

LRWG Report to LHATF

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Agenda for this session

1. **Review and discuss the updated drafts of Model Regulation and Actuarial Guidelines.**
2. **Review Federal Income Tax Considerations**
3. **Discuss several critical technical issues that need resolution in order to adopt the LRWG proposal:**
 - Individual assumption margins
 - Aggregation
 - Discount Rate
4. **Review list of outstanding issues**
5. **LHATF vote to expose for comment the updated drafts**



Summary of Changes to Model Regulation

1. Incorporated the Greatest Present Value of Accumulated Deficiencies (GPVAD) method in the Stochastic Reserve calculation.
2. Updated and clarified the stochastic modeling exclusion in light of the GPVAD changes.
3. Expanded the requirements to determine Prudent Best Estimate assumptions and Margins to include:
 - Considerations for setting Margins that must be addressed
 - Disclosure of the impact of each assumption margin on the reserve now required (in addition to the disclosure of the aggregate impact of all Margins on the reserve)
 - Disclosure of Margin Ratio now required (i.e. the “Z-value”)
4. Expanded the discussion of the requirements dealing with reinsurance.



Summary of Changes to Model Regulation

5. Dropped the option to select a “Predetermined Scenario Set” provided by the NAIC for the Stochastic Reserve (SR) calculation, but added the option to use a “Proprietary Scenario Set” determined by the company.
6. Incorporated changes to accommodate equity indexed products.
7. Added several changes requested by small companies:
 - Added an option for a state to exempt a form/product from the PBR reserve calculation.
 - Clarified that a simplified approach to determine the Net Asset Earned rates can be used.
 - Allow a company to increase the required minimum Deterministic Reserve in order to meet the stochastic modeling exclusion.



Summary of Changes to Model Regulation

8. Other changes:

- Clarified that the scope does not include group life (but does include contracts sold as part of a group plan that are marketed, sold and underwritten as individual life policies.)
- Clarified that a Qualified Actuary must provide a certification that the reserve calculation meets the regulatory requirements and applicable ASOPs.
- The Actuarial Report is to include a summary of the company's controls on actuarial judgment and the effectiveness of "feedback loops" to update assumptions.
- Clarified that due and accrued investment income is included in starting assets, and included in investment income each period.
- Reserve calculations cannot be made more than 6 months prior to the valuation date.



Summary of Changes to Actuarial Guideline PBR-VAL

1. Added requirements for setting best estimate assumptions
2. Added a new section giving requirements for setting assumption Margins that apply to all Risk Factors
 - Considerations that the actuary must address
 - Sensitivity testing of margins is required
 - Conditions that justify a higher margin
 - If margins are adjusted to reflect the aggregate impact of all margins, the rationale for such an adjustment must be demonstrated and documented.
3. Added specific requirements for setting margins in the respective assumptions sections



Summary of Changes to Actuarial Guideline PBR-VAL

4. Added a new section that outlines requirements for setting reinsurance assumptions
5. The requirements to determine the mortality assumption have been substantially revised
 - Added additional guidance and requirements
 - Updated the prescribed credibility methodology
 - Selection of final valuation table based on aggregate Seriatim Reserves (not Reported Reserve)



Federal Income Tax Considerations

1. The federal income tax implications of PBA reserves are complicated and we are pursuing a PBA proposal that is consistent with the existing federal tax laws.
2. A Tax Advisory Subgroup (TASG) reporting to the LRWG has been established to review PBA proposals as they emerge and suggest modifications when appropriate.
3. Portions of the PBA proposal have already been revised to accommodate some of the federal tax laws, for example, the inclusion of a seriatim deterministic reserve calculation.
4. Several significant technical tax issues are currently under discussion by Academy and ACLI tax groups.



Federal Income Tax Considerations

5. The ACLI has begun a dialogue with the US Treasury Department regarding the application of the federal income tax laws to PBA reserves.
 - Some tax issues can only be resolved through guidance from the Treasury Department.
 - We believe that guidance will help us to further refine the PBA proposal to conform to the federal tax laws.
6. The LRWG will continue to work toward a resolution regarding the proper integration of PBA reserves and the federal income tax laws.
7. We will keep LHATF and the NAIC informed of our recommendations.



Individual Assumption Margins

Issue: Should margins on individual assumptions be set ignoring the aggregate impact of all margins on the resulting reserve, or should adjustments on individual margins be permitted that takes into consideration the aggregate impact of all margins on the resulting reserve?

