

Post-NAIC/PBA Webinar Update 18

April 6, 2010

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Soundness / Risk Management Committee
(AKA PBA Steering Committee)



Agenda for Webcast

- Spring 2010 LHATF Update: Larry Bruning, Chair of LHATF
- VM-20 Update: Dave Neve, Chair of the Academy of Actuaries Life Reserve Working Group
- Life Risk-Based Capital Update: Philip Barlow, Chair of the NAIC Life Risk-Based Capital Working Group
- Solvency Modernization Initiative: Nancy Bennett, Senior Life Fellow of the American Academy of Actuaries
- Questions



Spring 2010 LHATF Update

Larry Bruning, FSA, MAAA

Chair, Life and Health Actuarial Task Force (LHATF)

Chief Actuary, Kansas Insurance Department



LHATF Update

- Society of Actuaries/American Academy of Actuaries Joint Project Oversight Group (SOA/AAA JPOG) Report on Mortality
- American Academy of Actuaries (Academy) Non-forfeiture Improvement Work Group Report
- Oliver Wyman Presentation on Observations of C-3 Phase II RBC and Actuarial Guideline XLIII Principle-Based Reserves
- Actuarial Guideline XXV
- Report of the Accident and Health Working Group
- Report of the Compact Standards Working Group
- Federal Health Care Legislation Update
- Valuation Manual Update
- Next Steps



LHATF Update

- **SOA/AAA JPOG Report on Mortality**
 - 2012 CSO Experience Mortality Tables
 - Development of a mortality margins framework which includes the application of credibility theory when company mortality data exists
 - SOA Committee on Life Insurance Research report on application and adoption of credibility theory for life insurance and annuities
 - Limited Fluctuation Method / Buhlmann Empirical Bayesian Method
 - Price Waterhouse Coopers report “Analysis of Methods for Determining Margins for Uncertainty under a Principle-Base framework for Life Insurance and Annuity Products”
 - ❖ Random fluctuation in the individual risks or losses arising from pooled insurance policies
 - ❖ Uncertainties with regard to the mis-estimate of mean experience
 - ❖ Uncertainties with regard to the use of inappropriate trend assumptions
 - ❖ Uncertainties with regard to the assumed relationships between risk factors



LHATF Update

- **SOA/AAA JPOG Report on Mortality**
 - Development of new valuation Payout Annuity Mortality Table and Projection Scale
 - ❖ Preliminary table created
 - ❖ Analysis of table continues
 - ❖ Goal to have proposed table and projection scale for August LHATF meeting
 - Development of a new valuation mortality table for Guaranteed Issue/Simplified Issue contracts
 - ❖ Company survey on market, distribution and risk selection due April 1, 2010
 - ❖ 153 responses received to date
 - ❖ Analysis of survey data will get underway



LHATF Update

- Academy Non-forfeiture Improvement Work Group Report
 - Work Group continues development of a Principle-Based approach to the determination of non-forfeiture values for life insurance and annuities
 - 2nd draft revision of the report is currently being discussed



LHATF Update

- Oliver Wyman Presentation on Observations of C-3 Phase II RBC and Actuarial Guideline XLIII Principle-Based Reserves
 - Represent 12 of the top 20 North American Variable Annuity writers
 - Analyzed 12 companies C-3 Phase II and AG 43 results
 - Several observations were noted in the presentation
 - Two areas noted where capital and reserve requirements yielded results that are not intuitive and suggest that anomalies may exist
 - Hedging programs do not appear to be reducing tail risk
 - Aggregate reinsurance produces odd reserve pattern vs. individual reinsurance
 - Oliver Wyman is going to drill down deeper into the results to try to determine root causes of anomalies and investigate potential amendments to C-2 Phase II and AG 43 frameworks that may eliminate anomalies
 - They will report back to LRBCWG and LHATF on results



