PRINCIPLE-BASED APPROACH A NEW SOLUTION FOR NEW TIMES

NAIC A Committee Interim Meeting - Principle-Based Approach for Reserve and Capital Requirements

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Today's Consumers

Increasingly Demand

Options and Flexibility

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A "Simple" Coffee at Starbucks

Contains 5-10 options

For a product consumed

In 10-20 minutes

Some Insurance Products

Are not fully consumed

- For 10-20 years
- Or even for 50 or more years
- Or even for a lifetime

Long Term Insurance Products

- Require
  - Options
    - That apply now
    - That apply in the long term
    - That are flexible

Long Term Options

In Life Insurance

- Produce
  - Multiple scenarios
  - with different values for "different futures"

Long Term Flexibility

In Life Insurance

- Allows for

  Policyholder behavior impact

  on these “different futures”

Long Term Options and Flexibility

In Life Insurance

- Makes

  Measurement of Current Values

  of these “different futures”

  difficult to measure

Long Term Options and Flexibility

In Life Insurance

- Produce

"Hard to Measure"

Liabilities

Long Term Options and Flexibility

In Life Insurance

- Require

Better/More company-specific

Measures of Liabilities

"One Formula Fits All"

Satisfies neither

of these criteria

Dual Mission/Challenge of Regulation

- Catch the bad guys - Enforce the rules
- Develop/Support a competitive market so good companies can provide valuable products
- In other words – Keep Healthy & Happy Companies and Happy Consumers

Market Response – Product Design

- In early 90's consumers saw annuities with new designs:
  - Market Value Adjusted, Variable, Equity Indexed, GMIB, GMDB
- They also saw Life products with new designs:
  - Secondary guarantees in reaction to vanishing premium problems

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Market Response – Product Design

- In late 90's market responds to desire for blend of equity yields and fixed guarantees:
  - Variable products with guaranteed death and income benefits
  - Fixed products with S&P participation
  - Life Products with secondary guarantees
- Led to Challenge of What to do About "Hard to Measure" Liabilities

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Market wants and rewards "Accounting"

- Thus the critical focus on "expected earnings"
- Past only useful for framing an "actual to expected" dialogue
- Insurance Products are "Forward Looking Products"
  - Actually sell a bundled set of assets and liabilities as one "product"
  - With guidelines for risk sharing between owner and debtor

Banking Approach to Governance

- Basel II proposed 3 pillars instead of old formula standard
- Pillars are:
  - Technical reserves or capital (formula or internal models -)
  - Supervisory oversight
    - must approve internal models
    - can require more capital under certain conditions
    - monitoring of company management
  - Required Market Disclosure

SVLII Similar Approach

- Principle-Based Approach for Reserves and Capital
  - Reflecting Company Based Experience
  - Based on Enterprise Risk Management
- Supervisory Oversight
  - Facilitated by Required Peer Review
- Disclosure/Transparency to
  - Regulator
  - Required Peer Reviewer
  - Market Conduct Examiner

Principle-Based Approach

- Not Without Challenges
  - Accountability, oversight, governance
  - How can the regulator get comfortable?
  - Review of results
  - Complexity
  - Need to change Regulations and Laws?
  - The “T” word
  - Education and Guidance

Principle-Based Approach

- But with many benefits:
  - Utilizes Enterprise Risk Management (ERM) concepts to map risk
    - For Life Insurance
    - Next for Long Term Care Insurance
  - Utilizes modeling based on company experience
  - Improves regulatory oversight

    By adding
    - Required Peer Review
    - Regulatory ERM Review

ERM - The Four Dimensional Challenge

- The Life Practice Council's (LPC) goal
  - Is to develop a series of anchor initiatives to implement the new ERM structure in 3-5 years.
  - Will require the involvement of and coordination with the Academy's Health Practice Council and Risk Management & Financial Reporting Council as well as several other major groups.
- Our major challenge is that the new ERM system must address a "multi-dimensional challenge"
  - With four dimensions including
    - Product type
    - Risk type
    - Diversification/Risk correlation structure
    - Risk measurement level.

