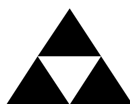

AMERICAN ACADEMY *of* ACTUARIES

Summary of Responses to New York Changes to Model Regulation from the American Academy of Actuaries' Life Reserves Work Group

August 2006

The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

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Summary of the American Academy of Actuaries' Life Reserves Work Group (LRWG) Responses to New York Changes to Model Regulation

The LRWG has incorporated the changes suggested by New York in the September draft of the Model Regulation on Principles-based reserves for life products except for the items listed below. The LRWG has identified from this list the five most critical issues that it would like to discuss in Albany on August 25.

1. **Discount rate**. The LRWG shares the concerns of New York regarding the potential for companies to adopt a riskier investment policy (e.g., invest in junk bonds) in order to lower the reserve. However, we believe the following factors 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.
    - There would be **negative reaction from rating agencies**, putting downward pressure on a company's financial strength rating.
    - The LRWG proposal requires disclosure of the magnitude of the aggregate embedded spread over Treasuries in the current portfolio using a market value-based approach. If the company adopts a riskier asset investment strategy into the future, the aggregate embedded spread will increase (all other things being equal), and the **regulator can require that the company lower spreads** to a more acceptable level.

    Since the aggregate embedded spread is currently only a disclosure item, the burden is on the regulator to take the initiative to identify what is an unacceptable aggregate spread, and then to take appropriate action. The LRWG may support imposition of **a cap on aggregate embedded spread using a market value-based approach (i.e. the approach defined in the current proposal).** If the aggregate embedded spread exceeds this cap, additional educts would need to be reflected in the projected investment earnings to bring the aggregate spread below the cap. This requirement is patterned after the default sensitivity test incorporated in New York's annual letter. The cap would be prescribed, but since this measure is market value-based, it should widen and narrow as current market spreads change. The Academy and the SOA are jointly sponsoring a research project to analyze historical spreads that will assist in the determination of an appropriate cap that varies by current market spreads.

    For both administrative and conceptual reasons, we believe the LRWG approach to establish a cap is more appropriate than a static cap of 50 bp (Deterministic Reserve) and 75 bp (Stochastic Reserve). First, the New York approach would impose an enormous administrative burden on companies, for example:

        1. For each asset in the portfolio, the company would need to identify and capture the appropriate Treasury rate from each Treasury curve that was in effect in the past, and project cash flows under this "artificial" asset portfolio.
        2. A separate and parallel cash flow projection would need to be made using these presumed Treasury rates for both existing and reinvestment assets. For the Stochastic Reserve, this could involve running thousands of additional interest rate scenarios.

    Imposing a cap in the embedded spread proposed by the LRWG essentially gets to the same result, but with much less effort. Most companies already have the embedded spread information calculated on each asset as part of their normal portfolio management.

Second, the LRWG believes the above approach to determine a cap is more appropriate than using the approach proposed by New York because:

1. The cap should vary by current economic conditions (i.e. not be a static cap).
2. The discount rates would be the same as the asset earned rates. The New York proposal creates an inconsistency between the two.
3. The New York cap is based on an artificial asset portfolio that does not reflect the actual characteristics of the actual asset portfolio, which is inconsistent with a principles-based approach. For example, it ignores the differences between bonds and commercial mortgages.

2. **Aggregation**. A fundamental principle of the principles-based approach is that the reserve must reflect the actual risks associated with the contracts. Permitting offsets for covariant risks is consistent with this principle. The purpose of the required disclosure of the impact of aggregation in the LRWG proposal is to provide the regulator with the necessary information to determine if a limit needs to be imposed on the degree of the covariance between major product lines. The LRWG believes that some limit to the degree of covariance may be appropriate, but to completely eliminate the impact of covariance is not. Further, as noted in the Model Regulation, the imposition of the cash surrender value as a floor in the Deterministic Reserve calculation already imposes a limitation on the degree of covariance.