LHATF Update

■ Actuarial Guideline XXV

- Guideline deals with calculation of minimum reserves and non-forfeiture values for policies with guaranteed increasing death benefits tied to an index
- For non-forfeiture values, the current AG XXV prescribes an assumption of level death benefits (e.g. no increases) for policies where any death benefit for any policy year would not exceed \$10,000 in absence of any annual increases based on the index
- On January 19, 2010 LHATF amended AG XXV and exposed the amended AG XXV for comment. Amendment updates the \$10,000 limit by defining a “Threshold Amount” which is based on the increase in the Funeral Expenses expenditure category of the Consumer Price Index for all Urban Consumers as of the end of June (index). The Threshold Amount shall be \$ 10,000 until December 31, 2009 and after December 31, 2009, the Threshold Amount for a statement year shall be the product of \$25,000 and the ratio of the index as of June of the statement year and the index as of June 2009. Ratios less than 1.0 shall be set equal to 1.0



LHATF Update

■ Actuarial Guideline XXV

- LHATF asked the American Academy of Actuaries to review the background and rationale for the original development of AG XXV and consider LHATF's proposed amendment to the Threshold Amount and review the consistency of AG XXV as amended with the Standard Non-forfeiture Law for life insurance
- Academy presented a report to LHATF in Denver supporting LHATF's amendment with 2 recommended changes:
 - ❖ Adjust the \$10,000 amount in the current AG XXV reflecting the change in the All Urban CPI between January 1, 1991 and the effective date of the amended AG XXV and prospectively change future amounts using the change in the All Urban CPI index
 - ❖ Cap any annual change in the All Urban CPI index at 5.0%
- LHATF amended the current exposure draft of AG XXV to incorporate the Academy's recommended changes and re-exposed AG XXV for comment as amended



LHATF Update

■ Report of the Accident and Health Working Group

- Discussed the status of proposed changes to Medicare Supplement refund formula in Appendix A of the Model Regulation to Implement the NAIC Medicare Supplement Insurance Minimum Standards Model Act. Work on the refund formula will continue on conference calls.
- Adopted modifications to the Medicare Supplement Compliance Manual to state that Medicare Supplement plans of the same plan and type designation should be pooled for rating purposes.
- Discussed several proposed changes to the Accident and Health Policy Experience Exhibit. The working group decided to cease working on this project to require the Exhibit by each state.
- Recommended to the Life and Health Actuarial Task Force that VM-25 is complete and ready for adoption.
- Discussed the update to the Guidelines for Filing of Rates for Individual Health Insurance Forms. Working group considered proposing the revisions to be incorporated in a Model Law but deferred consideration until the proposed updates are evaluated and the impact of Federal Health Care Legislation is known.



LHATF Update

- **Report of the Accident and Health Working Group**
 - Discussed Long-Term Care rating considerations.
 - Recommended modification of the charge regarding the 1985 NAIC Cancer Cost Tables. Because of lack of data, no replacement table can be developed. The working group requested the American Academy of Actuaries recommend appropriate guidance on current application of the 1985 Tables.



LHATF Update

- Report of the Compact Standards Working Group
 - Update on standards for Deferred Paid-Up Non-Variable Annuity Contract Standards (commonly marketed as Longevity Annuities)
 - Update on Guaranteed Living Benefits for Individual Deferred Non-Variable Annuities
 - Update on Guaranteed Living Benefits and Guaranteed Minimum Death Benefits for Individual Deferred Variable Annuities



LHATF Update

- Federal Health Care Legislation Update
 - Brian Webb of NAIC discussed the impact of the new Federal Health Care Bill on the NAIC and specifically on LHATF
 - Parts of the bill will defer to the NAIC for data collection
 - Parts of the bill will defer to the NAIC for administration
 - Some items of the bill need to be completed within the first 90 days of passage
 - Some items of the bill take effect within the first 6 months
 - Other items of the bill take effect in 2014
 - Stay Tuned



LHATF Update

- Valuation Manual Update
 - LHATF amends VM-20 to incorporate the Academy Life Reserve Asset sub-group's proposed framework for determining default costs on existing assets
 - LHATF asks the Academy Life Reserves Asset subgroup to next develop a framework for determining investment spreads on reinvestment assets for consideration in VM-20
 - LHATF amends VM-20 to incorporate the ACLI's net premium component of the Principle-Based Approach to valuation
 - LHATF agrees on the margin language in VM-20 for policyholder behavior assumptions and company expenses



LHATF Update

- Valuation Manual Update
 - LHATF discussed the idea of limiting the scope of VM-20 to UL, UL with Secondary Guarantees and Competitive Term products, but decided that VM-20 would require all life products, except Credit Life and Preneed, to be subject to the exclusion tests as defined in VM-20. If a life product passes both the deterministic exclusion test and the stochastic exclusion test, it will be subject to current valuation requirements. Products (other than Credit Life and Preneed) that do not pass the deterministic exclusion test or the stochastic exclusion test will be subject to the valuation methodology of VM-20. A certification that products pass the stochastic exclusion test is acceptable.



