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# Highlights of the June 2001 NAIC Life and Health Actuarial Task Force Meeting and Other Topics

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*Editor's Note: Summarized below is what took place at the various task force and working group meetings of the NAIC in June, 2001.*

## Actuarial Opinion and Memorandum Regulation (AOMR) Revisions

The revisions to the AOMR were adopted unanimously by both the Life (A) Committee and Health (B) Committee. The major revisions to the AOMR include:

- Eliminates Section 7 Formula Reserve Opinion: The revised actuarial standards of practice "Analysis of Life, Health or Property/Casualty Insurer Cash Flows" and "Statements of Opinion Based on Asset Adequacy Analysis by Actuaries for Life or Health Insurers" will provide guidance to the opining actuary in determining what level of reserve/asset adequacy analysis is appropriate for the blocks of business to which the opinion applies.

- Regulatory Asset Adequacy Issues Summary: The model regulation requires that an executive summary of asset adequacy analyses be prepared by the actuary. Various information to be included in the summary is specified in the revised AOMR. Results, assumption differences from prior analyses, sensitivity testing, blocks subjected to analysis and treatment of reinsurance are examples of areas to be highlighted in the summary.

- Allows State of Domicile Opinion: Subject to requirements set forth by each state.

- Eliminates Required Interest Rate Scenarios: In favor of the Appointed Actuary's judgment as guided by the revised ASOPs.

The modified AOMR does not address state variation very well in the sense that states are still free to do what they want in accepting the opinion and the opining actuary will still be subject to the laws, regulations and regulatory policy as each state sees fit. The appointed actuary also has the option to continue to file a "this state" opinion (Section 8) as they have been for the last ten years.

The revised AOMR is scheduled to be adopted by the Executive and Plenary Committee at the Fall NAIC meeting. Currently, only a small portion of the AOMR is included in Appendix A of the codified NAIC Accounting Practices and Procedures Manual so it appears that the revisions will have to be adopted in the form of a revised regulation in each state.

## Life Insurance (A) Committee

Summarized below is the work of several working groups reporting to the Life (A) Committee:

1. ***Life and Health Actuarial Task Force (LHATF):*** LHATF met prior to the NAIC meeting and discussed many ongoing projects. Items of note with an emphasis on life and annuities include:

**- Actuarial Guideline MMMM – VAGLB Reserving Guideline:** The group received an update report from the Academy of Actuaries on this project. The fund return database was updated for two years of recent data and the group has studied the advantages and disadvantages of using distributions other than the lognormal distribution. The Academy group is studying the feasibility of a calibration approach which would give the actuary flexibility to choose from several methodologies provided the approach qualifies based on calibration points. One simplified approach being considered is to use the lognormal, but with lower mean returns and higher standard deviations in order to thicken the tail exposure.

Future plans include finishing the calibration analysis, reviewing the feasibility of simplified alternatives such as representative scenarios or the Keel method, modification of the AG VAGLB as appropriate, and to work with the Life RBC Working Group toward a long-term non-formulaic VAGLB solution.

***- Actuarial Guideline AXXX:*** LHATF split the draft actuarial guideline which clarifies XXX into two pieces by carving out specific reserving guidance for universal life shadow account products, for which consensus has not yet been reached. In order to keep the basic guideline moving forward, a separate guideline for shadow account reserving may be drafted at some point in the future. The current guideline will only reference shadow account products as ones which fall within the scope of XXX. A revised draft of the basic guideline is scheduled to be exposed in July, 2001. The guideline would apply retroactively to business written in 2000 and later consistent with the life policy model regulation (XXX).

***- 2001 CSO Mortality Table:*** The regulators received a report from the Academy of Actuaries related to analysis of margins to be applied to the New Basic Table previously developed. Generally, the margin approach is similar to that used for the 80 CSO with a 15% margin overall, which varies by age and is subject to various smoothing criteria. This level of load covers the mortality of 15 of the 21 companies included in the underlying experience data.

LHATF recommended the new table for exposure. The goal is to have the table adopted by the Life (A) Committee in September and by Executive and Plenary in December, 2001. The table will most likely be available for use January 1, 2003 and mandatory by January 1, 2008, similar to the structure used for the 80 CSO model regulation.

The LHATF received a model regulation drafted by the ACLI which would implement the New CSO Table. Tentatively, X-factors in the XXX Model Regulation would apply and a minimum 20% has been used as a placeholder. The appropriateness of the 20% factor will be reviewed in the future. Based on the meeting discussion, this draft will be modified and a new draft model regulation will be exposed in July, 2001.