The First Dimension - Product Types

- Variable Annuities – separate and fixed account, w & w/o guarantees
- Universal Life – with and without secondary guarantees
- Traditional Life – participating/non-participating (term and whole life)
- Variable UL – separate and fixed account, w & w/o guarantees
- Long-Term Care
- Equity Indexed Annuities
- Fixed Annuities
- Long-Term Disability and possibly Short Term Disability
- Medical
- Others such as Dental and Accidental Death?
- Hybrids of any of the above

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The Second Dimension - Risk Type

- Asset Risk (C-1)
- Mortality & Morbidity Risk (C-2)
- Other Pricing Assumption Risks e.g. persistency, expense, reinvestment risk not covered by C-3 measures(C-2)
- Equity Risk (C-3)
- Interest Rate Risk (Includes level of interest rates as well as volatility risk) (C-3)
- Business Risk (includes items like modeling risk and delays in rate approvals) (C-4)
- Risk of new growth or lack of growth or availability of reinsurance (historically has been in the C-4 catch-all).

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The Third Dimension – Diversification/ Risk Correlation

- Between risk types
- Between product types
- Between issue years
- Other?

The 4th Dimension - Action & Measurement

- Reserves
- Capital/RBC
- Integration of feedback loops and other review processes

Where is the AAA going in 2005?

- Continue support of work for:
  - UL with Secondary Guarantees
  - C3 Phase 2 and VARWG
- Coordination with:
  - NAIC
  - International Bodies
    - IAIS
    - IAA
- Governance/Verification
- Checklist/Roadmap for regulators

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UL Work Group Update for A Committee

August 22, 2005

David E. Neve
Co-chair, Academy UL Work Group

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Objectives of this Session

1. Review list of ULWG basic principles
2. Review basic framework of proposed methodology
3. Discuss observations and concerns raised by LHATF
4. Emphasize importance of a strong regulatory governance process
5. Discuss key areas of future regulator involvement

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Basic Principles of a Principle-based Framework for Life Products

Basic Principles

- **<u>Principle 1</u>:** Methodology will appropriately capture the nature and magnitude of risk underlying the product being valued, including the magnitude of "tail risk".
- **<u>Principle 2</u>:** Methodology will provide a framework that can be applied to all individual life insurance products.
- **<u>Principle 3</u>:** A **deterministic** reserve approach may be appropriate for certain products, depending on the nature and level of risk, and **stochastic** approaches may be necessary for other products.

Basic Principles (cont)

- **Principle 4:** For risks that the company has some degree of control over (e.g., mortality), assumptions should reflect a blend of company experience (if credible data is available), and prescribed assumptions.

  For risks that the company has no control over (e.g., interest rate movements), prescribed assumptions or methods for setting the assumption should be used that are the same for all companies.

- **Principle 5:** For risks that are not stochastically modeled, assumptions should be based on "prudent best estimates" that incorporate appropriate margins for uncertainty.

Basic Principles (cont)

- **Principle 6:** Assumptions will not be locked in at issue, but will be allowed to change as expectations as to future experience and economic conditions change.

- **Principle 7:** While a stochastic cash flow model attempts to include all real world risks, it will still contain limitations because it is only a model.
  - The actuary must take the model's limitations into consideration when setting assumptions and applying the methodology
  - The use of assumptions and risk management strategies should be appropriate to the business and not merely constructed to exploit "foreknowledge" of the components of the methodology

Basic Framework of Proposed Approach

Basic Framework

Based on Gross Premium Reserve (GPR):

- Reserve = PV of future benefits and expense (excluding FIT) less PV of future gross premiums
- Reserve assumptions will be determined for all material risks (mortality, interest, expenses, lapse, premium levels, etc.)
- Reserve assumptions will include a margin for adverse deviation (not best estimates)
- Discount rates will be pre-tax

Basic Framework (cont)

Reserve is the greater of:

1. A deterministic, seriatim, single scenario reserve calculation
2. A stochastically derived reserve (if needed) using a prescribed CTE level

Since the stochastic reserve is done in the aggregate, risk offsets between contracts are recognized.

