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December 15, 2014

Life Insurance and Annuity Pricing ASOP
Actuarial Standards Board
1850 M Street, NW, Suite 300
Washington, DC 20036-4601

Re: Request for Comments - Life Insurance and Annuity Pricing ASOP

The Life Products Committee of the American Academy of Actuaries[1] is pleased to provide comments on the development of an Actuarial Standard of Practice (ASOP) that would apply to actuaries when pricing new and in-force life insurance and annuity products.

The ASB has asked for responses to the following four questions:

1. **Would an ASOP on life insurance and annuity pricing be beneficial to the profession?**

   Yes. Although we believe that many of the practices employed by actuaries in the pricing of life insurance and annuity products are covered by other standards currently (or soon to be) in place, a standard that is specifically devoted to new product pricing would be valuable, since it would:

   (a) Provide one place that would refer to all of the standards that apply to pricing these products, some of which apply directly to pricing and some of which apply to actuarial work in general;
   (b) Go into some depth on profitability analysis, which we believe is an area that is not well covered by other standards; and
   (c) Cover all the major factors to consider in pricing these products, which will bring a level of standardization to the process that:
      - The public has a right to expect from a self-regulated profession; and
      - Will provide a framework for the pricing process that a less-experienced actuary can rely upon when considering new benefit designs; but
      - Will not be so prescriptive as to unduly restrict the reasoned professional judgment of a more-experienced actuary.

[1] 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.

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Specific comments on Section 3 of the proposed ASOP ("Analysis of Issues and Recommended Practices") follow. A general suggestion applicable to all of the topics addressed in Section 3 is to distinguish carefully between what the actuary "should" do and what the actuary "should consider" doing (as these terms are defined in Section 2.1.a. of ASOP No. 1).

a. Coverage and Product Features – would provide general guidance necessary prior to beginning the pricing exercise. An example of such guidance is, "the actuary should be aware of and take into consideration all pertinent coverages or benefits found in the insurance product being priced."

Comment: We agree that general guidance on how to prepare for the pricing exercise is important. The pricing actuary should have a sufficient understanding of the benefits to be provided in the insurance contract being sold and all the other knowable risks being assumed by the insurer (such as market-based persistency and mortality) and their interaction with each other before beginning the pricing process. We therefore suggest that the example be changed to "the actuary should have a sufficient understanding of the coverages and other benefits of the insurance products being priced, the reasonably knowable risks assumed by the insurer, and the interaction of the benefits and risks, in order to take all such benefits and risks into consideration appropriately in the pricing process."

As with the other areas of guidance, we believe it is important not to be too specific and prescriptive.

b. Developing the Model Framework – would provide guidance on establishing the model used in the pricing process. Examples of other items to be addressed in this section are the development of the pricing cells for which to price, model horizon, accounting basis, deterministic vs. stochastic, cost of capital, etc.

Comment: We believe that the example is too prescriptive. The ASOP should refer to the new Modeling ASOP and go into additional detail (without being too prescriptive) only in areas not sufficiently covered by the Modeling ASOP for the purpose of pricing. For example, the ASOP should state that the model must be sufficiently robust to accommodate the product design and related risk elements properly, so that it can satisfactorily simulate the impact of the product on future company financial requirements and results under a range of scenarios and economic environments.

c. Selecting and Using the Profitability Analysis Methodology – would provide the framework for selecting the methodology used to quantify the risk and return elements from the pricing model (internal rate of return, profit margin, return on assets, etc.).

Comment: We believe this is an area that is not well covered by the other current standards and deserves attention here.

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We believe that guidance in selecting a Profitability Analysis Methodology is appropriate but that "methodology" should also allow for more than one methodology, since it may be appropriate for an actuary to consider different methodologies for different purposes.

Consistent with our prior comments, we believe that the guidance provided by the ASOP should be very broad in nature. The ASOP should not limit the actuary's choice of profitability analysis methodology(ies) to those in a prescribed list. Guidance should be limited to describing the basic characteristics of appropriate profitability methodologies, such as the need to reflect net cash flows, regulatory requirements, and the time value of money and to discussing in general any limitations on the ability to aggregate results (e.g., considering whether the profitability measure of the average of several cash flow streams equals the average of the separately-calculated profitability measures of the cash flow streams), etc.

Because of the generally mandatory nature of ASOPs, the provision of profitability or methodology checklists and the in-depth descriptions and comparisons of various methodologies, etc., might better be left to practice notes and other non-mandatory vehicles.

d. Assumption Setting – would provide guidance for selecting assumptions. For example, whether and to what extent mortality improvement should be used, reflecting credibility in the assumptions, setting policyholder behavior in a new product design, etc.

Comment: While we agree that guidance for selecting assumptions is important, we are concerned that the examples listed may be suggesting a level of inappropriate prescription in the ASOP. We are hopeful that the intention of the ASB in listing these examples is to require that the actuary *consider* including such type of assumptions in their pricing process, and *not to provide guidance or limitation on development of any assumptions*. We believe that it is beyond the scope of an ASOP to get into guidance on specific assumptions.

We believe that the detailed discussions about assumptions found in other ASOPs on reserves and pension funding are appropriate for those topics, since these are areas that relate to financial adequacy and, consequently, consistency of approach among actuaries is of value. However, we believe that, for a pricing ASOP, the treatment should be less mandatory in nature and use more discretionary language, such as "should consider."

