments related to AG VACARVM as well as its response to certain New York comment letters, review the most recent New York proposal and then receive comments from the ACLI including a new proposal for a simplified version of the standard scenario.

a) *Academy Comment Letter:* This letter responds to certain comments/proposals contained in two New York comment letters dated August 19 and September 22, 2005. The discussion focused on items impacting 1) the CTE Amount and 2) the standard scenario.

Comments on Proposal that Impact CTE: Following are several of the Academy's comments.

1) *CTE 80 vs. CTE 65:* New York proposed CTE 80 rather than CTE 65 to offset some of the aggressiveness it sees in the actuarial assumptions. The Academy pointed out that CTE 65 for reserves had already been decided by LHATF in prior meetings and also that CTE 80, which is a pretax calculation could result in no capital requirement because CTE 80 (pre-tax) would be greater than CTE 90 (after-tax) in many situations.

2) *VAGLBs vs. Non-VAGLBs:* The Academy argued that the New York proposal to separate VAGLBs from non-VAGLBs is inconsistent with general risk management aggregation principles by not allowing offsets between different types of benefits.

3) *Revenue Sharing:* New York wants a statement in AG VACARVM that recognition of revenue sharing should only be allowed if that revenue is contractually guaranteed to the insurer and its successor. The Academy feels that the language in AG VACARVM is already clear.

4) *Credibility:* New York would like to have prescribed assumptions where there is no experience or credibility. The Academy feels that the concept of Prudent Best Estimate (PBE) already addresses this issue and that focus of work prospectively should be on research, literature and studies used to support assumptions where experience is lacking, and highlighting generally accepted practice rather than on prescriptive methodology and assumptions.

Standard Scenario Comments: The Academy comments with respect to the Standard Scenario continue to be the same from the standpoint that there are many different runs required, which tend to defeat the purpose of the C-3 Phase II modeling process by diverting the valuation actuary's attention from

evaluating risks in the contracts using a principles-based approach, to performing mechanical exercises specified by the actuarial guideline. The Academy would prefer a simplified process for the standard scenario, serving as a benchmark for regulators' use in reviewing the reasonableness of reserves set using the principles-based approach. The Academy asked that the concept of limited aggregation be pursued and pointed out that because of the lack of aggregation in the standard scenario, reserves could be greater than the capital requirement.

- b) *New York Proposal:* New York next reviewed its most recent modifications submitted in a November 10, 2005 e-mail. Modifications included, among other things:
- Language was added indicating that reserves should “substantially cover the tails.”
 - Prudent Best Estimate was strengthened to include a margin above best estimate when full credible data is used.
 - Policyholder Behavior: When credible data is available currently but credible experience is not available in later years, a five-year grade from the assumption based on credible data to the worst optimal policyholder behavior would be required.

The Academy commented that it has not yet reviewed the modifications contained in the most recent New York proposal, but felt that assuming 100 percent adverse policyholder behavior was not reasonable.

- c) *ACLI Presentation:* LHATF heard a presentation from John Bruins of the ACLI related to AG VACARVM. The ACLI recommended adoption of the April 29, 2005 AG VACARVM exposure draft with changes as recommended in the AAA August 10, 2005 document. The ACLI is 1) opposed to extending from CTE 65 to CTE 80 as New York has proposed, 2) does not support New York's recommendation to separate VAGLBs from other guarantees and therefore not allowing hedging of different product benefits and 3) is opposed to use of the standard scenario as a floor and recommended a simplified alternative to the standard scenario in a separate proposal.

The ACLI also recommended that AG 39 not be extended to January 1, 2008, because there is no release mechanism in the accumulation of charges methodology and no provision in the reserve to recognize hedging of risks. Their feeling is that focus should be on moving forward to get a reasonable version of AG VACARVM in place by December 31, 2006, which could be adjusted as necessary going forward.

The ACLI sponsored a project aimed at alleviating reserve levels for life insurance on an interim basis prior to formal adoption of a principle-based approach to reserves.