Basic Framework (cont)

Deterministic Reserve:

- Uses a single set of assumptions that is aligned with economic reality, yet still provides an appropriate level of conservatism
- Is not designed to capture tail risk
- Is subject to a cash surrender value floor on a contract by contract basis

Basic Framework (cont)

Stochastic Reserve:

- Multiple scenarios will be defined to properly capture the "tail risk" of the contract (risks that have high impact, but low probability)
- Will use a CTE (conditional tail expectation) level that is set by regulators, such as 65 CTE
- Current thinking is that only interest rate movements will be modeled stochastically

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Basic Framework (cont)

"Prudent Best Estimate" Assumptions

- Assumptions will be based on "prudent best estimates" that include a provision for adverse deviation
- Definition: Conservative end of actuaries best estimate confidence interval
- Since actuarial judgment is involved, will need to set limits and controls on setting assumptions

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Basic Framework (cont)

Asset Model Needed to Project Cash Flows

- Needed for both Deterministic and Stochastic Reserve
- Asset Model is used to determine:
  - Discount rates for GPR
  - Earned rates for surrender benefits
- Discount rates for GPR
  - Based on projected portfolio rates in each year
  - New money Treasury rates will be prescribed for Deterministic Reserve; modeled for Stochastic

Basic Framework (cont)

Principle-based versus Asset Adequacy Analysis

- Both involve more actuarial judgment than current "rules-based" valuation approach
- Asset adequacy analysis has very few limits and controls; actuary has a high degree of discretion in setting assumptions
- In contrast, the principle-based approach will have controls, caps and limits placed throughout the framework

Governance

Governance

- An acceptable regulatory review and governance process must be established (e.g., peer review, disclosure requirements, etc.) to enable the regulator to properly evaluate the appropriateness of the results.
- Not the focus of the ULWG – the Academy's SVL II work group is taking the lead to work with regulators on developing an acceptable governance process
- The ULWG is closely coordinating our activities with the SVL II work group

Governance

- Since a Principle-based approach will rely more heavily on actuarial judgment to establish assumptions and other related items than the current rules-based approach, appropriate controls, limits and caps will be incorporated throughout the methodology to establish boundaries on the degree of actuarial judgment that can be exercised.
- The ULWG proposal will have strong disclosure and documentation requirements to provide the peer reviewer and the regulator with sufficient information to evaluate the appropriateness of the resulting reserve level.

Summary of observations and concerns arising from face-to-face discussions with LHATF Members

Benefits of Discussions

1. Enhanced understanding of the ULWG proposal by Task Force members
2. Education of other staff members on the principle-based approach
3. Facilitated specific feedback to the ULWG (i.e. what they like, what they don't like, suggestions to improve, etc).

Several states requested that we come back periodically in the future to provide updates

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LHATF Observations

- LHATF could begin the effort to amend the SVL now, rather than waiting until the ULWG proposal is finalized. Both efforts can be done in parallel.
- Most support the concept of developing multiple preferred different mortality tables representing different preferred and standard risk classes as part of the principle-based approach.
- A few states mentioned that consistency with VACARVM / C3 Phase II is not critical.

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LHATF Concerns

- Establishing controls on setting assumption margins
- Difficulty of projecting future premium levels for UL
- Volatility due to updating reserve assumptions
- Need alternative approach for small companies
- Need to phase in the new approach over several years
- Non-forfeiture rules may need to be changed
- Gross Premium approach doesn't recognize timing of profits (may lead to higher reserves increases in later years compared to earlier years)

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Key Areas for Future Regulatory Involvement

