August 17, 2007

TO: Thomas Hampton, Chairman, Principles-Based Reserving (EX) Working Group, National Association of Insurance Commissioners (NAIC)

FROM: Dave Sandberg, Vice-President, Life Practice Council, John Schubert, Vice-President, Health Practice Council, and Robert Miccolis, Vice-President, Casualty Practice Council, American Academy of Actuaries

RE: Comments on the Exposed NAIC Principles-Based Reserving (EX) Working Group Life and Health Principles

On behalf of the Life Practice Council, the Health Practice Council, and the Casualty Practice Council of the American Academy of Actuaries (Academy),[1] we have reviewed the proposed Life and Health Insurance Principles that were exposed by the Principles-Based Reserving (EX) Working Group (Working Group). We are pleased with the direction that the NAIC is taking to modernize US regulatory requirements and the progress that has been made to implement principles-based reserves and capital requirements for life and annuity products.

With respect to the exposed 'principles,' we believe a broader discussion of these principles is necessary before they are applied more generally to non-life insurance product lines. Different lines of business have varying circumstances and risk management characteristics. Current reserve and capital requirements differ among lines and the same terms may be used differently across practice areas. Thus, the principles, as outlined by the Working Group, cannot be applied to all coverages without, in some cases, creating additional requirements that are not beneficial. Specific comments and examples have been provided herein to illustrate important differences amongst product lines to support the need for a broader discussion of these principles. We also believe an important part of this process is the assessment of the related costs and benefits.

Almost all of the proposed principles, or their agreed upon revisions, could be adopted in a uniform fashion by the NAIC using their current deliberative processes. However, for life reserves, the earliest possible adoption cannot occur until 2010, assuming a new Standard Valuation Law is adopted by the NAIC in early- or mid-2008 and by all 51 legislative jurisdictions in 2009. Uniform reserve requirements are essential for a principles-based approach to be effectively implemented.

Beyond these general comments, we offer the following specific comments:

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

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- Principle I. A.

  Unless the principles are written very broadly, recognize that different language will be needed for health and property/casualty products than for life and annuities. Some examples of differences are noted in the comments below.

- Principle I. C.

  The exposure document states that international solvency standards are preferred and that any deviations should be explained.. One obvious deviation is that US regulatory reporting requires the statement of liabilities and most assets on a book value basis. The NAIC should confirm that this still remains the preferred/required methodology in the US, even for a principles-based approach.

  Comparatively, the US health and medical insurance market differs in many respects from the rest of the international community. There are few international principles that relate directly to health insurance due to the very different systems of healthcare financing. Also, some health coverages are more similar to life products (e.g. long-term care and individual disability income), while others are less similar to life products (e.g. group medical, dental, group long-term disability).

- Principle II. C.

  We urge the Working Group to keep in mind the revised drafted principles that are under discussion with the Life and Health Actuarial Task Force (LHATF). We believe it paramount that the language and intention remain consistent between both sets of principles. Additionally, the immediate application of "principles-based reserves" is not anticipated to include Health by LHATF. We recommend that the associated action items be limited in application to principles-based reserves as required by the proposed Valuation Manual.

  We would caution against using the word "objective" in the sentence, "(T)he valuation methodology for establishing reserve liabilities must be explicit, reliable, and objective." There will be times when appropriately supported "judgment" will be used by the actuary in setting assumptions and this could be considered as not being "objective." The principles-based reserves currently being considered by LHATF involves such actuarial judgment. And while a methodology may be objective, there may be a need to choose between several methodologies depending on judgment and tradeoffs between the methodologies.

  Additionally, in the health and property/casualty insurance businesses, much of the actuary's work is dependent upon appropriately supported subjective professional judgment.

  After the sentence in the proposed principles on valuation methodology referenced above, it may be useful to add: "It should recognize the solvency objective of statutory reporting."

  The second bullet states "Reserve liabilities should be sufficient to cover all expected claims and associated expenses and some of which are more adverse than expected…." While we agree that this is an appropriate "principle" for life and annuity products, it may not make sense for other lines of business. For property/casualty coverages, SSAP 55 now directs management to record its "best estimate" for claim reserves, not an estimate allowing for some outcomes that are more adverse than expected. A change in this rule without coordination with changes in provisions for risk margins and the time value of money would have significant financial repercussion for the property/casualty industry.

  The third bullet point states that "the prudence must be explicitly identified." This should be eliminated, since assumptions and margins are discussed under Principle D.

- Principle II. D.

  We would recommend that there be more consistent use of definitions and terms in this entire section. The phrase "current estimate" is used, whereas the terminology currently established by the exposed

PBR proposal at LHATF uses the phrase "estimate using anticipated experience" with respect to the actuary's assumptions. In addition, under Principle II.B., reference is made to SSAP 55 which currently requires that "management's best estimate" be the basis for the reported reserves.

