Summary of meeting with the New York State Insurance Department (NYSID) to discuss PBR proposal for Life Products

September 10, 2007

Purpose of the meeting:

1) Discuss the current areas of disagreement between the Academy and the NYSID on the principles-based reserve (PBR) proposal for life products.

2) Discuss the approach to resolve remaining areas of disagreement.

Attendees from NYSID

Bill Carmello
Fred Andersen
Amanda Fenwick
Mark Greene

Attendees from the Academy's Life Practice Council ("Academy")

Dave Neve
Donna Claire
Dave Sandberg
Tom Campbell
Gary Falde (by phone)
Craig Hanna

Summary of areas of disagreement between New York and the Academy

The Academy had previously provided the NYSID with a written response to a list of 26 comments submitted by the NYSID on the PBR proposal for life products, based on the June exposure draft. Based on this response from the Academy, New York identified the following areas of disagreement for discussion.

1) **Use of modeling date up to 6 months prior to valuation date**. New York prefers to limit this to no more than 3 months. The Academy reiterated the concern expressed by some actuaries that up to 6 months will be needed to perform all of the required calculations, at least in the first few years after adoption. It was agreed that this is an implementation issue for the NAIC and the industry to resolve, and not an issue for the Academy to address. The Academy proposal will continue with the 6 month time limit.

2) **Grouping of policies into modeling cells for Stochastic Reserve calculation**. New York did not like the use of the word "intentional" in the current wording: "Grouping may not be done in a manner that intentionally produces a Stochastic Reserve less than what would result with no grouping." Agreement was reached to delete the word "intentional" from the sentence.

3) **Aggregation of risks across all policies in the Stochastic Reserve calculation**. <u>This continues to be a major area of disagreement.</u> New York feels that policies with non-homogeneous risks should be modeled separately to make it possible for the regulator to properly audit the reserve, and to add conservatism to the resulting reserve. The Academy continues to maintain that full aggregation of risks across all policies is a fundamental element of a principles-based approach and needs to remain. However, to assist the regulator in performing their audit, the PBR proposal includes a requirement to disclose the impact of aggregation.

4) **Stochastic modeling exclusion for policies with hedges**. New York feels that all policies with existing hedges must be stochastically modeled, and are not eligible for the stochastic modeling exclusion. In general, the Academy supports this view for future transactions, but is planning to recommend a list of acceptable exclusions for future hedging transactions in the December draft. However, the Academy does not support the NY view for existing hedges, since some types of existing hedges such as interest rate swaps or currency swaps are often perfect hedges having no residual risk (other than counterparty risk) and do not require stochastic modeling.

5) **Discount rates used to determine present values.** <u>This continues to be a major area of disagreement</u>. New York supports the use of a prescribed spread over risk free rates as the basis for discount rates rather than the approach defined in the PBR proposal where the discount rate is set equal to the projected path of net asset earned rates, using prescribed net spreads over Treasuries for reinvestment assets. The Academy emphasized the point that using prescribed discount rates that are lower than the path of net asset earned rates for the Stochastic Reserve may not be conservative. Due to the use of the GPVAD approach, the use of lower discount rates may result in a <u>lower</u> reserve, depending on the number of negative accumulated deficiencies compared to the number of positive accumulated deficiencies used in the CTE calculation.

6) **Assumption margins should reflect the results of sensitivity testing** (e.g., higher margin is required when the reserve is highly sensitive to changes in the assumption for the risk factor). Both parties are in agreement with this concept, but there is disagreement on the wording used in the June draft. The Academy pointed out that the new September draft has incorporated improvements in the wording on margin requirements, and asked New York to review these new changes and make further suggestions if needed to improve the wording.

7) **General guidance on assumptions**. New York expressed concerns that items that were moved to the new PBR ASOP discussion draft may need to be put back in the reserve requirements. The Academy's position is that only required elements should be in the reserve requirements, and that general guidance on how to comply with the requirements is more appropriate to be placed in the PBR ASOP discussion draft. The Academy asked New York to identify the specific items that have been moved to the PBR ASOP discussion draft that are of concern to the NY department.

