

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 enforce
- 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

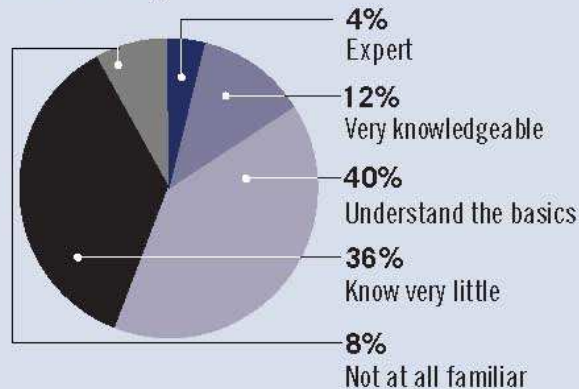
Some Related Academy Work Groups

- 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

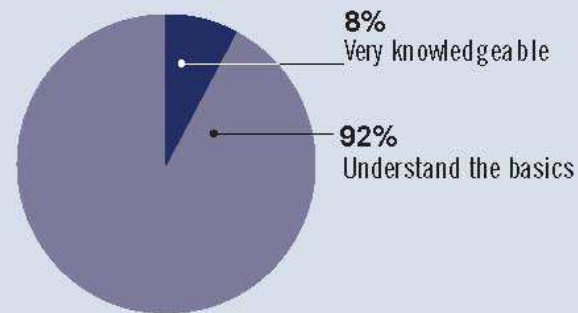
Tillinghast CFO Survey #18

EXHIBIT 1
CFOs' Knowledge of New Principles-Based Regulation

2006 Survey



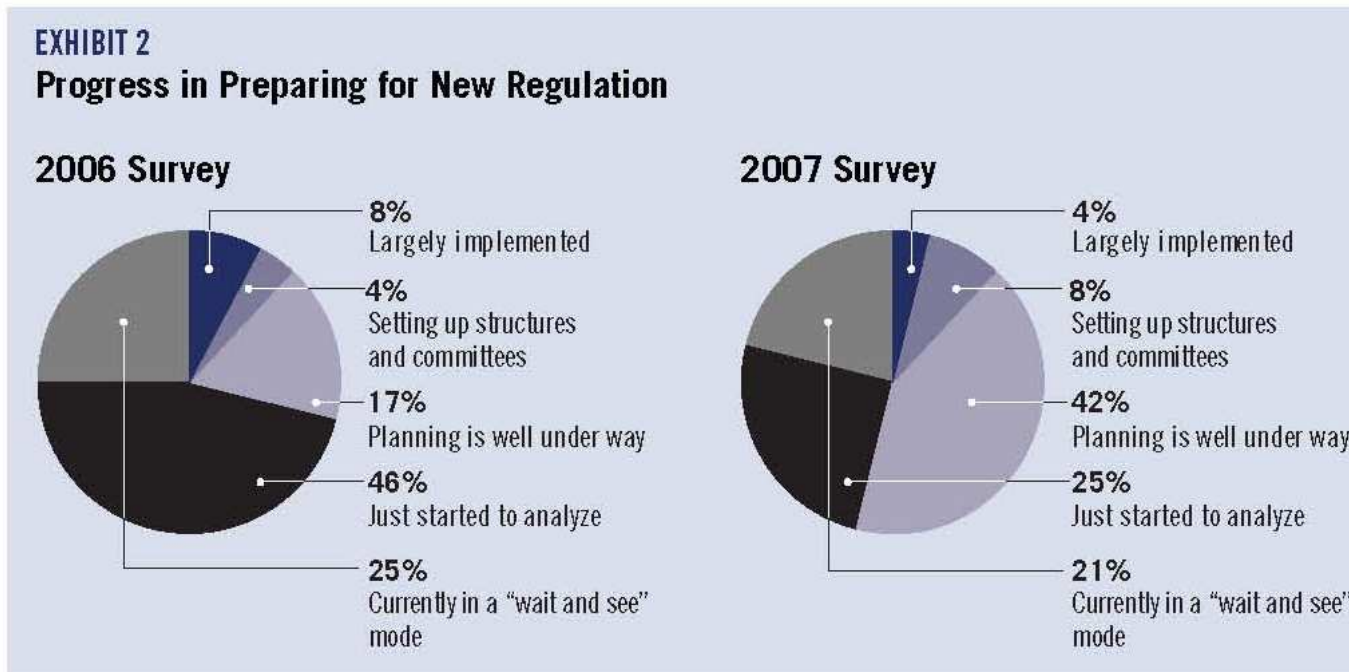
2007 Survey*



*No respondents selected "I am not at all familiar with the new framework" or "I know very little about the new framework."

Increased knowledge about principles-based regulation is evident throughout the company

Tillinghast CFO Survey #18



Respondents were actively preparing for principles-based regulations despite the uncertainty in timing

Tillinghast CFO Survey #18

EXHIBIT 3

Anticipated Changes to Competitive Landscape

0% 20 40 60 80 100%

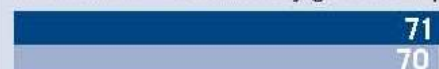
Will create greater need to develop hedging programs



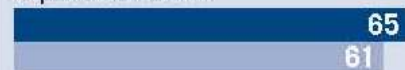
Will lead to lack of comparability of results across companies



Will significantly reduce reserve redundancies for term and UL secondary guarantee products



Will proliferate development of alternative capital structures



Will lead to new ways to manipulate the system



2007 survey 2006 survey

EXHIBIT 4

Anticipated Changes to Company's Approach to Dealing With Regulators

0% 20 40 60 80 100%

Will create greater need for company resources



Will create more complex regulation for us to deal with



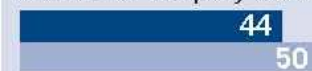
Will increase expense levels for the company



Will create significant challenges for our external communications



Will allow regulators to gain a better understanding of what our company is doing



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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