LHATF Update

- Valuation Manual Update
 - On an interim conference call LHATF amended VM-20 to not allow aggregation of life insurance products subject to the valuation methodology of VM-20. LHATF reversed that decision at the Spring 2010 NAIC meeting in Denver given the discussion on scope and what products will likely not pass the deterministic and stochastic exclusion tests. NY had raised the aggregation issue in an amendment proposal adopted on the conference call and indicated that they may still raise this issue but wanted some time to think through the issues.



LHATF Update

- Valuation Manual Update
 - LHATF amends VM-20 to incorporate the Academy's Economic Scenario Generator with a modification in the determination of the mean reversion parameter (MRP). The MRP is rounded to the nearest 25 bps:
 - ❖ AAA MRP is $.5 \times (M - .0025) + .5 \times A$
 - ❖ LHATF MRP is $.2 \times (M - .0025) + .5 \times A + .3 \times B$where M = Median 20-year yield over most recent 600 months
 A = Arithmetic average 20-year yield over preceding 36 months
 B = Arithmetic average 20-year yield over preceding 120 months
 - The Joint LHATF/CADTF may need to consider this modification in an effort to have a uniform economic scenario generator to be used for determining capital and reserves under a Principle-Based Approach



LHATF Update

- Valuation Manual Update
 - Having adopted several amendments during interim conference calls and during the two day March LHATF meeting, LHATF exposed for comment:
 - ❖ A new draft of VM-20
 - ❖ A new draft of VM-31
 - ❖ A new draft of VM-50
 - ❖ A new draft of VM-51
 - Two other items not discussed at the LHATF meeting will be dealt with on conference calls
 - ❖ Revisions to AG 38
 - ❖ Response to PBR (EX) Working Group on Statistical Agent



LHATF Update

■ Next Steps

- LHATF to adopt Valuation Manual end of June or early July
- Conference calls organized by VM section for adoption
- Each adopted section sent to NAIC legal department for final review
- A-Committee to adopt Valuation Manual by end of July
- Plenary to adopt Valuation Manual at August NAIC meeting in Seattle
- State Legislators to consider amendments to the Standard Valuation Law and Valuation Manual in legislative sessions beginning in 2011



VM-20 Update

Dave Neve, FSA, CERA, MAAA

Chair, American Academy of Actuaries Life Reserves Work Group

Vice President, Capital Management, Aviva USA



Topics

- Decisions made at March LHATF Meeting
 - LRWG Asset Default Proposal
 - ACLI Net Premium Reserve (NPR) Proposal
 - Scope
 - Assumption Margins
 - Anticipated Experience Assumptions
- Aggregation (recognition of risk offsets)
- LRWG Concerns with Direction of PBA
- LRWG Priorities for 2010



Summary of Asset Default Framework

1. A prescribed methodology with parameters set by regulators.
2. LRWG still prefers a non-prescriptive approach, but has agreed to develop a prescribed approach for LHATF.
3. Projected default costs are the sum of three components:
 - a. **Baseline annual default cost factor.** Based on historical corporate default and recovery experience. Includes a margin for conservatism. Factor is a table “look-up” based on a “PBR credit rating” from 1-20, based on actual independent ratings, and weighted average life of the asset.
 - b. **Spread related factor.** Based on the corporate bond spread environment as of the valuation date. Adjustment can be positive or negative, and grades off over three years (subject to a floor and a cap).
 - c. **Maximum net spread adjustment factor.** Portfolio-wide upward adjustments, graded off over four years, if the net spread of the portfolio exceeds the net spread of a “regulatory threshold” index bond.



