



## AMERICAN ACADEMY *of* ACTUARIES

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**To:** NAIC Life and Health Actuarial Task Force (LHATF)  
**From:** American Academy of Actuaries Life Reserves Work Group (LRWG)  
**Subject:** LRWG Proposal for a New Principles-based Valuation Standard for Life Products  
**Date:** November 11, 2005

Attached to this memo are four documents that comprise the proposal from the Academy Life Reserves Work Group for a new principles-based reserve (PBR) valuation standard for Individual Life Products. These documents are:

1. [Draft Model Regulation](#)
2. [Draft Actuarial Guideline on Determining Valuation Assumptions](#)
3. [Draft Actuarial Guideline on Documentation and Disclosure Requirements](#)
4. [Draft Actuarial Guideline on Requirements for Establishing Assumption Margins](#)

Elements of the proposal that represent fundamental principles and methodologies of the PBR approach have been placed in the draft Model Reg. While the expectation is that these elements will be less likely to need future revisions as we move forward with the PBR approach, major decisions on governance are still outstanding. Elements that are more likely to need revision in the future were placed in the draft guidelines, since changes to the new reserving approach are expected to occur over time as regulators and companies become more familiar with the PBR framework (e.g. required disclosure requirements, level of assumption margins, etc).

It is important to note that some of the material that appears in the three draft guidelines might better be placed or restated in an Actuarial Standard of Practice ("ASOP"). This is especially true for the material in AG PBR dealing with establishing valuation assumptions. The LRWG has been in contact with the Actuarial Standards Board to discuss the need for one or more ASOPs to complement this effort. We anticipate that the next draft of this proposal will move some of the material currently in the three draft guidelines to an example of what a new ASOP might contain.

It is also important to emphasize that this proposal represents the "best estimate" views of the Academy in the absence of some major decisions on required governance. The proposal presumes that the SVL has been amended to enable the use of a principles-based approach for Life Products, and a new Model Regulation and/or Actuarial Guideline has been adopted to establish an acceptable regulatory and governance process to address the regulatory demands of a principles-based approach. Having these two elements in place is critical in order for this proposal to be successfully implemented. After the adoption of actual governance processes, the Academy will review this recommendation to verify if any changes to this proposal are warranted since governance options include revised audit requirements and roles as well as additional legal rights and obligations.

This proposal has been developed with the goal of having companies determine both reserve and RBC requirements in a consistent fashion using similar methodologies. The LRWG plans to coordinate our efforts throughout 2006 with the newly formed Academy C3 Phase III work group that is addressing RBC requirements for Life Products.

In addition to the major change in format since our last draft (sent to you in August), we have made several changes in the basic framework, and many new elements have been added. These are listed in the attached Appendix. While there are several aspects of the proposal that are not finalized, **we believe this current draft is complete enough for LHATF to expose the proposal for comment at the upcoming December LHATF meeting.**

As you review this material, please note the following:

1. Elements of the proposal that need to be added or expanded upon are mentioned throughout the material in drafting notes.
2. Specific margin requirements for assumptions have been removed from the proposal. LHATF will need to decide if they need to establish them and how they fit into the governance process. These are all listed in the AG MAR. The LRWG will provide a list of alternatives for each margin (with pros and cons) early in 2006.
3. While the proposal has incorporated a number of new elements to address variable life products (see the Appendix for details), there are still several outstanding items for variable products that need to be addressed. In addition, there will likely need to be additional considerations added for equity indexed Universal Life products.

## Appendix

Major Changes and Additions to the LRWG Proposal since September 2005 Draft

**Note: Locations of each item in the various documents are identified.**

(MR = Model Reg; AG = Actuarial Guideline)

### Changes:

1. Scope has been expanded to include all life products, including traditional Whole Life and equity indexed Universal Life. (MR Section 3).
2. Valuation mortality assumption. (PBR AG, Section III)
  - a. Once the Prudent Best Estimate assumption is determined (the prior version stopped here), the actuary then selects a valuation mortality table from a range of NAIC-approved valuation tables that best maps to the actuary's Prudent Best Estimate assumption.
  - b. The credibility method is now prescribed (rather than giving the actuary the flexibility to choose his or her own).
3. The company can use its own interest rate generator for the Stochastic Reserve if mandated calibration standards are met, or the company can use a prescribed generator. In the prior version, only a prescribed generator could be used. MR Section 7 (D)

### Additions:

1. Impact of aggregation of policies (i.e., risk offsets). MR, Section 7 (H) (7); AG DIS, Section III (C).
2. Treatment of Non-guaranteed elements. MR, Section 7 (J). AG PBR Section VII
3. Stochastic Reserve Exclusion (i.e., only the Deterministic Reserve is required).  
MR, Section 7 (H) (2); AG DIS, Section III (D)
4. Method to calculate path of Net Asset Earned Rates. MR, Section 7 (F)
5. Determination of Discount Rates for reserve calculations. MR, Section 7 (F)
6. Aspects related to Separate Accounts, including modeling of hedges, standards for clearly defined hedging strategies, and grouping of variable funds and subaccounts.  
MR, Section 7 (E); AG PBR Section VI (C); AG DIS Section VII (B) (6).
7. Revenue Sharing. AG PBR Section VIII
8. Allocation of total reserve (now called Reported Reserve) to individual policies. MR, Section 7 (L)
9. Determination of starting assets. MR Section 7 (E)
10. Test of aggregate margin from all assumptions. AG DIS Section III (B)
11. Definition of Asset Segments. MR Section 5 (A)
12. Documentation requirements expanded (e.g., documentation of asset assumptions and modeling decisions). AG DIS (all)