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AMERICAN ACADEMY *of* ACTUARIES

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January 11, 2013

Commissioner Susan E. Voss  
Chair, Principles-Based Reserving (E) Working Group  
National Association of Insurance Commissioners

Dear Commissioner Voss:

The American Academy of Actuaries<sup>1</sup> Life Practice Council (LPC) appreciates the opportunity to comment on the November 19, 2012 Draft Principles-Based Reserving (PBR) Implementation Plan.

The LPC views the PBR Implementation Plan as a good start to determining and prioritizing the issues involved with implementing PBR and establishing the necessary procedures to ensure that companies can comply with and administer PBR requirements contained in the Valuation Manual and that regulators have the resources, infrastructure and support needed to effectively oversee compliance. However, we also believe the Plan should contain greater emphasis on the procedures needed to evaluate the overall effectiveness of the PBR methodology. PBR for life insurance is a new process – one that the states, the NAIC and the companies have not used as a regulatory tool in this way before. Consequently, everyone should expect that the methodology will need to be adjusted as experience with PBR unfolds. PBR involves the use of an integrated modeling methodology with many intertwined assumptions and components. Adjustments should be based on the evaluation of the methodology in its entirety.

We reiterate the concerns previously expressed in our [letter](#) of July 16, 2012 and in our [presentation](#) of August 12, 2012 made to the PBR (E) Working Group. Resources need to be allocated as follows:

- (1) to support state insurance departments as they review companies' reserves using the principle-based approaches described in the Valuation Manual, and
- (2) to evaluate the overall effectiveness of PBR for the industry at large.

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<sup>1</sup> The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

We also said that the NAIC should act now to determine the most effective means for ensuring the necessary tools and resources are in place to review, assess and improve this new dynamic approach to valuation (“PBR Review and Updating Process”).

An optimal process to evaluate the overall effectiveness of the PBR methodology is best addressed without pre-conceptions of the resulting reserve level or other components of the methodology.<sup>2</sup> An effective evaluation of a stochastic process will not follow a pre-defined set of steps but rather is more investigative and flexible in approach, meaning that the focus or direction of the review could shift during the review. The ultimate outcome of a review should not determine if a value is right or wrong but rather, whether the value is reasonable. Actuarial judgment and experience will be needed to review stochastic modeling results.

Since principle-based reserving will apply at first only to certain policies and only to new business written on those policies, some may conclude that evaluation of PBR results can be deferred until PBR reserves represent a material percentage of total reserves. However, we believe it is important to begin this evaluation process now because (1) it may take many years to gather credible data and evaluate the information and (2) much of the information that is needed to do this evaluation will be available from the companies at the time they are being examined for compliance with the Valuation Manual procedures as currently written.

The LPC believes the following elements are essential to support the evaluation of the effectiveness of the PBR methodology:

- **“Sanitization” of Confidential Data** – In reviewing company filings, only state regulators would have access to the data that is essential in evaluating the effectiveness of PBR generally. Therefore, some process should be worked out between the NAIC regulators and companies by which company information can be redacted or “sanitized” in order to publicly expose as appropriate to interested parties for informed analysis and comment on the issues.<sup>3</sup>
- **Periodic Progress Reports** – We believe there should be a requirement for periodic reporting by the NAIC on their detailed review of PBR filings and commentary on the PBR methodology. The NAIC of course should determine which group is best equipped to author the report (e.g., the Actuarial Analysis Working Group (AAWG), NAIC staff). A requirement for a written report, such as an annual report, would place an appropriate

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<sup>2</sup> “Results” (especially in the early stages of evaluation) can be many things – e.g. level of reserves, assumptions used, the timing of when minimums and maximums come into play, ease of calculation, ease of review, tendency to misunderstand requirements, and the use of different methodologies where judgment is needed, etc.

<sup>3</sup> Many groups (e.g., Society of Actuaries, actuarial consulting firms, investment management firms, research firms) conduct surveys of companies where company-specific data is gathered. These groups are able to remove identifiers and still publish useful information at a company level. We suggest that the NAIC investigate the practices used by others in surveying and publishing data to facilitate the use of the valuable information that can be gathered in the regulatory review process.

sense of timely responsibility on the drafting group to analyze the overall methodology and can help shape priorities for updating the VM.

