



# AMERICAN ACADEMY *of* ACTUARIES

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## Report of the American Academy of Actuaries' Valuation and Law Manual Team

### Presented to the National Association of Insurance Commissioners' Life and Health Actuarial Task Force

San Francisco, CA – June 2007

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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The Team would also like to recognize the following individuals for their valuable input: Dave Christensen, Dan Daveline, Joe Musgrove, Josee Piche, Richard Plush, Martin Snow, Brad Spenny and Bill Weller.

The Academy of Actuaries' Valuation Law and Manual Team (VLMT) continues to work on its objective to provide the Life and Health Actuarial Task Force's (LHATF's) recommendations regarding the Valuation Manual (Manual) and input regarding changes to the Standard Valuation Law to implement the Valuation Manual.

This VLMT report covers progress by its subgroups since the March 2007 NAIC meeting and covers the draft Valuation Manual submitted with this report. A list of key areas for LHATF input is provided at the end of this report. Also, attached to this report is a summary of regulator responses to a survey regarding possible exemptions of products or phasing in products for purposes of principles-based reserves.

#### SUBGROUP 1 (Chaired by Dave Neve)

1. Developed reporting requirements for reserves using a principles-based approach (PBA). Reporting requirements developed to date are focused on life insurance. Principles-based reporting requirements for other products will be developed later.
2. Considered comments provided during the March Life & Health Actuarial Task Force meeting regarding whether the state or the company should hire the independent PBA review actuary. At this time Subgroup 1 recommends no change to the draft requirements submitted to LHATF at the March meeting in which the company is responsible for hiring the independent PBA review actuary. Although regulators cannot rely solely on such an independent review without some review of their own, it is believed the amount of work and cost would be reduced for the regulator with the independent review versus without. The benefit for regulators is similar to the benefit provided in their review of the annual independent audit work for purposes of their examinations. The reporting provided by the independent review is expected to enhance this benefit. These submitted draft requirements are entitled: "Principles-Based Valuation Review Opinion Requirements".
3. Subgroup 1 recommends exposing these draft requirements for comment at the June 2007 LHATF meeting. The draft of these requirements is attached to the draft Valuation Manual provided to LHATF at this meeting.

#### SUBGROUP 2 (Chaired by Mike Boerner)

1. Developed a draft of the Valuation Manual which is enclosed with this report. There have been many iterations of the Manual since the March meeting to get to this current draft and many changes are expected before a more complete version is ready for the September meeting. The attached draft Valuation Manual is not complete and is intended to give an understanding of the proposed structure of the Valuation Manual and how the various reserve standards will fit into the Manual.
2. Several Subgroup 2 interested parties have been working to provide the NAIC Statutory Accounting Principles Working Group (SAPWG) input on how the Accounting Practices and Procedures Manual could refer to the Valuation Manual. Coordination with the Accounting Practices and Procedures Manual is a key consideration as the Valuation Manual is developed. A few slides are provided to illustrate how this coordination is proposed to occur.

#### SUBGROUP 3 (Chaired by Russ Menze)

1. Subgroup 3 has refined the section on Experience Reporting requirements along with the development of an appendix. The appendix provides the instructions and template for the life experience reporting plan. Other experience reporting plans are still to be developed.
2. Each of the work products from Subgroup 3 has undergone refinements including adding a table of contents for clarity and navigation purposes.

#### SUBGROUP 4 (Chaired by Pam Hutchins)

1. Subgroup 4 worked with the Academy's Life Reserves Work Group (LRWG) to recommend appropriate principles-based applications for business with less risk that may not need the full rigor of a stochastic principles-based approach. This liaison developed a test to determine the level of material tail risk. This test can be used to decide whether stochastic modeling is needed or whether the simpler deterministic reserve would be appropriate. Material

tail risk modeling efforts are now being discussed to test for material tail risk and refine this test. A placeholder for this material tail risk test is currently reflected in the LRWG requirements presented at the June 2007 LHATF meeting. The subgroup is continuing to work other areas where simplification may be desirable but still work within a principles-based process.

2. Subgroup 4 also developed a survey which was sent to LHATF members and interested state regulators. The purpose of this survey was to obtain input from state regulators regarding phasing in or exempting life products by type of product or type of risk (either initially or long-term) from principles-based reserves. The survey elicited input for exemptions based on either the product type or based on type of risk. Results of this survey are summarized and enclosed with this report.
3. Although the deadline has passed Subgroup 4 encourages LHATF members and other regulators that haven't responded to the survey to respond. Subgroup 4 also needs input from LHATF regarding the approach for the material tail risk which is mentioned as one of the key areas for LHATF input at the end of this report.

## DRAFT VALUATION MANUAL:

Attached to this report is a draft of the Valuation Manual. As mentioned previously, the draft Valuation Manual is not complete. This draft is intended to give an understanding of the proposed structure of the Valuation Manual and how the various reserve standards will fit into the Manual. Many pieces are still missing and work remains on flow and presentation including format structure and page numbers. The following reviews current contents and future efforts.