LHATF exposed for comment the April 29, 2005 AG VACARVM, supplemented as described in the AAA August 10, 2005, document along with the ACLI standard scenario recommendation. The ACLI will begin to draft language for AG VACARVM with respect to its simplified standard scenario recommendation for LHATF to consider.

2. Interim Proposals Relative to New Valuation Standards from ACLI:

The ACLI sponsored a project aimed at alleviating reserve levels for life insurance on an interim basis prior to formal adoption of a principles-based approach to reserves. The interim proposal introduces preferred mortality rates by splitting the 2001 CSO Table into preferred and residual standard mortality, introduces the use of lapse rates in the calculation of reserves for UL policies with secondary guarantees, and allows non-premium-paying UL contracts with secondary guarantees to use a surrender charge as an offset to the additional reserve calculation. The ACLI proposal included a cover letter outlining the proposal, a report from Tillinghast on a Preferred Version of 2001 CSO Mortality Table, a draft model regulation implementing such a Preferred Table and a revision to AG 38 to allow use of lapse rates subject to certain constraints for UL policies with secondary guarantees. The proposal splits the 2001 CSO Table into three non-smoker and two smoker tables. For example, the 2001 NS VBT was split into super-preferred (SP-NS), preferred (P-NS) and residual standard (RS-NS) classes.

Michael Taht, who was closely involved in developing the 2001 CSO Table, provided a presentation related to the 2001 CSO Preferred Tables. Regulators also discussed a letter from New York objecting to various aspects of the ACLI proposal.

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Focus will be on a principles-based approach as defined by the Academy, which captures all material risks, benefits and guarantees including the tail risks, as well as the revenue to fund the risks.

It was noted that mortality has little impact on reserves for UL products with secondary guarantees so as a result, the proposal includes two other elements: 1) introduction of lapse rates of 2 percent (in years 1-5) and 1 percent thereafter subject to certain limitations and 2) a surrender charge offset to the additional reserve for non-premium

paying UL policies with secondary guarantees.

The ACLI asked that the Tillinghast report, the model regulation for preferred table use and the revisions to AG 38 be exposed for comment at this meeting to facilitate ongoing discussions related to the proposal. A separate independent legal review of the consistency of these changes with existing Standard Valuation laws is underway, as well.

Regulators felt uncomfortable exposing the documents given they had little time to review them, rather a February conference call will consider these documents in more detail and possibly expose them at that time.

3. Joint SOA-AAA Project Interim Table for Preferred and Standard Mortality: Next, LHATF received an update from the SOA, MIB and AAA on development of preferred tables by the SOA. It was noted that this project is not linked to the ACLI proposal discussed above, however, it is similar in nature in terms of its goal. The goal of this project is to have a preferred valuation table or factors for use with the 2001 CSO Table by April 15, 2007. Various teams have been formed including a data validation team, an underwriting criteria team, an experience analysis team, a valuation basic team, an implementation team and a valuation table team. The goal is to have an experience table by September 30, 2006, a valuation table by December 31, 2006 and a regulatory document by some time in 2007.

4. Report of Academy SVL II Work Group: Donna Claire gave a presentation related to the Academy's Risk Management and Financial Soundness Committee (also known as the SVL2 Steering Committee), its structure, as well as the subcommittees reporting to it (Capital Adequacy, Experience, Life Valuation and its work groups such as the Life Reserve Work Group, Variable Annuity Work Group and Annuity Reserve Work Group).

Focus will be on a principles-based approach as defined by the Academy, which captures all material risks, benefits and guarantees including the tail risks, as well as the revenue to fund the risks. The approach would also use risk analysis, stochastic models where appropriate, permit recognition of company experience subject to credibility and relevance constraints and provide for an appropriate level of conservatism through prudent best-estimate assumptions.

Further work will be done in all areas including peer review, format standards for reviewers and regulators, standard definitions of terms, use of judgment and the system of governance.

The ACLI noted that it has formed a committee of lawyers and actuaries to begin to put a new valuation law together for consideration by LHATF in March 2006.