- **Evaluation of Capital Requirements:** While our specific comments in this letter apply to the PBR Implementation Plan as exposed by the PBR Working Group, our comments should also be considered with principle-based capital requirements.
- **Definition of Stakeholder Roles** - It is important to define the roles that the states, the NAIC, the Academy and other interested parties will likely fulfill in reviewing and maintaining the Valuation Manual. Putting definition to these roles while the PBR Implementation Plan is being developed will help further define the detailed elements of the Plan. For purposes of our comments we assume the following roles:
  - **PBR (E) Working Group** – Sets priorities and timelines. Currently the Principles-Based Reserving (E) Working Group has been delegated aspects of this responsibility, and we assume it or another designated group, will continue to do this going forward.
  - **State Insurance Departments** – Primary compliance gatekeepers, but also a source for recommended changes to the Valuation Manual.
  - **NAIC staff** (including existing actuarial and technical staff and additional staff or consultants to be hired) – To facilitate PBR evaluation and review with the states and the NAIC committees.
  - **NAIC Committees** (e.g., Life Actuarial (A) Task Force (LATF), the Actuarial Analysis (E) Working Group, Capital Adequacy (E) Task Force (CADTF)) – Facilitator of analysis and recommendations to the state regulators on issues raised by the states, NAIC staff, American Academy of Actuaries and interested parties.
  - **Interested Parties** (including industry, professional, consumer groups) – Potential sources for recommended changes to the Valuation Manual and for analysis and recommendations regarding changes proposed by others.
  - **Statistical Agents and Society of Actuaries** – Collectors of experience/assumption data.
  - **American Academy of Actuaries** – Architects of the PBR methodology, who will continue to provide support to the NAIC committees, based on publicly available data gathered by the states, NAIC staff, interested parties, and statistical agents.

With the above general comments as a background, we have provided detailed comments on various sections of the Implementation Plan in the Appendix to this letter. We have excerpted the relevant sections from the plan and followed each section with a specific comment. These comments are focused on select aspects of the plan. We anticipate there will be subsequent revisions to the plan and will comment on other aspects of the plan at that time as necessary.

The LPC strongly believes that establishing effective processes and securing sufficient resources, including skilled human resources, is essential for this new PBR regime to function as intended and to be a critical element in regulating the solvency of US life insurers. The LPC further believes (1) that it is critical to the success of these reforms that there be a process in place to continue to review and assess the reasonableness of the framework and the resulting reserves and (2) that it would not be prudent or responsible to adopt a PBR methodology without also creating and maintaining a process to ensure its continued review, assessment, and improvement.

Please feel free to contact John Meetz, the Academy's life policy analyst ([meetz@actuary.org](mailto:meetz@actuary.org); 202/223-8196) if you have any questions about this letter or our suggested changes to the work plan.

Sincerely,

Cande Olsen, Vice-President  
Life Practice Council  
American Academy of Actuaries

#### LPC Members

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John MacBain  
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## Appendix

### Surveys of State Resources

To inform policy decisions, it is recommended that the Principle-Based Reserving (E) Working Group survey the states to obtain information on their current level of resources, the anticipated resources necessary to support PBR, and the expected costs of, and potential for, obtaining the necessary resources. The Working Group should attempt to develop survey questions, administer the survey and compile results for presentation at the 2013 Spring National Meeting.

*LPC Comment - The LPC believes that this survey should be just a starting point for determining the resources necessary to support PBR. The states will need to continue to work closely with the NAIC as their views of the types and level of needed PBR resources evolves.*

#### **I. PBR Review and Updating Process – Regulatory Support for PBR Review**

##### NAIC Actuarial Resource (Resource)

- Maintains a confidential database accessible by regulators to support consistent judgment and treatment of PBR questions and issues.

*LPC Comment - On the surface this appears to be a reasonable procedure; but, this information will need to be used as the basis for a recommended change to the PBR methodology. Thus there will need to be some process by which the confidential information can be edited to hide the identity of the company and shared and exposed as appropriate to interested parties for informed analysis and comment on the issues. This is especially the case if an American Academy of Actuaries group is asked for their input on the recommendation. We suggest that the NAIC study the practices used by the Society of Actuaries, consulting firms and other organizations that regularly gather company-specific confidential data for the purpose of publishing that data in a summarized form. These companies have found ways to communicate conclusions from the analysis of the data while at the same time protecting the source of the data. If the NAIC can find a way to publish confidential results that are the basis of recommended changes to the PBR methodology, it will add credibility to those recommendations.*

- Provides analysis and recommendations to LATF for PBR issues in need of address in the Valuation Manual.