***- Credit Disability Valuation Table:*** The A&H Working Group modified the Health Reserving Model Regulation to incorporate the recently developed Credit Disability Valuation Morbidity Table. LHATF adopted the changes and recommended them to the Health (B) Committee.

***- Actuarial Guideline VL-GMDB:*** The LHATF adopted the previously exposed guideline and recommended it to the Life (A) Committee for adoption.

***- Actuarial Guideline XYZ - Non-forfeiture for Products with Secondary Guarantees:*** The regulators heard a report related to testing performed on the exposed Actuarial Guideline XYZ.

The task force continues to discuss nonforfeiture generally, issues related to codification (single premium credit life refund reserves, disclosure note related to reserves that are higher than the codified standard), and various other issues.

2. ***Life Liquidity Risk Working Group:*** The Life Liquidity Risk Working Group heard a presentation from Federal Reserve Board representatives on their approach to financial regulation of banks. Next, they discussed Moody's approach to review of GIC/ funding agreement and similar spread based business exposures. The NAIC may take a similar approach to accumulate this type of information. New York indicated that as a result of its circular letter, there were not as many formal liquidity plans as it might have expected. Rather, companies are choosing to respond to all the questions in the New York circular letter. The working group abandoned consideration of a life RBC factor to address stress liquidity. Finally, an approach drafted by Mike Boerner (TX) focused on stress liquidity was discussed which would include comment from the appointed actuary and a company officer certification with respect to stress liquidity, as well as require New York circular letter type information.

3. ***Suitability Working Group:*** The Suitability Working Group met and discussed two issues with respect to the model regulation. Item 1 – IMSA - a reference to IMSA will create a safe harbor, but becomes problematic for regulators because currently no one is auditing IMSA and the IMSA reference is objected to by consumer groups because it provides a safe harbor for insurance companies. Regulators are hesitant to place an endorsement of IMSA in an NAIC model regulation. Item 2 – record keeping is a big issue for insurers. Some regulators would want records kept for all recommendations including those that do not necessarily result in a sale. Companies say that this will be nearly impossible and would prefer to maintain only recommendations that result in a sale.

4. ***Small Face Amount Working Group:*** The Small Face Amount Working Group heard a report from a smaller working group summarizing a frame work for disclosure with respect to policies where cumulative premiums could exceed the policy face amount. Rules would apply to new issues not inforce. The working group authorized the smaller work group to move forward in drafting a model regulation on disclosure. Finally, two states' specific guidance was discussed: (1) Illinois — a draft regulation specifies that it is a company's responsibility to search their records for multiple policies when notified of a death claim, and (2) Florida — a bill which died in the House would have required face amount increases for policies where premiums exceed a certain percentage of the face amount. That particular bill would have increased face by 50% if premiums exceed 250% of face amount, and would increase face by 150% if premiums exceed 500% of the face amount.

## Accounting Practices and Procedures Task Force

Several accounting related working group meetings are summarized below.

1. ***Emerging Accounting Issues Working Group:*** The Emerging Accounting Issues Working Group (EAIWG) adopted various interpretations and discussed outstanding issues. With respect to disclosure of differences with codification, the EAIWG decided to require disclosure of differences between established and codi fied reserves if the company and auditor determine the differences to be material, even in cases where reserves are stronger than codification. It had been the opinion of LHATF that because codification specified a minimum standard and companies have always been free to hold a stronger reserve than the minimum standard, stronger reserves might not trigger a disclosable event in that case. Another argument relates to it being cumbersome to maintain a parallel set of reserves (minimums) when the emphasis of statutory accounting is on solvency and conservatism. This guidance just applies to reserves for new business issued in 2001 and later. Business issued prior to Jan 1, 2001 follows the laws and regulations of the domiciliary state.

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The EAIWG also adopted the NAIC's staff recommendation related to margin for adverse deviation in claim reserves. Even though SSAP No. 55 refers to "best estimate," the concept of conservatism is inherent to the estimation of reserves and as such should not be specifically prohibited in the consideration of management's best estimate.

2. ***Statutory Accounting Principles Working Group:*** The Statutory Accounting Principles (SAP) Working Group held the two meetings discussed below.