Changes since December Proposal

1. Proposed approach does not apply to fixed income assets that do not have an NAIC designation. Currently includes commercial loans and residential whole loans. Plans are to develop an appropriate approach for these assets at a later date.
2. The recovery assumption used to determine the baseline annual default cost factors has been modified to use the historical sample mean instead of CTE 70 for Baa1/BBB+ ratings and above, grading to CTE70 at ratings of Ba3/BB- and below. Results in baseline default costs being about 20% lower than December proposal.
3. The process to assign a PBR rating is fully prescribed for all assets in scope.
4. The “regulatory threshold” asset is now proposed to be Baa2/BBB (PBR rating of 9) rather than prior proposal of A3/A- (PBR rating of 7).
5. The spread related factor is no longer based on the current option adjusted spread of each asset, but rather, is based on the difference between current and historical mean spreads of index



Proposed approach was adopted by LHATF

1. Actual VM-20 language for the proposal has been developed and was incorporated by LHATF at the March meeting.
2. Appendix has also been included that gives the needed tables/factors to perform the calculations. The appendix also describes the methodology used to determine the factors.
3. The LRWG will be developing a proposal for prescribed spreads on reinvested assets that is consistent with this proposal on existing assets.



Net Premium Reserve Framework

1. Has been under development by the ACLI for several years.
2. The proposed Net Premium Reserve was incorporated into VM20.
 - Based on a preliminary term approach in which the expense allowance is expanded from the current CRVM.
 - Lapse is considered for products without cash surrender values.
 - A higher interest rate is available for products without cash surrender values.
3. The valuation for UL (Fund Based products) has been added to VM-20.
 - Follows the current retrospective valuation for the primary guaranteed values.
 - A second prospective valuation is required if there is a secondary guarantee, using a level annual gross maturity premium, prescribed lapse rates, and the SVL interest for no cash surrender value products.



Scope

- Current exposure would require all products to be subject to VM-20 (except credit life and pre-need).
- Two options to “opt out” of VM-20 requirements:
 - Pass both the SR and DR exclusion tests
 - Actuarial certification that if tests were done, policies would pass
- If opt out of VM-20, default to current SVL CRVM requirements.
- SR and DR exclusion tests are required for all products (not optional)
 - If pass both tests: use current CRVM
 - If pass SR test, but not DR test: minimum reserve is the greater of the DR and the NPR
 - If fail the SR test, then don't need to do the DR test: minimum reserve is greater of SR and DR, but subject to NPR floor



Other issues

■ Margins

- Current exposure does NOT establish prescribed margin ranges on the lapse assumption and other PHB assumptions.
- Current exposure defines a prescribed range for mortality assumptions. Expect the prescribed margin range for mortality assumptions to be the recommendation under development by the VBT team and the LRWG.
- Current VM-20 margin guidance is adequate.

■ Anticipated Experience assumptions with lack of credible data

- Incorporates LRWG proposal on current exposure on guidance regarding appropriate methods to “blend” company experience with industry data, depending on type of risk factor.
- Includes use of actuarial judgment on risk factors when there is no company or industry experience.



Aggregation

- LHATF voted to require sub-aggregation by product during Feb. conference call, which essentially removes the benefit of risk diversification in the SR calculation.
- LRWG requested that LHATF reverse this decision and return to a full aggregation approach. Reasons:
 - Adds an arbitrary level of conservatism
 - Introduces a potential anomaly into the calculation (e.g., modeled crediting rates may not be consistent with actual company practice)
 - Creates an incentive for a company to make non-economic decision (e.g., decide against issuing a new product with risks that offset current products)
- Regulators can still audit and analyze the impact of aggregation by appropriate disclosure requirements (lack of ability to audit was one of the main reasons to remove full aggregation).
- LHATF voted to remove the sub-aggregation approach in the current exposure draft, but still wants to review the issue before a final decision is made.



LRWG Concerns with Direction of PBA

- Prescribing margins for each assumption in VM-20
- Elimination of aggregation between products (not final)
- Prescribed defaults costs
- Elimination of the option to use a company's own stochastic generator
- Arbitrary haircuts on revenue sharing
- Including amounts in NGE that do not arise from experience of the policy (not final)
- Maintaining the risk transfer rule for reinsurance



LRWG 2010 Priorities

1. Aggregation / Risk offsets
2. Provide analysis to LHATF on the net premium approach
3. Appropriateness of using the DR and SR exclusion tests as “traffic lights” to define scope.
4. Appropriateness of DR exclusion test.
5. Finalize method to define prescribed spreads for reinvestment assets
6. Encourage the use of a Margin factor to quantify the aggregate margin, based on a cost of capital approach.