**LPC Comment** - As noted in the comment below, the LPC believes it is important to establish a process that ensures that all components of the PBR methodology are addressed, rather than those raised by individual states or interested parties.

As noted in the prior comment, if such analysis and recommendations are based on confidential information, there needs to be some process by which the confidential information can be edited to hide the identity of the company and then shared and exposed as appropriate to interested parties for informed analysis and comment on the issues.

Through ongoing communication with regulators, industry and interested parties, the Resource will facilitate the refinement, revision, development and implementation of PBR reserve requirements. For example, the process will address the need to adjust margins as appropriate to maintain conservatism, to recognize improvements in modeling techniques, or to effect changes in assumptions due to emerging experience.

**LPC Comment** - As we noted at the beginning of our letter, there is no specific set of procedures outlined in the implementation plan to carry out this process. We believe that in order to do this, it is necessary to begin at the outset to gather specific information from the companies, such as:

**Examples of Measurable Components**

- Is the prescribed approach of credible mortality experience functioning as intended?
- Are companies' net asset returns as defined in VM-20 consistent with their actual net asset returns?
- Are the aggregate margins reasonable?

**Examples of Company Best Practices**

- How are companies establishing margins? Are best practices emerging?
- How many scenarios do companies use and how do they justify that the number of scenarios produce reasonable results? Are best practices emerging?
- What modeling efficiency techniques are being used and how do companies justify these techniques?
- How should best practices be communicated to regulators, companies, and other interested parties?

Information of this sort can be gathered through the examination process, NAIC surveys of the states, industry surveys of companies, or through regulator/company discussion groups like the one established by the LPC to discuss the Actuarial Opinion and Memorandum Requirement. Some combination of these approaches would likely yield optimal comprehensive results.

Once a list of the types of information and the processes for collection is established, priorities and a time line can be set. The NAIC could then allocate the resources (or get

*the commitment from states and/or interested parties to allocate resources) to get the necessary work done.*

New NAIC Working Group - Actuarial Analysis Working Group (AAWG):

- Responding to states in a confidential forum regarding issues and questions arising during the course of annual PBR reviews or PBR examinations.
- Utilizing the Resource to assist in responding to issues and questions.
- Relying on the Resource to maintain documentation and the database mentioned above to support consistent judgment and treatment of PBR questions and issues.
- Providing analysis and recommendations to LATF for PBR issues in need of address in the Valuation Manual.

Example of Initial Use of Resource and AAWG:

- Prior to PBR operative date, Resource works with regulators to develop Financial Analysis Handbook procedures and examination procedures for PBR. Some automation tools and supplemental procedures may also be developed and referenced by these financial analysis and examination procedures. In addition to other objectives, these procedures and tools are intended to provide reasonably consistent PBR reviews regardless of whether internal state regulatory actuaries are used or whether a state uses contract actuaries.
- Domestic states can be encouraged to trigger the portion of the SVL to require independent PBR peer review for those companies coming up for examination.
- For companies coming up for examination, Resource reviews PBR annual report and independent PBR peer review and provides analysis and any recommendations to the domestic state.
- Resource is available to answer any questions but will make use of the AAWG as appropriate depending on the issue/question.
- States can also pose questions/issues to the AAWG during the course of any PBR annual review or examination using a formal submission form or by raising a question for initial discussion
- As mentioned above the Resource will maintain documentation to support consistency in the regulatory review of PBR which would be accessible by states.

NOTE: The above is focused on use of the Resource for companies coming up for examinations. An expanded use of this Resource could also be discussed to apply to more companies than just those coming up for examination in a particular year. For example, companies should have a thorough review of their use of PBR models and assumptions within the first two years of applying PBR.