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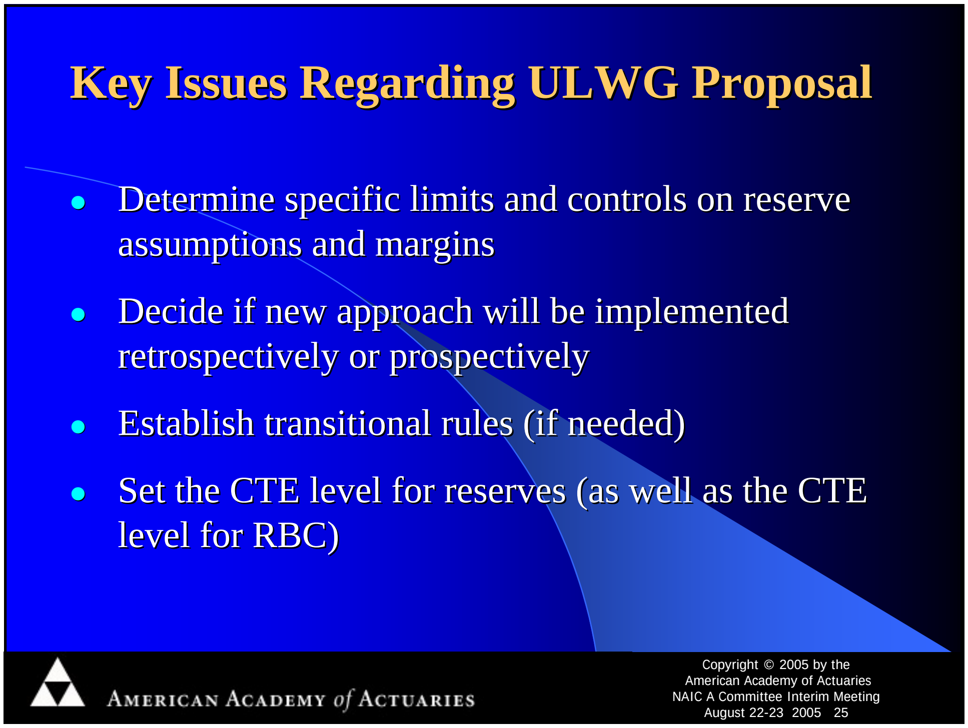
Regulatory Involvement

ULWG Process and Timeline

- Review and expose for comment the ULWG report by December 2005
- During 2006, decide if changes will be implemented by a change in the SVL, a new Model Regulation, or a new Actuarial Guideline (or combination)
- Finalize Principle-based approach for A Committee approval by December 2006 (for example, final form of new NAIC Model Regulation)

Key Issues Needing Regulatory Attention

- Development and implementation of an acceptable governance process
- Discuss feasibility of changing the SVL now to allow details of the new Principle-based approach to be defined by regulation and/or actuarial guideline
- Coordination with ACLI efforts regarding the development of an "interim solution" for Triple-X products that will not delay implementation of the Academy's Principle-based "long-term solution"


Key Issues Regarding ULWG Proposal
Determine specific limits and controls on reserve assumptions and margins
Decide if new approach will be implemented retrospectively or prospectively
Establish transitional rules (if needed)
Set the CTE level for reserves (as well as the CTE level for RBC)
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Principle-Based Approach for Reserve and Capital Requirements

NAIC A Committee Interim Meeting - Minneapolis, MN

August 22-23, 2005

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What Will Be Covered?

- Process Objectives and Timing
- Who are the Players?
- What Changes Will Need to be Addressed for Each of the Players?
- Miscellaneous

Magnitude of Changes

- Decision needed:
  - When will Change be introduced via baby steps, walking steps and well thought out “leaps of faith”?
- Change needs to be coordinated among the players reflecting unique process change forums
  - State legislators
  - NAIC
  - Academy
  - Accountants
  - Treasury or Congress (if tax issues involved)

Breadth of Scope
Layers Could Include:

- Moving up corporate organizations:
  - At individual product level
  - At company level for all products sharing same risk
  - At holding company level
- Are some or all life/annuity risks to be included?
- Are some or all health and personal lines to be included?

Challenge

- The desire to go slowly may create double the workload for regulators (and industry) to maintain both formulas and principles.
- How long to keep the training wheels on?
- Who controls when and how they come off?
  - Legislature
  - NAIC
  - Individual Commissioners

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What are the Goals?

- How will we recognize success or failure?
  - Problems need to be seen as opportunities to improve or fix as part of a self-correcting, learning process as opposed to a need to abandon ship.
  - How to allow for evolutions over time when more gradual change is appropriate.
  - How will processes of all parties be coordinated?