The enclosed draft Valuation Manual provides a table of contents which includes an Introduction and seven sections:

### Introduction:

The Introduction provides background and a high level description of the Valuation Manual. This section also discusses a process to determine the operative date of the Valuation Manual and a process for updating the Valuation Manual. The operative date discussion provides suggestions beyond that contained in the current Standard Valuation Law exposure for LHATF consideration. Likewise, the discussion on the process to update the Valuation Manual should be treated as initial suggestions for LHATF and other appropriate NAIC groups for their consideration.

### Section 1: Principles-Based Overview

This section describes the principles-based reserves and provides common elements of a principles-based valuation.

### Section 2: Authority and Applicability

The authority for the Valuation Manual requirements is pursuant to the exposed Standard Valuation Law. Applicability or scope is discussed briefly and is consistent with the applicability and scope of the exposed Standard Valuation Law which includes essentially all life, annuity, and health business. This section goes further to address applicable requirements for business in force on the operative date of the Valuation Manual. The current proposal is that minimum reserve requirements for in force business on the operative date of the Valuation Manual are those of the adopting state. However, some exceptions may be made such as for the requirements found in the proposed VACARVM where the intent is to be applicable for in force business. Additional requirements may apply as provided in the Valuation Manual, such as experience reporting. For business issued on and after the operative date, the Valuation Manual specifies the reserve and other requirements pursuant to the current exposed Standard Valuation Law changes.

### Section 3: Reserve Requirements

Requirements are categorized by the general product types of life, annuity, deposit-type contracts, and health:

- Life: This section provides draft principles-based requirements from the Academy's Life Reserves Work Group.
- Annuity: The draft principles-based requirements (i.e., VACARVM) from the Academy's Variable Annuity Reserve Work Group are provided in this section. This section will also provide the principles-based draft requirements from the Academy's Annuity Reserves Work Group for non-variable annuities.
- Deposit-type Contracts: Requirements are to be provided.
- Health: This section contains the current premium, claim, and contract reserve requirements for health business in the NAIC Health Insurance Reserves Model Regulation. These have been reformatted but no substantive changes were made.
- Credit Life & Disability: Current NAIC model requirements are to be provided. For this draft it is assumed this business will not be subject to principles-based reserves on the operative date of the Valuation Manual.

### Section 4: Reporting Requirements

This section contains the current requirements for actuarial opinions and memorandums. This section will eventually contain all principles-based reporting requirements. Life principles-based reporting requirements are provided in this draft along with principles-based reporting requirements applicable to any product. Principles-based reporting specific to other products will be provided in later drafts.

### Section 5: Annual Principles-Based Review Requirements

This section contains requirements for the annual principles-based review provided under the current exposure of the Standard Valuation Law. The requirements in this draft are similar to the current exposure of the Annual Principles-Based Review Requirements.

### Section 6: Experience Reporting Requirements

Requirements relating to Experience Reporting are provided in this section as well as information relevant to experience reporting including the role of statistical agent(s), role of professional organizations, reports produced, etc.

## Section 7: Appendices

### Appendix A: Reserve Guidance

This appendix is intended to include guidance to supplement or explain reserve requirements contained in the Valuation Manual. Currently only the Health Reserves Guidance Manual is provided in this appendix.

### Appendix B: Experience Reporting

This appendix contains the experience reporting instructions and statistical plan templates to be used in reporting experience.

## FUTURE STEPS FOR THE VALUATION MANUAL:

It is intended that the following steps be substantially completed by the September 2007 NAIC meeting in order to provide LHATF a more complete draft of the Valuation Manual at that meeting.

- 1) Include the draft requirements from the Academy's Annuity Reserves Work Group.
- 2) Reflect a recommendation in the life principles-based reserve requirements for products with low risk that do not need to follow the full stochastic principles-based requirements.
- 3) Incorporate current NAIC requirements as appropriate for products not covered by new principles-based requirements.
- 4) Benchmark with applicable requirements in the Accounting Practices and Procedures Manual to assure appropriate coverage and coordination is reflected in the Valuation Manual. This includes monitoring efforts with the Statutory Accounting Principles Working Group regarding efforts for the Accounting Practices and Procedures Manual to coordinate with and refer to the Valuation Manual.
- 5) Make any changes needed for consistency in the structure and format of the Valuation Manual.
- 6) Consider any requests from LHATF, the Principles-Based (EX) Working Group, or other NAIC groups relating to the Valuation Manual.

**KEY AREAS FOR LHATF INPUT:**

The following are listed in order of more immediate need by the VLMT where the first is the most immediate need.