***LPC Comment** - We support implementing an objective process for thorough review of select companies in the first two years. However, it will be important to establish what basis or criteria should be used to determine a sample of companies whose review would provide the most useful information about PBR. These PBR reviews should go beyond the scope of the routine risk-focused examinations. A major objective of these PBR reviews is to gather information to support an in-depth review of the PBR Methodology.*

*The LPC considers independent peer review to be high priority and will work within the Academy and the actuarial profession to provide appropriate professionalism input in setting qualification standards and/or other requirements.*

*We also believe that the NAIC, possibly through the AAWG, should issue periodic reports evaluating the effectiveness of the PBR methodology. Such reports can help shape priorities for updating the VM.*

## **II. Defining the Statistical Data for Collection**

***LPC Comment** - The LPC believes that gathering of PBR statistical data is an appropriate function of the NAIC using statistical agents. Input from Academy, Society of Actuaries, ACLI, and other interested parties is essential in designing useful and cost-effective analysis.*

## **III. Standardized Financial Reporting and Analysis Tools**

In order to accommodate the changes from PBR, a number of changes will need to be made to the NAIC life, accident and health annual statement blank and the NAIC health annual statement blank. Changes need to be incorporated to existing schedules and new schedules with experience reporting will have to be developed. More granularity of product information than currently exists will also be needed.

***LPC Comment** - The LPC offers its help with these changes.*

The VM specifies a number of items that are required to be included in the both the annual Statement of Actuarial Opinion, which is filed with the annual statement and the annual actuarial memorandum, which is prepared as a confidential report accessible by the state of domicile. Capturing confidential data for use in data analysis will be an important step. Determining the amount of public versus confidential data to be reported for solvency monitoring and prioritization will be an ongoing discussion.

***LPC Comment** - The LPC agrees that the use of confidential data is an important issue. As discussed above, there needs to be some process by which the confidential information can be shared and exposed as appropriate to interested parties for informed analysis and comment on the issues.*

Updates to existing NAIC automated financial analysis and prioritization tools will be needed, and new analysis tools to assist with evaluating models and their inputs need to be developed. The resulting tools, along with analysis of company experience data, will assist with identification of companies whose reserves may require more thorough review.

*LPC Comment – These tools will also help to identify if changes are needed to the methodology.*

Staff hired for the Resource would be assigned to assist existing or new staff in this development of tools and additional reporting needed.

## **V. Training**

An outline for a general overview training program that is targeted toward state examiners, other nonactuarial insurance regulators and industry has been prepared. Key members of industry and state regulators have agreed to contribute to the development of an online program for either late 2013 or early 2014. The proposed program would cover overviews of various sections of the VM and topics such as net premium reserves, exclusion tests, modeling and cash flow models, mortality assumptions, policyholder behavior and other key assumptions, documentation and review considerations. Some comments have asked the NAIC to consider if there is a need to request that the actuarial societies develop detailed actuarial training on specific topics.

*LPC Comment - The LPC offers its assistance with the design and development of training modules. We have already begun work with the NAIC on developing a training program on VM-20 and with the help of NAIC staff could have that program up and running during 2013. Note that the individuals reviewing the company filings must have actuarial and modeling expertise. It is essential that the reviews be conducted by actuaries with the appropriate training and experience.*

## **VII. Areas of Implementation and Charges to Other NAIC groups**

A number of the other NAIC Working Groups and Task Forces are involved in the implementation process which is further documented in the PBR Timeline. This work is coordinated with the Life Actuarial (A) Task Force and the Principle-based Reserving (E) Working Group and can be broadly described in the categories below:

- (1) Accounting – Developing changes to accounting and reporting
  - (a) Accounting Practices and Procedures (E) Task Force
  - (b) Statutory Accounting Principles (E) Working Group
  - (c) Blanks (E) Working Group
  
- (2) Actuarial issues and updating the Valuation Manual
  - (a) Life Insurance and Annuities (A) Committee
  - (b) Life Actuarial (A) Task Force

(c) Health Actuarial (B) Task Force

(3) Solvency Monitoring and Capital issues

(a) Financial Condition (E) Committee

(b) Financial Regulation Standards and Accreditation (F) Committee

(c) Capital Adequacy (E) Task Force

(d) Life Risk-Based Capital (E) Working Group

(e) Financial Analysis Handbook (E) Working Group

(f) Financial Analysis Research Development (E) Working Group

(g) Financial Examiners Handbook (E) Technical Group

(h) Exam Oversight (E) Task Force

(i) NAIC/AICPA (E) Working Group

***LPC Comment** - The LPC agrees it is important that a commissioner-level group such as the Principles-Based Reserving (E) Working Group coordinate the resources needed to oversee the work of all these different committees.*