Life Risk Based Capital

Philip Barlow, FSA, MAAA

Chair, NAIC Life Risk-Based Capital Working Group

Associate Commissioner, Insurance Bureau
Dept of Insurance Securities & Banking of Washington, D.C.



Life RBC Issues

- C3 Phase III Update
- C3 Phase II Results Subgroup Report
- Commercial Mortgage RBC
- Derivatives Risk-Mitigation Proposal



C3 Phase III Update

- Earliest Potential Date for C3 Phase III is 2011.
- LRBCWG had two exposures for comment:
 - Academy proposal for incorporating C3 Phase III requirements into RBC instructions;
 - ACLI proposal for materiality test and scope limitation.
- Comments received from the Academy and ACLI on the exposures.
 - LRBCWG extended the time for comments to April 10 to allow for promised comments from NY Department and any other outstanding comments.
- After April 10, the LRBCWG will develop a list of outstanding items to be addressed for C3 Phase III.



C3 Phase III Update

- LHATF adopted a proposal for the Economic Scenario Generator which included a proposal for a mean reversion parameter proposed by the PBR Scenarios Subgroup.
- LRBCWG previously agreed to use the same Economic Scenario generator adopted by LHATF



C3 Phase II Results Subgroup

- C3 Phase II Results Subgroup presented a report including observations and recommendations as a result of the Subgroup's review of Actuarial Memoranda from companies that agreed to provide the memoranda to the Subgroup.
- Since the Subgroup was reviewing specific company information the meetings of the Subgroup were closed, so this report is the first opportunity for people outside the Subgroup to review and comment on the work of the Subgroup.



C3 Phase II Results Subgroup Observations

Observation 1:

- The reported C-3 Phase II amounts for 12/31/08 appear low for companies reviewed, consistent with aggregate industry information from I-SITE.

For example, C-3 Phase II amounts reported were \$1.7 Billion. The net reserves in excess of cash value on these policies were \$29 Billion. Potential reasons for low C-3 Phase II amount relative to the reserves include:

1. Several companies cede this business to offshore affiliates that are not subject to U.S. RBC requirements and the RBC disappears. Unlike for reserves, no collateral requirements exist for ceded RBC.
2. Most companies are increasing reserves such that the reserve equals TAR, to maintain a higher RBC ratio than if they reported a portion of TAR as RBC. This is an “optics issue” driven by various parties, such as ratings agencies, using the RBC ratio for purposes that were never intended, such as ranking companies.
3. Flexibility in setting assumptions may result in too little conservatism – also, assumptions are often not supported by justification (see Observation 2).



C3 Phase II Results Subgroup Observations

Observation 2:

- Current disclosures and assumption setting as described in the C-3 Phase II memoranda do not provide enough information for an accurate qualitative evaluation. For example:
 1. Companies have adopted a formulaic “cookbook” approach in preparing the memoranda.
 2. Often there is not sufficient identification or quantification of key risk factors and how those risks were mitigated.
 3. Justification was not provided in many cases in order to evaluate the appropriateness of assumptions.
 4. Models not validating to actual data correctly were not adjusted in some cases.



C3 Phase II Results Subgroup Observations

Observation 3:

- Lapse assumptions on deep in-the-money (ITM) guaranteed living benefits are developed in a wide assortment of ways. These include assumptions based upon:
 1. Company experience for ITM and duration range with conservatism added because of possible change in the environment.
 2. Industry experience for ITM and duration range with conservatism added because of lack of company data or possible change in the environment.
 3. Based on judgment or based on pricing assumptions with some conservatism added.
 4. Based on industry average assumptions.



C3 Phase II Results Subgroup Observations

Observation 4:

- Total Asset Requirements (TAR) in excess of cash value are volatile when the market is volatile, even when smoothing is utilized.

However, the subgroup believes that the results have been volatile because they reflect the true economics, where the value of the guarantees goes up when the market goes down (and vice versa). Over the past few years, the S&P 500 has fallen 60% and has risen 60%. It is currently about 30% below its peak.