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Measuring Stick for New Regulation

- Is New Regulation an Investment or an Expense?
  - Expense comes if new reporting is just extra work
  - Investment means we are improving the future of the industry and the regulators

Investment Payoffs

- Incents good behavior so less likelihood of "surprise" failures
- Minimize the mess if something goes wrong
  - When takeover occurs, the most valuable "asset" to the regulator will be the internal risk based models and experience so it can best manage the run off or sell to another carrier
- More likely for takeover to occur when capital is gone, but reserves still sufficient

Responsiveness of New Oversight Process

- Degree of flexibility needed in the new structure
  - Legal changes to allow evolution and improvements to processes and practice.
  - Non legal
    - Accounting
    - Professional Standards
  - Valuation Manual Approach
  - Needs to be nimble

Example of C3 Phase 2 for RBC

- While built as a principle based solution, the current implementation is not
- The impact of the standard scenario makes it more like the current cashflow testing requirements
- The standard scenario is a “training wheel”. There is a NAIC committee that will review how soon the wheels can come off.

What does an actuary do?

Quote from Oakland Athletics GM, Billy Beane, in explaining his approach to managing a major league baseball team:

"We just try to use as much data as possible.
We can't predict the future.
We're just trying to redefine how we make decisions…..

It's risk management.
It's like an actuary."

What Rethinking is Needed?

- Joint CADTF/LHATF Subgroup Report begins by stating:
  - A principle based approach will "require a rethinking of how regulatory oversight will occur."
- Accepting challenge of "Not perfect governance, but adequate governance"

Redefining How We Make Decisions

- Who are the 'We'?
  - Regulators
    - Blue Book & Review Process – Staff Level
    - Dialogue vs. Dictate – Commissioner Level
  - Executives
  - Actuaries
  - Accountants
  - Reviewers
- Use of Additional Pillars – Capital is not alone
- Reserves & Capital more about Governance, than the "right" number.

Governance vs. Right Number

- Use of models allows the use of an "early warning system" about what could be coming in the future. More important to know the train is coming than whether train is coming at 70 or 90 miles.
- Formulas represent a decision about how to fund, on average for the future, to allow takeover of the company

Aligning Interests

- Use of carrots and sticks to reward transparency via:
  - Allowing lower reserves for Best Practice Transparency (Or require higher for unacceptable transparency)
  - Enhanced actual to expected reporting where variance in expectations leads to increased scrutiny as happens in FAS 97

More Salad (Carrots) , Please

- Are there alternatives to the current "bright line" tests for regulatory actions – i.e. what is the motivational impact of criminal or civil liability for individuals due to company failure or for non-compliance with required reporting?
- Aligning Interests should see convergence of rating agency and regulatory processes and conclusions

More Salad (Carrots) , Please

- Will enhanced ability to understand and manage current and future risks lead to lower formula minimums or just be more work on top of current work?
  - If current system is too low, then "strengthening" is needed.
  - If current system has too many redundancies, then minimums may need to change

Sticks and Stones

- How will reductions for the aggregation of risk be allowed to flow through balance sheet? (I.e. covariance)
- Are there limits/constraints on reductions?
- How will major changes be reported when covariance disappears – such as sell off of an annuity line?

Changing Requirements for Consistency

- Current requirement is assumption based. The same assumption across all companies assumes all companies manage risk the same
- Principle Based approach focuses on Consistency of Process instead of Consistency of Assumptions
  - May need concurrence by Treasury to effectively extend to tax basis as well

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Consistency - More

- Also needs to expand requirements so that internal company models used for reporting are "Consistent" with models used as the basis for managing the company and making decisions

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Needed Changes By Major Players - Regulators

- Managing Change Process
  - NAIC Breadth
    - A Committee – LHATF
      - Joint CADTF/LHATF
    - E Committee
      - Risk Assessment Working Group
      - NAIC/AICPA Task Force
      - Capital Adequacy
        - » Life SubCommittee
        - » Larry Brunings Sub
        - » Joint CADTF/LHATF

Needed Changes By Major Players - Regulators

- Managing Change Process
  - NAIC Breadth
    - F Committee - Accreditation
    - G Committee – International Positions on Issues
    - H Committee – Possible Linkage to International Accounting Positions
    - Possible B Committee – Health
    - Possible C Committee – P&C

Any Structural Changes Needed?