The statement the "current estimate should be based on the calculation of the net present value of all future cash flows associated with the insurance portfolio…" explicitly defines a reserving methodology. The description is consistent with the current proposed methodology for life insurance, but it may not work for all products. For example, the Academy's Annuity Reserves Work Group of the Life Practice Council is considering a definition of reserves as the book value of the smallest amount of the starting assets that will produce no accumulated deficiencies. Therefore, this sentence may be eliminated without adversely affecting the direction in which the NAIC goes.

The statement "the current estimate (or anticipated experience) would be the value of the costs of meeting the obligations arising from the insurance portfolio, taking into account the time value of money," may be appropriate for life and annuity products but may create difficulty for some health insurance and property/casualty products. For health products, some obligations are not discounted with interest because the extinguishment of the obligation is rapid. In addition, discounting for some claim liabilities may be inconsistent with the claim cost assumed in the premium and in the policy reserve, i.e., the claim cost assumed in the premium and released from the policy reserves may not have been discounted for interest, although the timing of the incurral of that claim cost may have been discounted back to the year of issue. To require discounting in the claim liability once a claim occurs would introduce an inconsistent and unnecessary complication when this item is not material.

Discounting of property/casualty liabilities is now expressly prohibited by SSAP65 except in very limited circumstances. A change in this policy without coordination with changes in provisions for risk margins would have substantial financial and solvency implications.

The statement, "the risk margin would reflect the intrinsic uncertainty of insurance obligations and would reflect the risk related to the full time horizon of the insurance contracts," is appropriate for life and annuity products but not for other lines of business. The statement may too broadly simplify approaches used for other lines of business by consolidating the myriad obligations and risks within the insurance company into one measure. It is vital to keep in mind that only the uncertainty surrounding the obligation being valued need be reflected in the risk margin. Also, for most health and property/casualty insurance products, the key risk is the adequacy of the premium level until the next time the premiums are adjusted, rather than the "full time horizon" of the contracts which could be infinite for group contracts.

- Principle II. D. Action Items

  This section requires a current estimate **<u>and</u>** a risk margin. Item 1 seems to emphasize that separate reporting would be preferred. There are several challenges with this. Sometimes the only objective information available may be a value that includes the current estimate and the risk margin together. Any split could be quite arbitrary. In addition, the current proposed PBA requirements include conservatism in both the margins and the methodology. Is this implying that conservative methodologies should also be disclosed?

  Item 2 requires LHATF to define **<u>the</u>** risk margin to be included. There could be different risk margins depending on uncertainty and volatility. A better approach may be to define the considerations that an actuary should use in determining the risk margin (e.g., to consider the uncertainty of results and volatility). It would also be useful for LHATF to evaluate different approaches (e.g., CTE, confidence levels, multiples of the standard deviation) to determine the level of the risk margins desired.

- Principle II. E.

While this principle may be appropriate for life and annuity products, we do not believe that homogeneous data for most health products is currently available, given the variations in state mandated benefits and rating rules, companies' benefit triggers, claim administration practices, and provider reimbursement levels. We recognize that the assumptions for health reserves should be based on credible experience whenever possible and regularly justified by comparing the actual payments to the expected values. For most health products, this comparison happens very quickly and is already a significant aspect of current regulatory reporting.

Throughout the principles, there is mention of "credibility," "sufficiently substantiated," and "industry data," all of which are appropriate for life and annuity products but may be problematic for health and property/casualty insurance. This is especially true when considering a new product type. For health lines of business, a large amount of work is necessary to gather and organize industry data into tables. Due to the varying contract provisions, regional disparities, and company practices, there is concern whether relevant and usable industry tables can even be built.

➢ Principle II. E. Action Items

1. We support developing credibility methods. We recommend you consider adding "actuarial judgment" to the list of possible alternatives.

- Principle III. A.

The purpose of the statement, "Insurance liabilities should be met even if the insurer is unable to continue in business," is unclear. We suggest that "liabilities" should be met by the insurer within some specified tolerance. Otherwise, this may imply a prohibitive level of reserves and capital, as well as no need for the state guaranty associations and US bankruptcy laws, which are to provide protection to policyholders should the insurer be unable to continue in business. Some additional consideration on this statement within the US regulatory context is needed.

- Principle III. B.

Within this principle, there is a statement which reads: "Risk-based capital should be explicit for each of the risks that attract a financial requirement, individually and in combination, how prudence is reflected in these requirements." We believe that some words are missing from this statement.

- Principle III. D.