3. **Aggregate impact of assumption Margins.** The intent of the proposed approach to set margins on each assumption is not to diminish or eliminate the need for appropriate margins on each assumption, but to establish margins on each assumption that results in an appropriate aggregate impact of all margins on the reported reserve. The LRWG believes that the overriding objective of achieving a proper level of conservatism for statutory reporting purposes is on the resulting **reserve level** itself, not on the individual aspects of the reserve calculation. Establishing conservative benchmarks on each component of the reserve calculation can lead to unintended conservatism in the reserve level due to risk offsets.

   This is an issue that is fundamental to all products under a principles-based approach, and therefore is probably best addressed by the SVL, rather than within each Model Regulation for each product.

4. **Prescribed 2% return on GA equities for the Deterministic Reserve.** The LRWG is opposed to this prescribed assumption. What is the basis for 2%? The LWRG has discussed the idea of using a prescribed return equal to the 10-year Treasury rate. In any event, the return assumption for GA equities in excess of Treasuries will contribute to the aggregate spread on Treasuries that may be subject to a cap (as described above).

5. **Pre-tax approach for the reserves calculation.** The LRWG sent you a paper on May 19, 2006 providing an analysis and demonstration from both an actuarial perspective and a statutory reporting perspective that the calculation of principles-based reserves should ignore federal income taxes. If there are elements of this analysis that the state disagrees with, or has concerns about, the LWRG would like the opportunity to discuss this matter further. The LRWG believes that the use of a pre-tax approach is appropriate. It is the approach used in the current VACARM document, so to impose an after-tax approach would be inconsistent with the direction used for variable annuities.

Other suggested changes from New York not incorporated in September draft:

1. **Only hedges actually held on the valuation date are to be reflected in the Deterministic Reserve. The LRWG** proposes the following alternative limitation that may be more appropriate:

   Blocks requiring future hedge transactions generally would not be eligible for the stochastic modeling exclusion as cost of hedging may vary over economic scenarios. So although the regulation allows an exception based on a demonstration by the actuary, it may be necessary to include a requirement that the company receive pre-approval from the commissioner in order to get a stochastic modeling exclusion for such blocks.

   Given this limitation, we believe future hedges should be reflected in the Deterministic Reserve. Our reasons include:

   - The deterministic scenario should be based on the company's stated investment guidelines and strategies, just as the stochastic scenarios are. All information determining price and terms of hedge instruments should be equally incorporated.
   - Some products are structured around future hedge transactions, such as equity-indexed products.
   - Cash instruments and derivative instruments can be interchangeable parts of the company's investment strategy. It does not make sense to include one and exclude the other.

2. **Allow a member of the SOA who is not a member of the AAA to be a Qualified Actuary**. The LRWG believes AAA Membership, together with AAA requirements for providing this service, should be the qualification standard. If New York feels the AAA should have different standards for providing Qualified Actuary services, the Academy would be willing to take this under consideration.

3. **Reserve calculations cannot be performed earlier than three months before the valuation date. The LRWG prefers** six months. This is a significant issue for small companies, and while it makes sense to limit the interval that precedes the valuation date, we received input from small companies that three months is just too short.

4. **Commissioner can change the method and assumptions.** We believe this is best addressed in the SVL, not in the separate Model Regulations and/or Guidelines for each product line.

5. **Penalty Reserves.** We believe this is best addressed in the SVL, not in the separate Model Regulations and/or Guidelines for each product line.

6. **Deduction in Deterministic Reserve for ALM risk.** This issue is currently under discussion by the LRWG. We have not taken a position on this yet.

7. **Use of calibration criteria for integrated scenarios.** We believe integrated scenarios are the preferred approach (as opposed to separate scenarios for interest rates and equity returns). Concerns about giving the actuary too much room for judgment can be addressed by prescribing appropriate calibration criteria.

8. **Starting asset amount.** We agree that additional clarity in this section is needed, but we didn't have time to incorporate additional clarity in the September draft.