Observation 5:

- Risk mitigation programs are not identified if the company is not taking credit.

The subgroup noted that in a tail scenario, the reserve and RBC amounts may not cover projected claims because these products have risk exposures that are fat tailed. For this reason, it is important for the regulator to be familiar with how the company is mitigating the risk associated with these products. The regulator's review should include gaining a level of comfort with the company's hedging, reinsurance, and other programs for mitigating risk.



C3 Phase II Results Subgroup

The LRBCWG agreed to hold two or more conference calls between now and the next NAIC meeting, which will not be until August, to discuss the observations and recommendations of the Subgroup and get Interested Party feedback.

These calls will also cover the Oliver Wyman observations on C3 Phase II once that position paper is produced and the educational session has occurred.



Commercial Mortgage RBC

The ACLI presented an updated version of the long-term proposal for the RBC treatment of mortgage loans.

- The ACLI proposal continued to use the debt service coverage ratio normalized to a 25 year amortization.
- The ACLI added information to the report about the treatment of certain kinds of loans, “Special Circumstance Loans”, such as construction loans, credit-tenant loans, non-standard properties, etc.
- The ACLI is now working on a statistical analysis of mortgage experience, but does not expect to complete it until late in the third quarter at the earliest.



Commercial Mortgage RBC

- Regulators expressed concerns over some portions of the ACLI proposal, such as the sole use of a normalized DSC and the treatment of Special Circumstance Loans.
- A conference call will be scheduled to identify crucial issues that need more understanding.
- An interim meeting might also be held to gather more information for both the short-term and long-term mortgage proposals.



Commercial Mortgage RBC - 2010

- Because the long-term proposal for the RBC treatment of mortgage loans requires changes to the existing RBC formula, those changes must be completed 1 year prior to introduction. Therefore the earliest that the long-term proposal can be implemented is 2011.
- Currently the calculation for commercial mortgage RBC is set to use the original MEAF calculation for 2010, with the overall factor of 2.6% and a company specific adjustment of 50% to 350%.
- The CADTF exposed for comment a proposal to continue to use the 2009 range of 75% to 125%, but to increase the factor to 4.0%.
- The CADTF will hold a conference call at the end of April to discuss comments received on the exposed proposal.



Derivatives Risk-Mitigation Proposal

- After the Winter NAIC meeting the LRBCWG was still working toward trying to implement the proposal for 2010 for the “Basic” hedges. However, not all the issues were able to be worked through in a timely manner and this project now has a 2011 implementation goal.
- The ACLI continues to work on the proposal to address the issues that were raised by the WG. Year-end work however slowed progress.
- Because of the change to a 2011 implementation goal, the ACLI is proposing to address both “Basic” and “Intermediate” hedges. The WG supported that approach with the addition that the proposal should be done such that the two could be separated, if necessary.



LRBCWG 2010 Work Plan

- The LRBCWG expects to be very active in 2010, even though there are only two more NAIC meetings this year. Goals for 2010 include:
 - Completion of work on C3PIII.
 - Development and approval of a long-term proposal for commercial mortgages.
 - Finalizing the Derivatives Risk Mitigation Proposal for the “Basic” and “Intermediate” hedges.
 - Reviewing the observations of both the C3PII Results Subgroup and Oliver Wyman.



VOSTF Issues Affecting RBC

- At the recent NAIC meeting, the Valuation of Securities Task Force took actions that will have an impact on the calculation of the RBC.
 - The TF voted to continue using a model based approach for determining the designation for RMBS. A single vendor will be used for the modeling and the TF will be requesting bids soon. The modeling of expected future losses will be performed semi-annually, with the first update performed as of June 30, 2010.
 - The TF also voted to extend the modeling approach to all securitized assets including CMBS and ABS, if cost effective. In particular, NAIC staff will be reviewing if modeling would be cost-effective for ABS given the relative size of this asset class for insurers.