- Currently each state is responsible for its domestics and 49 other states as well. Each state needs to duplicate expertise and ask each company the same questions – Same issue is being raised in market conduct exams and in product filing areas.

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Regulatory Structural Changes

- Should there be:
  - Centralized Review, like SVO or Interstate Compact?
  - Some centralization may be temporary to get process "up and running"
  - Some may be permanent
  - Use of "virtual review groups"?

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Regulatory Structural Changes

- Expanding Review from Balance Sheet to:
  - Risk Process of Company (Already begun with RAWG and several states)
  - Internal Models
    - Defining Approved Models
    - Reviewing Approved Models
  - New and/or Expanded Use of Professional Review and/or Sign off of Principle Based Statements
  - Review and Approval of Company vs. Industry Experience for setting company assumptions

C3 Example Again

- Need coordination of accounting, reserve, capital and governance.
- Questions from NAIC capital groups get referred to accounting group.
  - Often difficult to present context or to coordinate timing

Little "p" Principles

- Recent role of Academy has been to include "strong" requirements constraining assumptions or procedures within the recommendations to NAIC.
- While enacted as part of regulation, are likely to be reviewed/approved by peer or audit review requirements. They set standards for review and documentation.

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Little "p" Principles (more)

- Was done for the Academy report to the LCAS (Life Capital Adequacy Subcommittee) for C3 Phase 2
- Are not rules as defined/used in traditional regulatory requirements

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Regulatory Structural Changes

- Expectations of Authority
  - FSA (England's regulator) is "determined to remain a risk-based regulator using administrative procedures to correct significant abuses rather than become an enforcer plodding laboriously through the courts."
  - Is there arbitrator authority available that is not court-driven?
    - A "shared" validation process will need defined arbitration processes

Regulatory Structural Changes

- Expectations of Authority - Continued
  - Just as there are concerns with setting bounds on company discretion in setting assumptions, there may be concerns with setting bounds on regulatory discretion as well.

Regulatory Structural Changes

- What is the role for the Academy as industry and regulators deal with their varying desires and move forward with compromises within a principle based framework?
- Development of little "p" principles as part of regulation helps define controls on actuaries. Same point that was made in ULWG presentation on need for limits and controls on assumptions.

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Regulatory Structural Changes

- Limiting Legal Liability
  - Both Canada and England have felt it important to add legal protections to actuaries operating in a principle based framework.
- Better definition and requirements around documentation will also contribute to providing protection

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Change For Other Major Players

- Actuaries – Academy & Standards Board
- Industry
- Audit

Change for Actuaries – Professional Controls on Actuarial Work

- Is there a need for actuarial guidance with regulatory force behind it that is stronger than ASOP's?
- In addition to ASB & ABCD are there other options?
  - Peer Review
  - Oversight of "public board" like PCAOB

Profession Controls

- Other Options Continued –
  - Process to more quickly adopt guidance for emerging issues when warranted
  - Change requirement to "face" one who a complaint is brought against.
  - Use of Little "p" principles

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Role of ASB

- Actuarial Standards Board Views on its Possible Roles Will be Covered by Bob Meilandar later today

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Change For Major Players – Industry

- Can an efficient process be supported for sharing/submitting company data and assumptions to a pool of "industry" data and assumptions?
- Will need professional and regulatory support for recognizing credibility of individual company experience
- Need clarity on tax implications and requirements
- Are litigation implications of new process understood and manageable?

Change For Major Players – Verification/Audit Function

- Expectations for Verifying Estimates and Models
  - Traditional stat audit signs off on reasonableness of balance sheet as a whole.
    - Does not sign off on reasonableness of assumptions or disclosed sensitivity results
  - Should internal models be audited for compliance with the standard by the regulator, independent/peer reviewer or auditor and who relies on whose work?