- 1) Comments on any lines of business which should continue with current NAIC requirements on the operative date of the Valuation Manual. (See attached summary of regulator responses to Subgroup 4 survey on this topic).
- 2) Input on the direction of the material tail risk test to discern business which may use a simpler deterministic approach for principles-based life reserves.
- 3) Initial thoughts for low-risk annuity products which should either have exemption treatment or a simpler deterministic approach for principles-based reserves on the operative date of the Valuation Manual. This would be useful for the Academy's Annuity Reserves Work Group in their drafting efforts.
- 4) Scope of the Experience Reporting Requirements on the operative date of the Valuation Manual.
- 5) NAIC determination of the implementation of an experience reporting process including the process to select the Statistical Agent(s), costs, subsequent analysis, and examination of the Statistical Agent(s). This includes the NAIC structure to address these areas and which current or newly formed NAIC group(s) would control.

# ATTACHMENT

SUMMARY OF REGULATOR RESPONSES

To

SUBGROUP 4 SURVEY

## ATTACHMENT: SUBGROUP 4 SURVEY SUMMARY:

**Subgroup 4 Survey: Summary of Responses (received from either LHATF member states or interested states):**

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Response ==>	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	
<b>1. Do you believe your state would support a phase-in of Principles-based reserves (PBR) in order to gain experience with the process?</b>																	
* Yes / No		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	
* If Yes, check which products you think should be included in Phase 1:																	
Variable Products	X		X		X			X					X	X	X		
UL with guarantees to 100 or for Life	X		X					X		(g)			X	X			
UL products subject to AXXX	X		X		X			X		X			X	X			
All UL products	X			X		X	X	X			X	X	X		X	X	
Term products subject to XXX	X	X		X	X	X		X		X		X	X	X			
All Term products							X			X					X	X	
Traditional Whole Life products																	
Equity Indexed UL	X			X				X					X		X		
Other (please list)						(c)	(d)	(f)						(n)		(u)	
<b>2. Do you believe your state would support exemption of some products from PBR?</b>																	
* Yes / No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No
* If Yes, check which products:																	
Credit Life		X	X	X	X	X	X	X	X	X	X		X				
Pre-Need		X	X	X			(e)	X	X	X			X				
Final Expense Whole Life			X					X	X	X			X				
Traditional Whole Life						X	X		X			X	X				
Group Term (annually terminable)		X	X		X	X	X	X	X	X	X	X	X				
Other (please list)													(k)			(v)	
<b>3. Do you believe your state would support exemptions of some products based on risks and /or the level of risks in the product?</b>																	
(If considered, we would work on definitions of "risk" and "options" included in products, and limited assets used to back up the products.)																	
* Yes / No	No	Yes	Yes	?	Yes	No	No	Yes	Yes	Yes	No	Yes	(m)	Yes	Yes	No	
* If Yes, check which risks:																	
Mortality								X	X	X					X		
Lapse								X	X	X (h)					X		
Investment Policy/Disintermediation								X	X	X					X		
Other (please list)			(a)									(i)				(w)	

<b>Subgroup 4 Survey: Summary of Responses (received from either LHATF member states or interested states):</b>													<b>Page 2 of 2</b>		
(a) Products with no/few policyholder options, with low lapse and market return sensitivity.															
(b) For example, PBA might add little value for short-term contracts subject only to pricing risk.															
(c) Variable products with guarantees which now require reserves in the general account.															
(d) Variable products with guarantees.															
(e) Non-UL forms															
(f) ROP Term															
(g) Possibly															
(h) Any product with material lapse support for reserves should not be exempted.															
(i) If the AAA can provide good reasons for some exemptions then would be willing to let them look into all options.															
(k) Simpler forms of individual term insurance.															
(m) Products with less risk may be measured by current efforts of Subgroup 4 and the LRWG to develop the material tail risk test. If certain products are less risky then they would not be exempt from principles-based reserves but rather would have a simpler deterministic approach for reserves. The combination then, of products exempt from PBR along with products subject to an appropriate application of PBR, may represent a viable approach on the operative date of the Valuation Manual.															
(n) All newly filed products															
(o) Leaning toward "no categorical exemptions". Exemptions allowed where appropriately demonstrated.															
(p) Very vague question. Our level of support obviously rests in how well defined the risks are.															
(s) Any exemption should be justified by analyzing the risk of the product, it seems like the following products are likely to be appropriately exempted from PBR upon final analysis.															
(t) If considered, we would work on definitions of "risk" and "options" included in products, and limited assets used to back up the products.)															
(u) Immediate annuities and others where current standars may produce innadequate reserves. It would not make sense to include policies that most likely will have a reduction in reserves compared to current standards and not include policies that may have an increase in reserves.															
(v) It is preferred that PBR address these products much in a similar fashion as they are addressed in asset adequacy analysis. Those products with less risk would not require the same degree of rigor in the calculation of reserves.)															
(w) See response for (v) above.															