This principle discusses the desire to allow standardized and advanced approaches, including internal models, in determining solvency requirements. This suggests a Basel II system with different Tiers for determining capital requirements. Within the Basel framework, the internal models are used to justify the *reduction* in formulaic-driven capital requirements. In the US, the NAIC framework defines *minimum capital requirements*, with company management deciding how much capital should be held in excess of minimum capital requirements. Solvency II, the European standard for capital requirements, also defines minimum capital requirements in a context similar to the NAIC framework.

We think this principle should be reconsidered in the context of the US regulatory capital framework, as it may not be consistent with the US framework. Longer term, the NAIC may want to consider a paradigm shift in US capital requirements where internal company models may be used to justify a *reduction* in capital requirements, which have been recalibrated from current required levels. While such a paradigm shift has significant practical challenges, the movement to PBA may serve as a catalyst to rethink the US regulatory capital framework.

In addition, the financial statements in the US are based on book value accounting. To the extent these principles are based on International principles established by the IAIS, we think it is important to remember that the IAIS has embraced fair value accounting with specific requirements on margins. Adopting these principles should be considered with appropriate consideration of the US accounting and reporting standards.

- Principle III. E.

  The concept of the "total balance sheet" approach is introduced. We think the term "total balance sheet" should be better defined. Several groups have used the "total balance sheet" terminology with different meanings, which could cause confusion or misunderstandings.

  The last statement reads: "The Risk-Based Capital requirements should be calibrated based on the level of reserve liabilities." We believe this statement is appropriate for life and annuity products and a total balance sheet approach, assuming it means that reserves and capital should be based on the same risk measures and model. If so, adding this point of clarification would be informative.

  We mentioned the myriad of products, contract provisions, regional disparities, state mandates, and company practices in relation to reserving for health products. If additional risks are contemplated for capital requirements, the situation becomes even more complex. No work has begun on a principles-based solvency system for health insurance, though some limited coordination is occurring. It is difficult to envision a model-based system that produces meaningful and comparable results across the health insurance industry. Although model based reporting is at the heart of the life and annuity proposals and is already used for life and P&C products, the biggest challenge is the comparability of those models across major product lines like health, P&C, and life. The current framework for P&C RBC has company-specific, experience-based reserves to which is applied a factor-based capital requirement and the Health RBC factors apply mostly to premiums, but vary by loss ratio for some risks.

- Principle IV. C.

  In reviewing principle C, relating to internal controls, it is not clear why Actuarial Standards of Practice are included in the action item. Further clarification would be helpful. In reviewing the current language, it reads that the Working Group would seek input from other groups in defining "a sound internal control system, company requirements, and methods to evaluate company compliance." It would, therefore, be appropriate to refer this topic to the Actuarial Standards Board (ASB), which is charged with the development of Actuarial Standards of Practice (ASOPs). For governance reasons, the ASB has been established as an independent entity, with its own, separate, deliberative process.

We also recommend that the following concepts be used by the NAIC in its work to finalize corporate governance principles.

<u>Suggested Corporate Governance Concept #1</u>
Governance requirements for risk management should be addressed separately from governance requirements for principles-based reserves and capital.

Reasoning: Risk management requires evaluation of insurance organizations on a enterprise-wide basis, but current proposals involve the use of principles-based approaches on only a fraction of an insurer's reserves and on only a portion of the factor-based NAIC capital formula. Consequently, governance concerns relating to risk management are not directly related to the extent to which principles-based approaches are used. Governance that relates specifically to principles-based reserves and capital should be based on the extent to which principles-based approaches are used.

<u>Suggested Corporate Governance Concept #2</u>
Corporate governance requirements should be principles-based and flexible.

Reasoning: Governance requirements should facilitate focus on the areas of greatest risk. The requirements should also allow for the evolution of risk management tools, best practices and procedures, and accommodate all types and sizes of insurance organizations. As a result, a prescriptive rules-based system could prove to be a barrier to efficient and effective governance.

Suggested Corporate Governance Concept #3

Corporate governance requirements should, to the extent possible, coordinate with requirements of regulatory bodies and international regulators.

Reasoning: Many insurance companies may already be covered by other governance requirements, such as requirements of stock exchanges or other domestic and foreign regulators. If statutory governance requirements are not coordinated with these other requirements, companies may have to develop duplicative structures and reporting mechanisms.

The Academy work groups and practice councils working on PBA value and appreciate the opportunity to share our thoughts on these proposed principles. We look forward to the continuing discussions that affect these regulatory changes. If you have any questions regarding these comments, please contact Craig Hanna or Geralyn Trujillo, staff liaisons for the American Academy of Actuaries, at (202) 785-6924 or hanna@actuary.org or trujillo@actuary.org.