Finally, New York made a motion, which was adopted, to continue pursuing its proposed valuation law changes via a small subgroup of LHATF members. The ACLI indicated that there were still significant industry concerns with the New York document.

5. Life Reserve Work Group (formerly ULWG): LHATF heard two presentations from the Academy related to the Life Reserve Work Group (LRWG). The first presentation by David Neve outlined an Academy proposal for a principles-based valuation standard for Life Products, which had been submitted to LHATF previously.

The Academy requested that LHATF expose this document, which includes:

- a) A draft model regulation, which outlines basic principles
- b) AG PBR, which defines prudent best estimate valuation assumptions
- c) AG DIS, which provides a documentation and disclosure framework
- d) AG MAR, which deals with margins to be reflected in assumptions

The above proposal assumes that the Standard Valuation Law has been changed to a principles-based approach and that an acceptable governance process is in place.

Additional changes to the proposal include:

- a) Scope is expanded to all life products.
- b) The mortality assumption would define an NAIC approved valuation table that best maps to the actuary's prudent best estimate assumption.
- c) A company's own interest rate generator could be used if calibration standards were met.
- d) Aggregation of policies would be allowed, but limited by a deterministic reserve.
- e) A methodology for earned and discount rates would be defined.
- f) Deterministic reserve approach is permitted provided it is demonstrated by the actuary to be sufficient.
- g) Non-guaranteed elements would change to reflect changing conditions under different scenarios in the models.
- h) Documentation and disclosure requirements are expanded in AG DIS.
- i) Other areas being considered include: separate account revenue sharing, stochastic reserve allocation to individual policies, quantification of the aggregate margin resulting from all assumptions (including disclosure) and modeling of hedges.

The goal of the Academy is to have a form for adoption by LHATF by December 2006 and to roll the new methodology out on a state-by-state basis in 2007. LHATF exposed the Academy proposal for comment.

Finally, LHATF received a second presentation from Tom Kalmbach representing the Academy related to testing performed for a twenty-year term product. Additional demonstrations will be prepared for shadow UL and accumulation UL products in the future. In the demonstration, deterministic reserves with margins were higher than current statutory reserves in early years because of the use of net level reserve methodology. Reserves in later durations of the illustration run roughly 60 percent to 80 percent of current statutory levels.

6. A&H Working Group Meeting: The A&H Working Group discussed the following projects:

– *LTC Annual Statement Reporting Forms:* LHATF received an Academy Report related to instruction changes and reporting forms for long-term care reporting in the annual statement. The reporting excludes accelerated benefit riders on life and annuity contracts. This is consistent with recommendations contained in an ACLI comment letter dated December 2, 2005.

The Academy recommendation was exposed for comment with a request for discussion related to actuarial certification and responsibility or ownership of the completed reporting forms.

– *Minimum Standards for Health Insurance Contracts:* The A&H Working Group continues to address issues related to incorporating recent changes on long term care reserve guidance and reflection of experience in group disability insurance claim reserves into codification.

– *Premium Deficiency Reserve Clarification:* A subgroup of regulators was formed to continue to consider whether a change in the statutory guidance is needed to clarify premium deficiency reserve calculations and methodology after receiving a proposal from Bill Weller.

– *Cancer Table Update:* Work continues on a cancer table update by the SOA. The goal is to have company data by December 31, 2005. Requests were made of 35 to 40 companies with five companies having agreed to participate at the date of this meeting. Initial data analysis is scheduled for April 2006, summaries by October and a draft report by November. Hope is that a final report and recommendation will be completed by December 2006.

– *Trends in Health Industry:* A presentation was received from Reden & Anders, Ltd. related to health care trends and analysis including recent actual trends and expectations for 2006 and 2007.

– *Individual Medical Rate Regulation:* The A&H Working Group continues to consider whether any changes can be made to the existing health insurance system to address the health claims spiral in closed medical blocks. A subgroup was formed to consider this issue further.

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7. LHATF General Matters Meeting: LHATF received updates on various other projects highlighted below.