LRWG position: Margins on each risk should be established that when taken in the aggregate, they produce a level of conservatism in the resulting reserve that is consistent with the solvency objective of statutory reporting.

Note: The Academy Life Practice Council feels this issue is a fundamental principle of the PBA approach that applies to all products. As such, it may best be addressed in the SVL, not the Model Regulations or AGs for each product.



Individual Assumption Margins

Rationale:

1. The objective of achieving a proper level of conservatism for statutory reporting is on the **reserve level** itself, not the individual aspects of the reserve calculation.
2. Establishing conservative benchmarks on each assumption margin may lead to unintended conservatism on the reserve level due to covariant risk offsets and diversification effects.
3. To assist the actuary and the regulator in assessing the degree of conservatism in the resulting reserve, the aggregate impact of all margins on the reserve is a required disclosure item.
4. If margins are adjusted to reflect the aggregate impact of all margins, the rationale for such an adjustment must be demonstrated and documented.



Individual Assumption Margins

Rationale (cont):

5. We recognize the practical difficulties of determining specific adjustments to individual margins. However:
 - We believe it is essential that this concept be maintained as a fundamental principle of PBA.
 - In applying this principle, the actuary will be guided by the evolving practice and expanding knowledge base in the measurement and management of risk.



Aggregation of Risk

Issue: Should risk offsets due to covariance between different product groups (UL, term, WL VUL, etc) be permitted?

LRWG position: Yes.

Rationale:

1. A fundamental principle of PBA is reflecting the actual risks associated with the contracts. Ignoring risk offsets for covariant risks between products is inconsistent with this principle.
2. The seriatim Deterministic Reserve with a cash surrender value floor imposes a limitation on degree of risk offsets recognized.
3. Disclosure of aggregate impact of aggregation is required. Thus, the regulator can further limit the impact the aggregation if the reserve is deemed to be inconsistent with the conservatism objectives of statutory reporting.



Discount Rate

Issue: Permitting the discount rate to be based on the projected earnings of the actual assets of the company may create an incentive for companies to invest in high-risk investments to lower the reserve.

LRWG position: We share this concern, but believe there are several factors that adequately address this concern. Thus, we support an approach that defines the discount rate to be based on the projected investment earnings of actual existing assets, as long as the aggregate embedded spread over Treasuries on existing assets (net of Prudent Best Estimate default costs) is a required disclosure item.



Discount Rate

Rationale:

1. The LRWG believes the following factors adequately address this concern:
 - The high C1 capital requirement on below investment rate bonds and equity investments creates a significant disincentive to invest in high-risk assets.
 - Negative reaction from rating agencies.
 - If a company adopts a riskier investment strategy, the aggregate embedded spread may increase. The disclosure of this spread creates a “red flag” for the regulator to potentially require the company to add additional interest rate deducts to lower the aggregate spread to an acceptable level.



Discount Rate

Rationale (cont):

2. A fundamental principle of PBA is reflecting the actual risks associated with the contracts. Ignoring the asset characteristics of existing assets backing the contracts is inconsistent with this principle.
3. This concern can be mitigated by establishing conservative margins on asset default assumptions.



Outstanding Items - LRWG

1. Definition of Working Reserve
2. Additional requirements/guidance for:
 - Asset default assumptions
 - Modeling non-guaranteed elements
 - Calculation of the Margin Ratio
 - Estimating the starting asset amount
3. Treatment of Hedges
4. Deduction in the Deterministic Reserve for ALM risk
5. Coordination with recalibrated interest rate generator
6. Methodology to select industry mortality table without margins
7. Definition of “optimal plausible” policyholder behavior.



Outstanding Items - LHATF

1. Prescribed CTE level
2. Prescribed stochastic scenarios and calibration points
3. Prescribed return assumption for equity investments in the Deterministic Reserve.
4. Prescribed cap on aggregate spread on reinvestment assets
5. Prescribed range of margins on withdrawal assumption
6. Implementation date and transition rules.



Action Item:

Vote to expose for comment the updated versions of:

1. Model Regulation for Principles-based Approach for Life Insurance Reserves
2. Actuarial Guideline on requirements for setting valuation assumptions for PBA life insurance reserves (AG PBR-VAL)
3. Actuarial Guideline on disclosure requirements for PBA life insurance reserves(AG DIS)

