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**AMERICAN ACADEMY *of* ACTUARIES**

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December 15, 2014

Actuarial Standards Board  
1850 M Street, NW  
Suite 300  
Washington, DC 20036

Re: Comments on Principle-Based Reserves for Life Products ASOP Exposure Draft

To Whom It May Concern:

On behalf of the Life Practice Council of the American Academy of Actuaries<sup>1</sup> I appreciate the opportunity to provide comments on the second exposure draft of a proposed actuarial standard of practice on Principle-Based Reserves for Life Products.

Overall, we believe the changes from the first exposure draft represent considerable improvement.

In particular, you have requested comment on the following:

1. Is the distinction between the company's responsibility and the actuary's responsibility clear?

Yes.

2. Does the language of the standard quote or summarize VM-20 text appropriately and usefully?

Yes.

3. A lot of duplicative material has been removed, although some language has been retained for clarification. Is the amount of material remaining in the standard appropriate?

Yes, subject to the specific comments that follow.

4. Is it sufficiently clear how the standard applies to actuaries who do not sign the PBR actuarial report but are involved in the preparation of principle-based reserves?

Yes.

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<sup>1</sup> The American Academy of Actuaries is an 18,000+ 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 have three specific comments for your consideration.

### **Section 3.4.1.d.2)**

The draft ASOP currently defines a cash flow model as one "...designed to simulate asset and liability cash flows." but does not deal directly with their linkage. Section 3.4.1.d.2) states, "...if the insurer bases credited rates on current asset yields, the actuary should model projected credited rates that are consistent with projected asset yields" and the actuary "...should determine policyholder behavior assumptions that are consistent with the nonguaranteed element projections". We believe these statements are related to section 7.C.3 of VM-20, which states, "Projected NGE shall be established based on projected experience consistent with how actual NGE are determined." Neither VM-20 nor the draft ASOP appear to suggest there needs to be a direct linkage between asset and liability cash flows, but there is no guidance on what the actuary is expected to do to demonstrate the required consistent with.

In terms of complying with the "consistent with" requirements of Section 7.C.3. of VM-20, a couple of examples might be appropriate:

1. The approach is consistent with projected asset yields if, under the applicable stochastic or deterministic scenario, future credited rates are not expected to deviate from currently credited rates (or the guarantees) so that the projection of liability cash flows using currently credited rates (or guaranteed rates) is appropriate.
2. The approach is consistent with projected asset yields if, under the applicable stochastic or deterministic scenario, liability cash flows from another source (e.g., GAAP cash flows) would not produce results materially different from those produced from a direct linkage of asset and liability cash flows.

### **3.4.2.f. Determining Assumption Margins**

Section 9.B.1. of VM-20 states, "The company shall determine an explicit set of initial margins for each material assumption independently (i.e., ignoring any correlation among risk factors) in compliance with this section. Next, if applicable, the level of a particular initial margin may be adjusted to take into account the fact that risk factors are not normally 100% correlated. However, in recognition that risk factors may become more heavily correlated as circumstances become more adverse, the initially determined margin may only be reduced to the extent the company can demonstrate that the method used to justify such a reduction is reasonable considering the range of scenarios contributing to the CTE calculation or considering the scenario used to calculate the deterministic reserve as applicable or considering appropriate adverse circumstances for risk factors not stochastically modeled."

3.4.2. f.2) of the draft ASOP states, "The actuary should establish **margins** such that the additive impact for all assumptions is at a level that, in the actuary's professional judgment, provides for an appropriate amount of adverse deviation in the aggregate, even if the **margin** for an individual assumption does not appear adequate on a stand-alone basis (see also section below on "Overall Margins")."

Given the VM-20 Section 9.B.1. requirement, we believe it would be appropriate to add the following sentence to the above paragraph in 3.4.2.f.2) of the draft ASOP, "The initially determined margin may only be reduced to the extent the company can demonstrate that the method used to justify such a reduction is reasonable, considering the range of scenarios contributing to the CTE calculation, considering the scenario used to calculate the deterministic reserve as applicable, or considering appropriate adverse circumstances for risk factors not stochastically modeled."