– *Extension of AG 39 VAGLBs:* At the objection of various industry representatives, LHATF voted to extend the expiration of AG 39 from January 1, 2006 to January 1, 2008. As indicated previously, the industry opposes extension of AG 39 accumulation of charges methodology because it has no release from risk mechanism, nor any credit for hedges related to the VAGLB risks.

– *Independent Peer Review (C-3 Phase II):* Regulators reviewed a document prepared by Mike Boerner of Texas related to independent peer review. Discussion by LHATF focused on two levels of review: pre-release review and post-release review which might take place during a triennial exam. Mike Batte (New Mexico), the chair of LHATF, expressed a desire to have a pre-earnings release peer review as part of the process.

– *SOA Pre-need Mortality Table:* Roger Annin representing the SOA Project Oversight Group gave an update of recent progress made in development of a valuation standard for pre-need mortality products. The 2001 CSO Table is perceived as inadequate for these products, which have limited underwriting, and reverse select and ultimate mortality. A recommendation will be provided to LHATF in June 2006.

– *AG ABC:* LHATF exposed revisions to proposed AG ABC, which addresses methodology to be used in projecting benefits under CARVM in the context of the new annuity

non-forfeiture law, which allows for minimum interest guarantees to be tied to an index.

Capital Adequacy Task Force (CADTF)

I attended several meetings of the CADTF. Highlights follow.

1. C-3 Phase II Market Risk Question and Answer Session: Regulators provided several presentations on C-3 Phase II as well as discussed some of the questions which have been submitted with respect to implementation of C-3 Phase II. This session was recorded and will be posted on the Academy website. Any answers to the questions will be posted on the NAIC's Web site as they become available.

Larry Bruning of Kansas will head up a results subgroup which is to evaluate the effectiveness of C-3 Phase II based on selected filings of December 31, 2005 results. Recommendations will then be made with respect to making the whole process more effective. The process will include: 1) a model dynamics review, 2) validation of model assumptions, 3) a review of margins, prudent best estimate, sensitivity analysis and 4) the impact of the Standard Scenario on results and whether it is causing any areas of concern. Areas to be reviewed included the mortality assumption (80 percent), hedge recognition and the equity return assumptions among others.

It was also noted that the RBC instructions were modified in the final version of C-3 Phase II to allow smoothing as an option. Therefore, companies with hedges can elect not to smooth so asset values and RBC calculations are consistent. It was also noted that smoothing takes place with respect to the Total Asset Requirement (TAR) so RBC may fluctuate dramatically due to fluctuations in reserves, which get subtracted from TAR for RBC determination.

2. Life RBC Working Group: Topics discussed by the Life RBC Working Group are highlighted here.

– *Modco Dividend Liability Issue:* The Academy said that a complete report on the treatment of the dividend liability in modco agreements will be provided at the March 2006 meeting.

– *Expansion of C-3 Phase I:* Regulators discussed a proposal by Minnesota to require C-3 Phase I for all companies subject to: 1) a \$100 million small company asset exemption and 2) that constraints of 50 percent and 200 percent of the base C-3 factors would be left in place. Blaine

Sheppard of Minnesota will work with NAIC staff to draft instructional changes for such a proposal. A conference call will be held prior to the March 2006 meeting to expose the changes. Industry representatives questioned what this change was intended to correct, having impressions that there were not any problems with C-3 Phase I as it exists today.

– *C-3 Phase III*: This project no longer refers to EIAs, but rather a broader scope project that would create a similar capital/reserve structure to C-3 Phase II for Life Products under the LRWG which would focus initially on interest rate risks on life products and then on a more complete risk review.

3. Capital Adequacy Task Force: Material discussed by CADTF included minutes of meetings of the various working groups reporting to CADTF as previously described. CADTF adopted minutes from prior calls and meetings which included C-3 Phase II work, adding a trend test to the P&C formula, Medicare Part D, etc.

– *Medicare Part D Factors*: Formulas and instruction changes for Medicare Part D coverage were exposed in their final form for adoption expected in March 2006. It was noted that certain changes such as the risk corridor might cause some changes in the 2007 and 2008 factors.

