Principle Based Reserves

SEAC 2008 Fall Meetings

Current Status of PBR – valuation manual, legislative progress

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Introduction

- Replacing formula-based reserves by principles-based reserves
- Life reserves
  - Controversy over ULSG products and AG 38
  - Added new “old-fashioned” formula in late 2005
    - Formula “sunset” in April 2007
- Academy working groups
  - Presentation to NAIC in December 2006
  - Two years later, still working on details
- Purpose of this presentation is to give a status report of where things currently stand
A principles-based approach (PBA)

- Utilizes risk analysis and risk management techniques to quantify risk
- Captures all material risks, benefits, and guarantees of contracts/Company
- Incorporates assumptions and methods that are consistent with a company's overall risk assessment process
- Permits the use of company experience, if credible, for risks over which the company has some degree of control/influence
- Supports the statutory objective of providing protection to policyholders and promoting solvency of companies
Rules-based approach

- Uses a static formula that may not capture all risk of the contract
- Uses prescribed valuation assumptions that are the same across all companies irrespective of their risk profile
Principles-based approach

- Number of initiatives for the principles-based approach
- Lots of activity
- Has been the focus of Life and Health Actuarial Task Force (LHATF) and NAIC’s Principles-Based Reserving (EX) Working Group
- The Academy has quarterly webcasts to keep people informed about status
Regulatory changes needed

- Two main changes are needed
  - Update the current Standard Valuation Law (SVL) to enable principles-based reserves (PBR)
    - Relevant valuation laws of each state
  - Create a Valuation Manual (VM) to define the requirements of PBR in detail
    - Essentially replace the current structure of model laws, model regs., and AGs for new issues after the effective date
    - Existing laws, regs., and AGs will stay in effect for inforce
Proposed Updated SVL and VM

- Revised versions of the SVL and VM were exposed for comments on 9/22/2008
  - Most proposed amendments have not been of great importance
  - ACLI has indicated they have no material objection to September law
- New draft to be exposed before December meeting
- Might be adopted by LHATF in December
- ACLI wants a substantially completed VM before they will help with state adoption of the SVL
What does the law say?

- Reserve standards for policies issued after the operative date of a VM are defined by the VM.

- Operative date of the VM is January 1st following the July 1st following:
  - VM adopted by at least 42 (75%) of the 55 NAIC members.
  - Revised SVL enacted by states representing at least 50% of direct written premium for 2008.
  - Revised SVL enacted by at least 42 of 55 NAIC members.
  - States that have enacted the revised SVL can follow the requirements of the VM without adopting any other law, regulations or requirements.
What does the law say?

- Future changes to the VM also require 75% of voting states including at least 50% of premiums.

- For principles-based valuation, the VM should specify:
  - A floor value for the minimum reserves.
  - Requirements related to reserve methods, models for measuring risk, assumptions, margins, etc.
  - Reserves should have a level of conservatism that includes unfavorable events that have a reasonable probability of occurring.
  - Greater uncertainty should result in greater margins.
  - For non-prescribed assumptions use credible experience (own, industry, reinsurer, market).
What does the law say?

- The commissioner may engage an outside actuary to review and opine on the reserves.

- Company must annually certify on the effectiveness of internal controls and that all material risks inherent in the liabilities and associated assets are included in the valuation.

- Company must file experience data as prescribed in the VM.

- The commissioner may exempt specific products for a company if they operate in only one state.
Valuation Manual – NAIC Goals

- Goals of the NAIC in developing the VM
  - Consolidate minimum reserve requirements in one document
  - Promote uniform valuation requirements across states
  - Provide process to update valuation requirements
  - Set requirements for and facilitate reporting of experience data
  - Enhance industry compliance
Valuation Manual – Sections

- VM – 00 Valuation Manual
- VM – 01 Definitions
- VM – 05 NAIC Model SVL
- VM – 20 Life PBR
- VM – 21 VA PBR
- VM – 25 Health Reserves
- VM – 26 Credit Life & Disability Reserves
- VM – 30 Actuarial Opinion Requirements
- VM – 31 PBR Reporting
- VM – 50 & 51 Experience Reporting
Scope of PBR for Life Products

Issue:
- PBR needed primarily for Term and Secondary Guarantee UL
- Other products should continue under current reserve requirements

Current Draft:
- PBR applies to all life products excluding credit life
  — 5 year window
  — Single state exception
VM – 20 PBR for Life Products

- Currently PBR is to be calculated prospectively
  - In the future may allow retroactive application to inforce

- PBR is the greater of
  - a single scenario deterministic reserve and
  - a stochastic reserve based on a prescribed CTE level
    — CTE level set at 70
VM – 20 PBR for Life Products

- May exclude some groups of policies from stochastic modeling if
  - Pass the Stochastic Exclusion Test
  - Provide a demonstration that the deterministic reserve adequately covers the risk
Some Related Academy Work Groups

- Modeling Efficiency
  - Goal is to make modeling for PBA easier
  - Has developed a bibliography of useful papers

- Credibility Practice Note
  - Goal is to help determine credibility of a company’s own experience
  - A practice note is available at the academy website

- Life Reserves and Capital Practice Note
  - Goal is to develop practical solutions to PBA related issues
  - Has completed an early draft
Increased knowledge about principles-based regulation is evident throughout the company
Respondents were actively preparing for principles-based regulations despite the uncertainty in timing.
Tillinghast CFO Survey #18

**EXHIBIT 3**
Anticipated Changes to Competitive Landscape

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**EXHIBIT 4**
Anticipated Changes to Company’s Approach to Dealing With Regulators

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<td>Will allow regulators to gain a better understanding of what our company is doing</td>
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2007 survey 2006 survey
Timeline

- Academy’s latest webcast predictions
  - SVL adopted by LHATF in December 2008
  - VM adopted by LHATF in Spring 2009
- Subsequent steps
  - SVL and VM introduced to state legislatures
- Life principles-based reserves effective ???
Questions / Comments

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