Likewise, 3.4.2.f.4) states, “The actuary should set overall **margins** such that the **minimum reserves** with **margins** are greater than the **minimum reserves** without **margins** by an amount that is consistent with the risk on the group of policies and the regulatory requirements for reserves. In evaluating consistency, the actuary may, for example, relate overall **margins** to a percentage of the present value of risk capital requirements on the group of policies, consider the conditional tail expectation level implied by the **minimum reserves** based on **prudent estimate assumptions**, or consider historical variations in experience.”

Again, given the VM-20 Section 9.B.1. requirement, we believe it would be appropriate to add the following sentence to this paragraph, “To the extent this requires a reduction in individual margins, such individual margins may only be reduced to the extent the company can demonstrate that the method used to justify such a reduction is reasonable considering the range of scenarios contributing to the CTE calculation, considering the scenario used to calculate the deterministic reserve as applicable, or considering appropriate adverse circumstances for risk factors not stochastically modeled.”

It may be appropriate to combine these two sections and/or the additional statements on demonstration/justification, but however it is done, we believe that it is important to remind the actuary that a demonstration is required to justify any reduction to individual margins.

### 3.5 Reinsurance

#### 3.5.7 Assets Held by the Counterparty or Another Party

Section 8.C.11. of VM-20 covers considerations involved in modeling a reinsurance transaction when “...some of the assets supporting the reserve are held by the counterparty or another party..”. One of the Guidance Notes included in Section 8.C.11. references the “special considerations” in this regard with respect to modified coinsurance or funds withheld reinsurance arrangements. The language in Section 8.C.11. requires the actuary to make a determination as to whether the assets backing the reserve need to be modeled and indicates some considerations involved in making this decision but provides little guidance as to an appropriate approach to use in performing the modeling.

The PBR ASOP addresses this issue in two different sections of the ASOP:

1. At the end of section 3.5.2., in commenting on the “calculation of the pre-reinsurance-ceeded **minimum reserves**,” and
2. In section 3.5.7., Assets Held by the Counterparty or Another Party.

Items a., b., and c. of section 3.5.2. provide approaches that may be used to “...estimate the net investment return on ceded assets.” The approaches indicated would seem to be better situated as part of the ASOP guidance in section 3.5.7. Section 3.5.2. gives general guidance for the calculation of the pre-reinsurance-ceeded **minimum reserve** (net premium, stochastic, or deterministic) rather than particular guidance on any one element of that calculation (e.g., net investment returns). Items a., b., and c. provide specific guidance on the approaches which may be used to determine the “hypothetical” asset portfolio and net investment returns when the assets backing the reserve are held by the counterparty to the transaction or another entity. They therefore are more logically situated in section 3.5.7.

Regarding the specific guidance given in items a., b., and c. of section 3.5.2., the recent efforts of the Emerging Actuarial Issues Working Group (EAIWG) of the National Association of Insurance Commissioners (NAIC) on Actuarial Guideline XXXVIII (AG38), Section 8D reinsurance issues might

provide additional guidance. A recently adopted Interpretation of the EAIWG provides guidance with respect to the creation of a hypothetical asset portfolio "... if an actual portfolio...is not complete or available for a company who [which?] has ceded some or all of the risk through coinsurance." The Interpretation provides that "...the company may coordinate with and make use of the reserve calculations of the assuming insurer [which presumably holds the assets], as provided in VM-20 Section 8.A.1. However the ceding company, in calculating the pre-reinsurance ceded reserve..., must assure that such modeling and assumptions are appropriate as provided by the first paragraph of VM-20 Section 8.D.2. and as provided by VM-20 Section 8.D.2.b."

Also, items a., b., and c. all deal with estimating a hypothetical investment return which is really the secondary issue. The guidance should be with respect to establishing a hypothetical asset portfolio, the modeling of which would generate, or which already has generated, the required net investment returns. Suggested wording for examples a., b., and c. is:

- a. "basing the estimate on assets generally available at the time the cash flows were ceded;
- b. assuming the estimate is equal to that based on the assets backing retained policies of the same kind or of the portion of the business retained; and
- c. assuming the estimate is to that based on the cash flows from a pro rata slice of the assets of the reinsurer that back the ceded reserves, subject to the **Guidance Note** in section 8.A.1. of VM-20."

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We thank you for your work on this proposed ASOP and for the opportunity to provide the comments above.

Please let us know if you need clarification on any of the points made above.

Sincerely,

Mary Bahna-Nolan, MAAA, FSA, CERA  
Vice President, Life Practice Council  
American Academy of Actuaries