Update on NAIC Solvency Modernization Initiative

Nancy Bennett, FSA, CERA, MAAA
Senior Life Fellow, American Academy of Actuaries



Discussion Outline

- SMITF Purpose
- SMI Work Groups
- Recent Activities of SMITF
- Specific SMI Conclusions
 - General SMITF comments
 - Solvency
 - Corporate Governance
 - Accounting
- Academy Involvement
- Next Steps for SMITF



Purpose of SMITF

- SMITF formed in June, 2008
- Current solvency framework has been in place for 20 years
- Global and international developments suggest a comprehensive review of the US insurance solvency regulatory framework is warranted
- Modernize, modify, expand, eliminate or enhance U.S. regulatory system as appropriate
- Review international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation



Purpose of SMITF (cont.)

- Develop a roadmap to identify questions and decision priorities
 - articulation of the U.S. solvency framework and key principles in one cohesive document to convey foundational concepts underlying the U.S. regulatory system and their interrelationships
 - study other sectors' and other countries' solvency and accounting initiatives and the tools that are used and proposed
 - improve the tools used for risk-focused examinations
 - create a new reinsurance regulatory framework
 - move to principle-based reserving for life insurance products
 - Consider change to group supervisory methods
 - implement new ideas to incorporate into the U.S. solvency system



SMITF Work Groups

- International Solvency (Ex)
- Group Solvency (Ex)
- Corporate Governance (Ex)
- International Accounting Standards (Ex)
- Principles-Based Reserving (Ex)
- (new) Statutory Accounting & Financial Reporting Subgroup (Ex)



Recent SMITF Activity

- Issued several consultative papers
- Soliciting comments on consultative papers
- Updates and SMITF activity posted on NAIC website:
http://naic.org/index_smi.htm
- April 28 SMITF webinar
- June 4 Group Solvency Issues (EX) Working Group Hearing



SMITF Observations: Regulator Comments

- US solvency framework has been very effective, particularly in the last two years, but there is always room for improvement.
- Recognized need to document and explain US framework.
- Primary focus of US framework is policyholder protection.
- NAIC is cognizant of the impact SMITF activities could have on an insurer's ability to compete globally.
- US framework is at least as strong as Solvency II framework
 - Little support for adopting a SII framework in the US.
 - Gaining equivalence with SII is not a specific objective of the SMITF. NAIC understands that gaining equivalence is desirable, assuming SII equivalence is outcome-based versus rules-based.
- Reaffirmed desire to converge solvency systems internationally where practical.



Academy's Solvency Task Force Comments to SMITF

- Academy's Solvency Task Force (STF) supports the NAIC's initiative to modernize the solvency framework
- STF agrees with the current purpose of RBC to define minimum capital requirements and establish objective trigger points for regulatory action.
- Refinements to the current methodology for establishing minimum capital requirements are needed.
 - Varies by the type of insurance and the methods for establishing reserves.
 - Health and Casualty refinements tend to fall more toward the minor end of the continuum
 - Life refinements are more major and comprehensive in nature.
- The refinements to RBC should be based on the following:
 - Changing risk profile of individual insurers and the industry as a whole
 - Length of guarantee promised to insured
 - Reliance on asset performance and the capital markets in delivering on promises
 - A company's ability to manage risk



Academy Comments to SMITF (cont.)

- Most important question is the role regulators envision for themselves in a modernized solvency framework.
- Many concepts being explored (e.g., economic capital) represent a paradigm shift in monitoring financial condition.
- A modern regulatory framework requires:
 - dedicated, trained professionals
 - tools to provide effective oversight of risk-focused approaches
 - a flexible regulatory process that can respond quickly to shifting risk profiles of insurers and emerging risks.



Solvency Discussion Topics

- Purpose of US regulatory capital
 - Identify weakly capitalized companies and establish trigger points for regulatory action
 - RBC is part of legal framework
 - RBC formula should not discourage risk management incentives and should not duplicate company risk management practices
 - Hazardous Financial Condition Regulation is the core solvency regulation because both qualitative and quantitative evaluation are addressed
- Group Capital
 - Recognized need for significant improvement in the regulation of groups
 - Improvement will likely take the form of solvency *assessment* rather than calculation of group capital requirements



Solvency Discussion Topics (cont.)