Work will continue in January and February related to the C-3 Phase II Results Subgroup, as well as on Medicare Part D factor refinement as necessary.

Reinsurance Task Force

The Reinsurance Task Force continues to consider collateralization issues with respect to foreign reinsurers operating in the United States and exposed both a reinsurance collateral white paper as well as a reinsurance collateralization roundtable report. The roundtable consists of regulators, as well as U.S. and non-U.S. industry representatives. Two proposals were considered: 1) a “rating proposal” and 2) a “pooling proposal.” The rating proposal has received the most support and would involve relying on creation of a national rating system to provide rating criteria for all reinsurers participating in the market. Collateralization requirements would decrease as a reinsurer’s rating under the system increased. The Reinsurance Task Force will begin to consider both alternatives as recommended by the roundtable.

The task force also heard a presentation from the ACLI related to modernization of the Life Reinsurance Model Regulation to clarify its guidance in agreements that fall outside of pure coinsurance and YRT reinsurance or reinsure only a portion of a policy’s risks such as reinsurance of secondary guarantees, long-term care riders, variable annuity guarantees, etc. The current ad hoc approach to recognizing these types of treaties in accounting and reserving causes problems for regulators, companies and auditors reviewing the financials. The ACLI presented a Form B proposal, which would allow for incremental modernization by preserving existing guidance, but allow its application to separable benefits within a policy. This proposal was forwarded to the Emerging Accounting Issues Working Group to decide whether it warrants a new project at LHATF.

Accounting Practices and Procedures Task Force

I attended several meetings of the working groups reporting to the Accounting Practices and Procedures Task Force. Highlights follow.

1. Emerging Accounting Issues Working Group (EAIWG): It was noted that the NAIC’s Financial Summit will be held again on February 13-15 in Orlando, Florida. Also, the reinsurance model regulation Form B received from the Reinsurance Task Force was referred to LHATF for its consideration.

2. Statutory Accounting Principles Working Group (SAPWG): Selected topics discussed at the Meeting Agenda are outlined here.

Meeting Agenda: SAPWG received an update from LHATF on its activities as they related to the accounting framework which include:

- Extension of the AG 39 sunset to January 1, 2008.
- Adoption of revisions to the MGA Model Regulation to achieve consistency with the new annuity non-forfeiture law.

The Reinsurance Task Force continues to consider collateralization issues with respect to foreign reinsurers operating in the United States and exposed both a reinsurance collateral white paper as well as a reinsurance collateralization roundtable report.


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2006 GRET Table

Finally, the NAIC Executive/Plenary Committee adopted the new 2006 GRET Table for use effective January 1, 2006.

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The next NAIC meeting will be held in March 2006, in Orlando, Fla. 

- Exposure of AG ABC, which defines CARVM methodology under the new annuity non-forfeiture law.

3. NAIC/AICPA Working Group: The NAIC/AICPA Working Group continues to move forward with implementation of certain aspects of Sarbanes/Oxley into the NAIC Model Audit Rule. The Title IV Subgroup on management's self-assessment presented its final draft, which contains a \$500 million premium threshold by legal entity to determine which companies must comply. Title IV was adopted by the Task Force with a charge to consider potentially increasing the \$500 million threshold.

It is expected that all changes to the Model Audit Rule (Titles II, III and IV) will now be exposed and one more set of industry comment letters will be considered. A subgroup will continue to work on adoption of compliance and implementation guidelines for the revised Model Audit Rule. Interested parties will develop a timeframe for developing the implementation guide.



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Risk Assessment Working Group

The Risk Assessment Working Group indicated that it is expected that a risk focused based approach to the financial examination will be included in the Examiner's Handbook with the 2007 release. The working group discussed transition issues where certain states might be using a risk focused rather than the traditional approach to examination during the transition, as well as accreditation issues that may come up. The working group also discussed the training program for regulators (via webcasts, Financial Summit) and coordination with other subgroups such as the Title IV subgroup revisions to the Model Audit Rule.