In setting pricing assumptions for new products, the actuary should be required to consider the new Modeling ASOP, ASOP No. 23, *Data Quality*, and ASOP No. 25, *Credibility Procedures*, as applicable. To the extent that they are relevant to a given product design, ASOP No. 2, *Nonguaranteed Charges or Benefits for Life Insurance Policies and Annuity Contracts*, and ASOP No. 15, *Dividends for Individual Participating Life Insurance, Annuities, and Disability Insurance*, should be recognized. Any additional guidance provided in the pricing ASOP should be limited to guidance that only applies to life and annuity pricing. One area not covered by the cross-practice ASOPs mentioned above is the need to select

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assumptions in the context of specific product design and risks and how the product is marketed, distributed, and administered, giving careful consideration to assumptions for new and innovative products. After considering these ASOPs (and all other applicable ASOPs) and any considerations only applicable to life and annuity risks, the actuary should be required to use professional judgment in setting reasonable pricing assumptions.

e. **Risk – would provide guidance in evaluating the risks associated with the product being priced in regard to contract guarantees and other elements of the contract.**

Comment: Guidance on doing a risk analysis would be similar to guidance on doing a sensitivity analysis (f). A risk analysis is an extreme sensitivity analysis that must address all significant risks. It also requires a discussion of and quantification of the impact of the risks and its mitigation, as well as the inter-relationship of risks.

Most importantly, the risk impact should be documented under (i) and disclosed to appropriate management under (k).

f. **Sensitivity Analysis – would provide guidance in performing sensitivity analysis of reasonable variations in assumptions prior to finalizing the assumptions and making a final pricing recommendation.**

Comment: We believe that sensitivity analysis guidance should require the actuary to consider performing more analysis for assumptions that have a significant impact on pricing results than for assumptions that have a less significant impact. That analysis should also consider the effect of changing one assumption on another.

g. **Controls – would provide guidance regarding the proper controls the actuary should have in place to ensure that the model and the pricing process work as intended. Controls should exist around the data used from administrative systems, experience studies, and within the pricing model.**

Comment: Documentation of those controls is important; however, the ASOP should not be prescriptive about the nature of the controls.

h. **Pricing Recommendation – would provide guidance in addressing issues faced when making a recommendation on the pricing of benefits or services offered. For example, whether past losses can be covered by future premium increases or whether one source of profit can be used to subsidize another.**

Comment: We believe that this section could be retitled "**Communication of Pricing Results**," since a formal pricing recommendation is not part of the process at all companies.

In this section the ASOP should also cover the actuary's responsibility when communicating results of the pricing process to management, including any rate and product design recommendations. The communication should include

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sufficient information on the results of sensitivity testing that was done to convey the potential impact on the company's financial results if management ultimately chooses to make adjustments to the recommended rates or the product design.

On the examples, we believe that guidance on subjects such as recovering past losses, premium subsidies, and similar issues may be a matter of management (and not actuarial) judgment—and consequently beyond the scope of an ASOP.

i. **Documentation – would provide guidance on maintaining and providing documentation of the product pricing processes.**

Comment: The ASOP should require documentation of all pertinent information from the pricing process so that the process can be understood by another qualified actuary. It should identify the assumptions made and the process used.

j. **Compliance – would provide guidance regarding the actuary's responsibility to be aware of regulations, laws, and standards that would affect the pricing of a product, such as state's non-forfeiture laws, suitability requirements, Illustration Actuary regulations, the definition of life insurance, and other IRS regulations, etc.**

Comment: The actuary needs to be more than "aware" of relevant product laws and regulations. The actuary needs to have sufficient understanding of the relevant product laws and regulations in order to be able to carry out his/her responsibilities in the pricing exercise. This may require in-depth understanding of some laws (e.g., nonforfeiture) and more general understanding of others (e.g., suitability requirements). We also believe that if there is any doubt about how a law applies, the pricing actuary should include in the documentation of results the alternative interpretations. If differences are material, this may also need to be part of communication of results.

k. **Disclosure – would provide guidance on disclosures such as the actuary's concerns if, in the actuary's opinion, a product design is not fair and equitable to the policy owner, in addition to the standard disclosure requirements.**

Comment: The ASOP should clarify that all disclosures should be included in documentation of results and material disclosures should also be included in Communication of Results.

As far as the example disclosure given, we believe there is no single, identifiable standard of "fair and equitable" that can be applied to a product design. The Academy monograph, "On Risk Classification," discusses the difficulties in applying such concepts to risk classification. Many of these difficulties also arise in the context of product design and pricing. Consequently, the potentially subjective nature of such an opinion may place it beyond the scope of an ASOP.

We think it might be beneficial to arrange the topics of Section 3 in the order in which they normally are (or should be) addressed in the pricing process. This also could result in combining some topics.

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2. **Are there areas where appropriate practice needs to be defined or current practice needs to be improved? If so, what are those areas?**

   We believe that, in general, current practice for most actuaries is fine. The main area where actuaries may fall short is in documenting the pricing process so that the process can be understood by another qualified actuary.

3. **Does the proposed ASOP cover the appropriate subject areas? If not, what changes do you suggest?**

   The proposed ASOP should clarify whether and to what extent the ASOP could be applicable to the development of combination products, e.g., life or annuity with LTC.

4. **How should the proposed ASOP interact with existing ASOPs that provide guidance regarding policyholder dividends and other non-guaranteed elements?**

   The pricing ASOP should recognize that practices in relation to nonguaranteed elements and dividends may be an important part of the new product pricing process; consequently, ASOP No. 2 and ASOP No. 15 should be directly referenced in this ASOP, as mentioned above in our discussion of assumptions in our response to question 1.

We hope these comments are helpful. Please contact Brian Widuch, the Academy's life policy analyst (widuch@actuary.org; 202-223-8196), if you have any questions.

Sincerely,

Linda Lankowski, MAAA, FSA
Chairperson
Life Products Committee
American Academy of Actuaries