8) **Reflecting ALM risk reflection in the Deterministic Reserve**. New York supports an explicit provision in the Deterministic Reserve to reflect ALM risk. The Academy believes the Deterministic Reserve is not designed to reflect certain risks (such as ALM risk) that can only be properly reflected in the reserve through stochastic modeling. Since the Stochastic Reserve makes provision for this risk, requiring an explicit provision for ALM risk in the Deterministic Reserve is viewed by the Academy as being redundant and adding unnecessary complexity to the reserve calculation. We also realized in the discussion that the use of a "conservative" yield curve for the projected deterministic scenario does already include a modest amount of provision for interest rate risk.

9) **Economic Scenarios**. We spent a fair amount of time discussing New York's concerns over giving companies the option to use their own stochastically generated scenarios with prescribed calibration criteria that must be met. They are concerned that the calibration criteria will not be rigorous enough, allowing companies to game the system to lower reserves inappropriately. Also, due to concerns over the ability to audit the results of a large number of stochastic scenarios, New York is questioning the meaningfulness of using a large number of stochastically generated scenarios, even if they are prescribed and the same across all companies. Thus, New York is considering the idea of adding a set number of prescribed deterministic scenarios (somewhat like the current NY7) that would be used either as an input to determining the reserve (might be in addition to, or replacement of, the current stochastic modeling requirement) or as a required disclosure/sensitivity item. New York stated that these scenarios would likely change each year as economic conditions change.

   The Academy expressed opposition to this idea on several fronts:

- It would be extremely difficult to develop a small set of common deterministic scenarios that would properly capture the risks of each company, based on the differences between companies in product features, product mix, and company risk management practices.

- If the scenarios change each year, there are concerns over communicating the new scenarios in a timely enough fashion to give companies the time to perform the calculations.

- Would the reserve be based on the scenario that gives the highest reserve? Or some sort of weighing of all or a subset of the scenarios? Would this replace the Stochastic Reserve?

- Using a different limited set of scenarios each year to set reserves could lead to reserves increasing or decreasing yearly in unexpected patterns.

- There could be major tax issues with defining the reserve to be the scenario that gives the highest reserve.

- Significant effort has gone into developing a set of calibration criteria that is robust enough to ensure with a high degree of confidence that a company would not be able to game the system, resulting in lower reserves compared to using the prescribed stochastic scenarios.

- Very few companies have the technical expertise to develop their own stochastic scenarios, and it is expected that the vast majority of companies will opt to use the prescribed stochastically derived scenarios.

- Concerns over the auditability of a large number of stochastically generated scenarios can be adequately addressed by developing a common template for reporting the stochastic modeling outcomes. The Academy agreed to send New York a copy of a preliminary draft of what this common reporting template might look like.

- Unlike current cash flow testing practices which do not define how stochastically derived scenarios are to be determined (leading to difficulty in auditing cash flow testing results and making comparison between companies), the PBR requirements define a prescribed stochastic generator or a set of stochastically derived scenarios that are the same across all companies, or alternatively, allow the company to use their own scenarios, but only if prescribed calibration criteria are met

- In terms of auditability, a suggestion was made to replace the “NY7” in asset adequacy testing with this random set of scenarios.