- Hearing Agenda: It was noted that the SAP Working Group has begun to consider comments related to Issue Paper No. 114 Accounting for Derivative Instruments and Hedging Activities. These comments and others will be discussed at an interim meeting on August 7, 2001. They plan to expose a revised issue paper prior to the September, 2001 NAIC meeting.

Next, Issue Paper No. 115 Investments in Foreign Subsidiary, Controlled and Affiliated Entities (SCAs) was discussed. The group decided to defer discussion of this paper and to consider all issues that have arisen related to SSAP No. 46 - Investment in Subsidiary, Controlled and Affiliated Entities. SSAP No. 46 did not provide specific guidance with respect to foreign SCAs.

- Meeting Agenda: The SAP Working Group discussed various proposals clarifying codification and directed them to the appropriate working group or committee to obtain additional feedback.

3. ***Financial Reporting Working Group - Risk Classification Subgroup:*** The Risk Classification Subgroup received a presentation outlining regulatory risk assessment framework as well as an American Academy of Actuaries report on Catastrophe Exposures and Insurance Industry Catastrophe Management Practices.

4. ***Separate Accounts Working Group:*** The Separate Accounts Working Group discussed the disclosure note with respect to guaranteed benefits provided by variable annuities and will proceed to develop a blanks proposal for such a note. The proposal would disclose the type of guaranteed benefit (death benefit vs. living benefit and detailed nature of the benefit including combinations), the dollar amount of account value to which the benefit applies, the reserve held, location of the reserve in the annual statement as well as relevant reinsurance related information.

   Next, a proposal for accounting for the CARVM/CRVM allowance in the general account for modified coinsurance of variable products was discussed. The proposal by interested parties would be to increase the allowance in the assuming company's general account statement and reduce the allowance in the ceding company's general account statement for variable life and annuity reinsurance. The regulators asked that an example be drafted as well as a blanks proposal and will hold a conference call in late June, 2001 to discuss this topic further.

## RBC, AVR/IMR & Invested Assets

1. ***Life RBC Working Group:*** Specific items discussed at the Life RBC Working Group meeting are described below.

***- Common Stock Covariance:*** The Life RBC Working Group adopted the common stock covariance formula in concept at the March, 2001 NAIC meeting. The revised covariance formula will treat C-1 common stock risk as being independent of other C-1 asset risk. In addition, an adjustment to the base 30% common stock RBC factor would be made to recognize a company's Beta. The basic factor of 30% gets multiplied by the weighted average Beta for the insurer's common stock portfolio but is subject to a minimum value of 22.5% and a maximum value of 45%. If Beta is not available, then the maximum 45% would be used. This modification was adopted by Life RBC to be effective at 2001 year-end. Note that the base 30% factor was later changed to 20% as part of changes related to codification.

***- C-3 Interest Rate Risk:*** The working group reviewed the results of December 31, 2000 annual statement filings prepared under the C-3 "cash flow scenario testing" instructions. Forty-eight companies were required to perform the testing:

***Lower C-3:*** 43 Companies - Most of these went down to the floor of 50% of base C-3 factors.

***Higher C-3:*** 5 Companies had C-3 factors increase but not above the 200% of base C-3 cap. One of the five companies hit the 200% cap.

It was noted by regulators, based on questions asked by their domestic companies, that there was some uncertainty related to the relationship of cash flow testing assumptions compared to cash flow scenario testing assumptions. The RBC instructions were clarified that there could be distinction between the two analyses because the scenario testing results are focused on the tail of the interest rate distribution rather than a range of plausible future events such as the N.Y. Seven scenarios. The instructions were revised to specify "consistent assumptions" rather than "same assumptions" and also clarified to emphasize the importance of reviewing for reasonableness the results of the testing under severe scenarios. This instruction change was viewed as non-substantive and will be effective for 2001 year-end.

***-Disability Income (DI) C-2 Factor Proposal:*** When Life RBC was originally adopted, the emphasis was on C-1 and simplified approaches were used for other risks like C-2 and C-3. The Academy of Actuaries performed analysis over the past 2 years related to refinement of DI factors as well as factors for other health lines for C-2 insurance risk. An initial DI proposal was presented in March and the regulators asked for additional analysis and sensitivity testing with particular emphasis on group LTD where the proposed C-2 factors were significantly lower as illustrated below.

| | Group Long Term Disability C-2 Insurance Risk Factors | |
|---|---|---|
| Inforce Base | Current RBC | Proposed |
| First $50 million of premium | 25% | 15% |
| Premium Beyond $50 million | 15 | 3 |

It was pointed out that even with the new factors, reserves plus RBC are intended to be adequate 95% of the time. Additional support and sensitivity analysis presented by the Academy convinced regulators to adopt the new C-2 factors for use at 2001 year-end for Life RBC.