Change For Major Players – Verification/Audit Function

- Will we want to redefine the verification to include signing off on risk processes?
- AICPA needs to be involved to identify and dialogue on any issues for auditors
- NAIC/AICPA Wking Group currently reviewing "Model Regulation Requiring Annual Audited Financial Reports"

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Comments for NAIC Hearing on Principles Based Reserves
August 22, 2005
Focus on ASB Activities
Prepared by Bob Meilander/Presented by Cecil Bykerk

Introduction

The Actuarial Standards Board (ASB) is an independent body originally formed by the American Academy of Actuaries to establish standards for actuarial practice in the US. These standards provide guidance to actuaries performing actuarial activities covered by the standards. Actuarial Standards will have a role in a new principles based reserving system. To understand that role you need to understand how Actuarial Standards of Practices (ASOPs) fit into a regulatory structure.

For today, I am planning to discuss how ASOPs, and the ASB, fit into a broader regulatory structure. I am going to discuss various different levels of regulation as well as existing ASOPs that would be involved in a principles based system. I will also take a look at the structure surrounding the illustration reg as an actual "case study" of how this might work.

Different Kinds of Standards (with a small "s")

Regulations (incl. Laws, Regs. and AGs)

- Force of law = must be followed
- Established by regulators or legislators
- Academy may play a role - recommendations
- May be based on existing practice, leading edge practice, or new practice
- Must include practices that regulators deem as necessary to "the system" (the profession cannot mandate required actions)

Actuarial Standards of Practice (ASOPs)

- Actuarial standards are developed, adopted, and published by the Actuarial Standards Board through its operating committees, and procedures for exposure
- ASOPs identify what the actuary needs to do in order to be considered to have appropriately completed an assignment
- Must be followed by actuaries unless:

1. applicable law (including regulation and other binding authority) conflicts with the standard and the actuary discloses that the assignment was performed in accordance with applicable law; or
2. the deviation is disclosed, and the actuary is prepared to justify the deviation

   Actuary may be called to justify deviation before the Actuarial Board for Counseling and Discipline if there is a complaint

- ASOPs are:

> *"Intended to provide actuaries with a framework for performing professional assignments and to offer guidance on relevant issues, recommended practices, documentation, and disclosure." – from the Introduction to the Actuarial Standards of Practice*

- ASOPs:
  - Set the bar at the level that is generally accepted practice for the profession and are unlikely to be based on new or leading edge practice (though there are exceptions)
  - Don't impose guidance when there is no consensus of appropriate practice
- That said, ASOPs can be useful in new practice areas, such as principles based reserves
  - For example, ASOP #7 covers analysis of cash flows that would be useful in a principles based system
- ASOPs can be developed for new ways of using old practice
  - A standard for the use of mortality results in a principles based valuation system could be developed based on current practice surrounding mortality analysis
- A number of existing ASOPs may apply to a principles based valuation system:

ASOP	***Title***
No 1	*Nonguaranteed Charges or Benefits for Life Insurance Policies and Annuity Contracts*
No. 5	*Incurred Health and Disability Claims*
No. 7	*Analysis of Life, Health, or Property/Casualty Insurer Cash Flows*

No. 11	*The Treatment of Reinsurance Transactions in Life and Health Insurance Company Financial Statements*
No. 15	*Dividend Determination for Participating Individual Life Insurance Policies and Annuity Contracts*
No. 19	*Actuarial Appraisals*
No. 22	*Statements of Opinion Based on Asset Adequacy Analysis by Actuaries for Life and Health Insurers*
No. 23	*Data Quality*
No. 40	*Compliance with the NAIC Valuation of Life Insurance Policies Model Regulation with Respect to Deficiency Reserve Mortality*
No. 41	*Actuarial Communications*
No. 42	*Determining Health and Disability Liabilities Other Than Liabilities for Incurred Claims*

A third type of actuarial "guidance" is practice notes.