10) **Market Value approach to liabilities**. New York expressed interest in moving both sides of the balance sheet to a market value basis. While the Academy has no objection to considering this as a possible approach in the long term, the Academy feels it would be extremely problematic to pursue this idea in the short term, giving the good progress made in developing the current PBR framework, and the long time frame that would be involved in developing this new market value approach. Another concern is that the new MV approach for reserves would likely only apply prospectively, resulting in part of the balance sheet on a MV basis (new business) and the other part on a BV basis (inforce business), potentially even requiring part of a single asset to be valued on a market value basis, while another part was valued on a book value basis. The Academy supports the approach of taking the necessary steps now to amend the SVL and adopting the Valuation Manual, so that down the road, there is a regulatory framework in place that could accommodate moving to a MV basis for reserves more easily by amending the Valuation Manual. Note that the basic methodology suggested by the Academy of determining reserves based on cash flows could be modified to be used with a market value reporting basis. However, a transition from the current proposal to a market value approach will likely need to include a significant amount of time and effort to develop and refine such an approach...

11) **Simultaneous formulaic and PBR submission.** New York supports the idea of dual submission until regulators can get comfortable with new PBR process. It was agreed that this is an implementation issue for the NAIC and the industry to resolve, and not an issue for the Academy to address.

12) **Treatment of Reinsurance**. New York expressed several concerns with the approach used to model reinsurance cash flows as described in the June draft. Concerns were also expressed by New York over the suggestion to replace the current risk transfer rules by incorporating additional requirements of the new PBR framework (e.g., defining prescribed approaches to model certain reinsurance features). The Academy pointed out that the Reinsurance Work Group of the Academy under Sheldon Summers has made several significant changes to the reinsurance requirements since the June draft, and we agreed to defer further discussion until New York can study the new proposed reinsurance requirements. But based on our discussion, it is likely that there will be disagreements between New York and the Academy over the modeling of reinsurance with the new changes, e.g., they would like to limit the effect of reinsurance so that the result of reinsurance would never reduce the reserves below zero. The Academy was concerned that valid reinsurance that, in a sense, "shares" profits, expertise and capital between direct and ceding companies might be constrained by this limit.

13) **Pre-tax approach to reserves**. New York is still not convinced that a pre-tax approach is the right approach. We did not spend much time discussing this issue, but encouraged New York to study the paper from Ed Robbins that was previously provided that provides a rationale for the use of a pre-tax approach.

<u>Summary of the discussion to resolve areas of disagreement.</u>

There was agreement that there are 3 issues that are the most critical in terms of needing resolution:

- Aggregation
- Discount Rate
- Selection of Scenarios

The treatment of Reinsurance is also an area where disagreements between New York and the Academy may exist. More discussion is needed once New York has reviewed the changes to the reinsurance requirements in the September draft.

New York still plans on reviewing how to set assumptions and margins in more depth and may have future comments, particularly after New York sees examples of how assumptions would be set in practice using the VM-20 methodology.

There were 2 other areas of disagreement that are of less importance but still need resolution:

- Reflecting ALM risk in the Deterministic Reserve
- Pre-tax versus post-tax approach to reserves

Key points made during the discussion to seek a resolution of these issues.

1) The Academy and New York have discussed the above 7 issues for nearly two years now without any change in the respective positions. Hence, it appears that we need to "agree to disagree" at this point, and look to LHATF to resolve the differences.

2) The Academy will continue to pursue finalizing the PBR proposal for life products over the next several months as part of the process of seeking NAIC approval of the Valuation Manual by early to mid 2008.

3) The Academy is concerned that if the majority of LHATF votes to adopt the Academy proposal or something similar to it and there are one or more of the above critical issues that have not been resolved, New York may decide to adopt a different set of PBR requirements, resulting in a "49-1" situation. This would be a very unfortunate result, and would create additional complexities and challenges for companies to implement the new PBR requirements.

4) The Academy believes that it is very desirable that the NAIC adopt the SVL changes and the Valuation Manual by mid 2008 in order to give state legislatures time to consider approving the changes to the SVL during the next legislative cycle. Since several states follow a two-year legislative process that begins in 2008, if the SVL changes and the Valuation Manual are not adopted by the NAIC by mid-2008, it's likely the implementation of PBR will be delayed 2 years. (The timeline for adopting changes to RBC requirements is not as critical, since these changes do not involve legislative approval).