**- Codification Changes – Full Tax Proposal:** The Life RBC Working Group adopted the interested parties tax proposal to take into account codification changes. The majority of the changes related to C-1 risk factors which now more fully need to take into account recognition of taxes given the creation of deferred tax liabilities (DTL's) and deferred tax assets (DTA's) by codification.

The most notable changes to C-1 factors and explanations are described below although C-1 factors for all asset types and classes were reviewed for appropriateness as part of this project.

*(Please refer to the chart below the dotted line.)*

**Life RBC – 12/31/2001**
**Codification**
**Selected C-1 Risk Factors**

| Asset Category | Current RBC C-1 Factor | 2001 YE RBC C-1 Factor | Comments |
|---|---|---|---|
| Bonds: | | | |
| 1-US Govt | 0.00% | 0.00% | Because DTAs are subject to limitations, tax recognition = 35% x 75% = 26.25% (was 17.5%). |
| 1-Other | 0.30 | 0.30 | |
| 2 | 1.00 | 0.90 | |
| 3 | 4.00 | 3.40 | |
| 4 | 9.00 | 7.50 | |
| 5 | 20.00 | 17.00 | |
| 6 | 30.00 | 20.00 | Recognize 35% tax rate similar to equities. |
| Preferred Stock: | | | |
| 1 | 0.90% | 0.80% | Tax rate = 35% x 75% = 26.25%. |
| 2 | 2.50 | 2.20 | |
| 3 | 6.00 | 5.30 | |
| 4 | 13.50 | 11.00 | |
| 5 | 25.00 | 18.00 | |
| 6 | 30.00 | 20.00 | Recognize 35% tax rate similar to equities. |
| Unaffiliated Common Stock (Base Factors) | 30.00% | 20.00% | Tax Rate = 35% |

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The RBC calculation would also recognize any DTAs and DTLs reflected in the balance sheet under codification. As noted, the Life RBC Working Group adopted this proposal to be effective for December 31, 2001.

2. ***Health RBC Working Group:*** The Health RBC Working Group received a report from the Academy of Actuaries related to progress made with respect to development of new C-2 factors for DI (proposal), LTC (under study) and Stop Loss (under study). The working group received the report but did not adopt the DI factors because this business is not currently as critical to HMO/HMDI entities as it is to life company RBC discussed earlier. Next, the working group considered the Academy's tax proposal to take into account codification changes. It was noted that there are already some formula differences between the Health, P&C and Life formulas such as AVR (life only) and common stock factors (15% for P&C, Health but 20% for Life) so Health RBC held off adopting the codification proposal.

   Recently, cost containment expenses have been modified for the life blank and health blank as well as the Accounting Practices and Procedures Manual into two categories: (1) quality assurance expenses and (2) cost containment expenses. The Health RBC Working Group will consider what changes need to be made to RBC as a result.

   An industry representative noted that the working group's prior decision to reverse DTLs/DTAs resulting from codification will be detrimental for many health entities with significant DTAs.

3. ***Recent RBC Conference Calls Related to Implementation of Codification:*** As a result of the summer meeting, the regulators have had several conference calls to attempt to resolve differences between the Life, P&C and Health formula treatment with respect to codification and taxes in particular. The current direction is to have an approach that is as consistent as possible across Life, P&C and Health.

   - All three RBC formulas will allow recognition of DTAs and DTLs in surplus used to compute adjusted capital.

   - An RBC sensitivity test will be required which reverses out of adjusted capital the impact of DTAs and DTLs.

   - Life Company RBC will be allowed to make the changes to the C-1 factors which the Academy has recommended to reflect codification changes to taxes (taxes are now recognized more immediately as a result of DTA's/DTL's).

   Even though the Life C-1 factors will be different than Health and P&C, it was felt that there are already other differences in the RBC formulas and accounting frameworks and that the revised C-1 factors are appropriate for Life RBC. The Financial Condition (E) Committee will vote on this approach in early July, 2001.

4. ***AVR/IMR Working Group:*** The AVR/IMR Working Group adopted changes to AVR factors to reflect the implications of codification with respect to deferred tax assets and liabilities consistent with changes made by the Life RBC Working Group.

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The next NAIC meeting will be held in late September, 2001 in Boston.

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