- Areas in need of review in current formula
 - Some factors are in need of revision to capture missing or understated risks
 - Covariance needs review
 - Trigger points need review – are triggers quantified properly?
 - Need to articulate the statistical safety level inherent in the RBC formula
 - Per Lou Felice, difficult to balance those refinements that better identify weakly capitalized companies and those refinements that reduce capital requirements
 - Factors developed in “normal” economic times may produce false negatives and false positives
- Newer solvency concepts being explored
 - Efforts to strengthen the detection of risky behavior will likely focus on gathering specific information about the risks vs. measurement of capital to hold the risk
 - Procyclicality
 - Liquidity requirements
 - Greater use of internal models (e.g., in a total balance sheet approach)
 - Use of EC or other sophisticated capital methodologies



Corporate Governance Discussion Topics

- Governance already addressed in existing solvency regs
- Regulators would like more explicit authority over an insurer's governance procedures
 - Should a formal risk management policy be required?
 - Does the international idea of ORSA (Own Risk and Solvency Assessment) have merit?
- Regulators are cognizant of existing state laws and the need to avoid conflict



Accounting/Reporting Discussion Topics

- NAIC positions:
 - Regulatory and general purpose accounting would be the same ideally, but NAIC has not yet committed.
 - Standing policy between IAIS and NAIC is to have as few differences as possible.
- Little support among interested parties to move to a market-consistent or fair value basis for assets, liabilities, and capital.
- Generally, SMITF should wait for FASB/IASB decision on valuation requirements for public financial reporting before promulgating a new standard for the NAIC.



Accounting/Reporting Discussion Topics (cont.)

- Increasing pressure on US regulators to change statutory accounting to converge with IFRS
 - G20 supports IFRS
 - IASB and FASB working on convergence
- NAIC formed new commissioner level group to determine the future of statutory accounting and reporting. Decision on direction expected in June 2011.



Federal & International Discussion Topics

- Review of other jurisdictions is informative
- Different jurisdictions have different regulatory cultures (e.g., number of regulated entities, legal framework)
- US federal government has agreed to support FSAP
 - FSAP is a joint IMF and World Bank effort
 - FSAP was introduced in May 1999
 - Goal of FSAP is to increase the effectiveness of efforts to promote the soundness of financial systems in member countries.
 - NAIC has stated a goal of differing from international standards only for an explicit reason.



Academy Involvement

- STF submitted comments to SMITF and its work groups (available at www.actuary.org):
 - United States Insurance Financial Solvency Framework (see appendix)
http://naic.org/documents/committees_e_us_solvency_framework.pdf
http://actuary.org/pdf/finreport/naic_dec09.pdf
 - Consultation Paper on Regulatory Capital Requirements and Overarching Accounting and Valuation Issues for the Solvency Modernization Initiative
http://naic.org/index_smi.htm
http://actuary.org/pdf/finreport/isftf_mar10.pdf
 - Consultation Paper on Corporate Governance and Risk Management
http://naic.org/index_smi.htm
http://actuary.org/pdf/finreport/naic_feb10.pdf
 - "Windows and Walls" Approach for Regulation of United States Based Insurers Operating within Corporate Groups
http://naic.org/index_smi.htm
http://actuary.org/pdf/finreport/windowsandwalls_jan10.pdf



Academy Involvement (cont.)

- Panelists at SMITF's Interim Meeting (March, 2010)
- Continued commitment to monitor SMITF activities and participate in modernization activities



Next Steps for SMITF

- Continue discussion of solvency topics
- Modify road map based on recent discussions
- Consider release of white paper on capital requirements
- Coordinate SMITF activities with activities of established NAIC committees



Appendix



US Insurance Financial Solvency Framework and Core Principles

- **Full paper available online:**

http://naic.org/documents/committees_e_us_solvency_framework.pdf

- **Seven core principles articulated**

- Regulatory Reporting, Disclosure and Transparency
- Off-site Monitoring and Analysis
- On-site Risk-focused Examinations
- Reserves, Capital Adequacy and Solvency
- Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities
- Preventive and Corrective Measures, Including Enforcement
- Exiting the Market and Receivership



How Will PBA Rock Your World

- Joint SOA/Academy seminar
- May 19, 2010 in Tampa, Florida
- Register on SOA website
- Topics include:
 - Stochastic Exclusion Test
 - Development of Assumption Margins
 - Modeling Results for Selected Products
 - Practicalities and Implementation Challenges of PBA



Questions?

