Report on Considerations for Application of Principle-Based Reserving to Inforce Blocks from the American Academy of Actuaries' Life Financial Soundness/Risk Management Committee

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The implementation of the Principles-Based Reserve (PBR) system will either be applied to new business only, all inforce as well, to some inforce business or to some inforce based on a phase-in. Note that these comments apply to reserves only – the application of a principles-based approach to capital may have different considerations.

Arguments for the Application to all Inforce Contracts on Effective date of PBR:

- Measures the risks of a company more appropriately
    a. Provides a Consistent methodology for all business
    b. Consistent with international actuarial and accounting directions
    c. A more rigorous approach for all blocks of business
    d. Provides better information for regulators
- Relieves redundant reserves and strengthens inadequate reserves
    a. Will lessen dependence on complex reinsurance and financing solutions
    b. Increases regulator comfort with previously issued innovative products
- Consistent with Enterprise Risk Management in that:
    a. The reserve incorporates the risks of the entire block of individual life business rather than just a subset
    b. Allows covariant risks offsets
    c. Reserves are set using same or similar models to those that should be used to manage the business
- Allows the entire asset portfolio to be reflected in the reserve calculation, removing the subjectivity of allocating assets between PBR and non-PBR liabilities.
- Potentially reduces ***on-going*** costs by not having to maintain multiple reserve approaches. [Note: This is contradicted below in terms of tax reserves].
- If adoption of PBR causes increased replacements because newly issued policies are less expensive, old blocks may suffer from unrecoverable acquisition expense and deteriorating mortality. Application of PBR to inforce blocks may mitigate this impact if reserve and capital requirements (and therefore expense) on the old blocks are reduced.

Arguments Against the Application to Inforce Contracts:

- Potential for large reserve discontinuity resulting from such a large block of business
- Potentially may have significant tax implications from inconsistent approaches between tax and statutory reserves
    a. Retroactive changes in the reserve method adopted by the NAIC are not permitted under the Internal Revenue Code for the calculation of federally prescribed tax reserves. Under Section 807 federally prescribed tax reserves must use the method and assumptions in effect at the "date the contract was issued."
    b. If retroactive application is permitted for annual statement purposes, a statutory reserve increase usually will not increase the tax-deductible reserve, whereas a statutory reserve decrease usually will decrease the deductible tax reserve, potentially doubling the impact of the change to taxable income in the year of adoption.
    c. Current valuation systems would have to be maintained for as long as current inforce policies remained inforce, to allow computation of tax reserves, even if such systems are not used for statutory reserves.
- This is a new process and making it retroactive does not allow for a "learning" period with respect to the overall application, systems, and peer review
    a. Starting with a smaller block of business will enable companies and peer reviewers to get comfortable with the process and better identify potential problems when they are still readily managed.
    b. It will take time for companies to determine how to set prudent best estimates for a large block of business and become comfortable with the process.
        - Can lead to a situation where initial assumptions or valuation techniques are less than optimal
        - The impact during the learning period would have a greater effect on possible changes in PBR reserve levels from year to year over the entire inforce, as companies adjust to the process.
    c. Companies may not have systems in place to develop assumptions or do PBR valuation for all inforce blocks;
    d. It may be difficult for some companies to implement changes on all their business;
- System implications and training may ***initially*** lead to large implementation costs.
- Application to inforce contracts would be inconsistent with most, but not all, past changes in reserve methodology.
- Some blocks may be very small or the reserves may already be equal to the Cash Surrender Value, creating a lot of additional work for little or no value.
- If PBR is adopted for inforce blocks that are reinsured, treaty provisions which rely on a commonly understood calculation result for the term "statutory reserve" will no longer have a unique meaning.
- If PBR is adopted for inforce blocks that are reinsured, the impact on inforce reinsurance cash flows of the one-time reserve change may cause unintended consequences like changes in the net amount at risk, unexpected experience refunds, or changes in relative profitability to the parties.

Partial/Phased Application to Inforce Contracts:

By limiting the retroactivity of PBR to certain contract types (e.g., only those subject to AXXX and/or XXX reserving) or to a particular date (e.g., July 1, 2005), some of the arguments against retroactivity are mitigated; however, it also weakens some of the arguments in favor of retroactivity.

There are three recent dates at which significant changes to statutory reserving regulations have been effective, as follows:

- January 1, 2000 for all products subject to XXX (and AXXX) reserves;
- January 1, 2003 for all products subject to AXXX Section 8 reserves; and
- July 1, 2005 for all products subject to AXXX Section 8 reserves.

Another option is to phase in the application to inforce contracts over time or the effect of the application to inforce contracts over time. For example, initially, PBR would be prospective only and the PBR methodology for older blocks of business could be phased in over the next "X" years. This approach allows for a learning period and the systems to be developed and vetted prior to introducing to a large inforce block of business.

The following are additional considerations particular to partial application to inforce blocks relative to one of the three dates listed above:

- Less Reserve Discontinuity exists by limiting the amount of business subject to PBR; the shorter the retroactive time period, the less of an issue this becomes.
- "Learning Period"
    a. Allowing certain product types and some retroactivity may help in the "learning" period, as companies will have a larger block of business to work with.
    b. Limiting the block to XXX and AXXX Section 8 products is unlikely to impact the solvency of a company due to an error in the application of PBR. However, not all companies sold products subject to AXXX Section 8 reserves so not all companies could participate.
- System Implications
    a. Limiting retroactivity to a particular product type(s) could help ease administrative programming and testing.
    b. Limiting to just a date probably doesn't ease system issues since all products subject to PBR sold since that date would be included.
    c. Does not ease the on-going administrative costs of having multiple reserving methods.
- Asset Segmentation
    a. Limiting the products included in retroactivity or to a particular date creates issues around how companies manage and segment assets.
    b. Companies that manage assets using a portfolio approach will need to determine a method for segmenting the block of assets to correctly depict the portfolio returns for the new block and remove the cash flow contributions from prior business.
- Tax implications do not go away by limiting the plans or period of retroactivity.

Other Considerations:
- A retroactive approach may lead to the unwinding of capital solutions or pressure to renegotiate reinsurance treaties since the previous level reserve relief may no longer be necessary.
- Retroactivity may not apply uniformly to all companies because of contract language that may prohibit using another valuation table or interest rate.
- If RBC is retroactive, is consistency between RBC and reserves preferable?