- indicate what could be done, not what should be done
- cover current practices in an area but make no judgment about the appropriateness of practice
- written by Academy members that are practicing in the particular area
- will note current practices in a given area
- are not binding in any way
- require no disclosure
- may lead to ASOPs but are not ASOPs
- frequently address areas where there is no ASOP
- Will not be in conflict with any ASOP

With that as background, let's take a look at how the regulatory community and the ASB worked together to create a regulatory structure surrounding acceptable illustrations of life insurance. When the illustration reg was created, it was done with an understanding of the things that needed to be done by regulation and those that could be done by an ASOP. The regulatory community worked together with the Life Operating Committee of the ASB to create both a model regulation and an ASOP that met the need for regulation. In the end the regulation covered those things that had to be mandated while the ASOP provided guidance on how to do the actuarial things that were needed to get the job done.

A Case Study - The Illustration Reg

The Reg is designed to make sure illustrations of non-guaranteed elements are legitimate

- Illustrated scale cannot be more favorable than either:
  - The currently payable scale, or
  - A disciplined current scale that is reasonably based on actual experience
- Requires two tests to assure that the illustration is appropriate:
  - Self support test
  - Lapse support test (if NFV can be developed)
- Also covers how the illustration is presented
- Requires actuarial certification

Requirements of the Reg

- The company must ID those forms with illustrations
- Format of the illustration
  - What to show, and
  - How to show it
- Provides rules for use of an illustration
- Prescribes the self-support and lapse-support tests
- Requires that illustrated scale cannot be more favorable than the current scale
- Establishes requirements for the delivery of the illustration
- Prescribes record retention rules
- Requires an annual report to the policyholder for those policies for which an illustration has been given
- Requires an annual certification from a board certified “illustration actuary” to the board and the commissioner that:
  - the ASOPs have been complied with
  - the illustration pass the tests
- Requires a certification from a responsible officer
  - that the format is compliant and that
  - the method for handling expenses is disclosed to the agents
- Requires disclosure:
  - Of changes inconsistent with experience
  - If new NGEs are inconsistent with old
  - If Illustrated NGEs are inconsistent with currently paid
  - Of the method used for expenses

- Sets rules governing the illustration actuary:
  - Must be certified by the board
  - Insurer must disclose when there is a change and the reason for the change
- Penalties

Provisions of the ASOP (ASOP #24 – Compliance with the NAIC Life Illustration Model Regulation) - (This standard is currently under revision but is unlikely to change in any substantial way.)

The standard parallels the Model reg in many ways

- Similar definitions
- Repeat of model requirements that are actuarial in nature
  - Self support test
  - Lapse support test
- Illustration actuary requirements as well as adding a few

ASOP 24 provides additional guidance (key word, “guidance”) on:

- Aggregation of forms
- Determination of experience factors used in the tests (must be based on historical experience if available) including
  - Interest
  - Capital gains
  - Mortality
  - Taxes
  - Expenses
    - Direct, and
    - All other
  - Persistency
- Also covers how to handle changes in methodology
- Procedures for setting the “disciplined current scale” used in determining if the illustration is appropriate
- How to handle changes in practice
- Guidance for determining when the illustration actuary may certify to certain things
- Required actuarial communications
  - Certification required by the Model
  - What to do when the actuary can’t certify
  - Reliance on others

    - Notice of error
    - Deviation from the standard
- Appropriate documentation

Key difference between the Model and the ASOP is that the ASOP provides guidance while the Model "requires" things. The actuary can deviate from the Standard but must disclose that deviation and be prepared to defend it if called upon to do so.

In working within this system the regulators need to determine which things need to be required and which can be left to actuarial judgment. Those things that the regulators need to mandate belong in a regulation. Those things that require appropriate actuarial behavior belong in an ASOP.

Actuarial standards can provide a flexible, professional way to provide guidance to actuaries dealing with regulatory requirements for actuarial work. They allow for appropriate actuarial judgment but provide appropriate bounds around that judgment.

The ASB, specifically it's Life Operating Committee, stand ready to assist the regulatory community in setting appropriate Standards for a principles based system. Work to date has consisted of participating in discussions surrounding peer review but revision of existing standards as needed, or the creation of new ones will also be done as needed to support this new system

The ASB has successfully working with regulators in this environment before and we are confident we can do so again.