AMERICAN ACADEMY of ACTUARIES

May 12, 2010

The Honorable Adam Hamm
Chair, NAIC (EX) Working Group
Commissioner
North Dakota Insurance Department
600 E. Boulevard Ave., Dept. 401
Bismarck, ND 58505

The Honorable Thomas Sullivan
Chair, NAIC Life Insurance & Annuities (A) Committee
Commissioner
Connecticut Department of Insurance
153 Market St.
Hartford, CT 06103

Dear Commissioners Hamm and Sullivan:

The American Academy of Actuaries'[1] Life Practice Council (LPC) has strongly supported the National Association of Insurance Commissioners' (NAIC) movement towards a principle-based valuation and capital approach (PBA) for life insurance, and has been a key participant in its development for nearly ten years. As two major PBA components near completion -- the Valuation Manual and the C3 Phase III capital requirements for life insurance -- we have observed significant concerns about the status and direction of the project being raised before various groups of the NAIC.

We continue to support a principle-based approach to reserve and capital requirements. The LPC believes that the appropriate principle-based approach has the following characteristics, as previously developed by the LPC and communicated to the NAIC:

1. PBA captures the benefits and guarantees associated with the contracts and their identifiable, quantifiable and material risks, including the 'tail risk' associated with the contracts, and the funding of those risks.

2. PBA utilizes risk analysis and risk management techniques to quantify risks and is guided by the evolving practice and expanding knowledge in the measurement and management of risk. This may include, to the extent required by an appropriate assessment of the underlying risks, stochastic models or other means of analysis that properly reflect the risks of the underlying contracts.

[1] The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of 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.

3. PBA incorporates assumptions, risk analysis methods and models and management techniques that are consistent with those utilized within the company's overall risk assessment process. The inclusion of the risk analysis methods and models should consider the original purpose of that analysis. Risk and risk factors explicitly or implicitly included in the company's risk assessment and evaluation processes will be included in the risk analysis and cash flow models used in the PBA.

4. PBA utilizes company experience, based on the availability of relevant company data and its degree of credibility, to establish assumptions for risks over which the company has some degree of control or influence.

5. PBA incorporates assumptions that, when viewed in the aggregate, reflect an appropriate level of conservatism and, together with the methods utilized, recognize the solvency objective of statutory reporting.

6. PBA reflects risks and risk factors in the calculation of the PBA minimum statutory reserves and statutory RBC that may be different from one another and may change over time as products and risk measurement techniques evolve, both in a general sense and within the company's risk management processes.

The LPC accepts certain practical impediments to implementation that may necessitate a need to depart from a pure principle-based approach. Examples of such practical issues are the need for a principle-based approach to accommodate regulatory review and current federal income tax law. Also, while we believe that a principle-based approach should ideally apply to all life insurance products, the LPC supports properly designed exemptions to minimize the necessity of processes and procedures that do not create meaningful reserve and capital measurement improvements relative to the additional burdens that they impose.

The LPC supports the NAIC-adopted revisions to the Standard Valuation Law (SVL), and the Valuation Manual framework, as well as the Academy's Life Capital Adequacy Subcommittee's C3 Phase III proposal the original draft of which was submitted by the LPC more than four years ago. The Academy's Life Financial Solvency/Risk Management Committee (LFS/RM), which is the LPC's primary committee working with the NAIC on PBA, communicated a number of concerns to LHATF at its March meeting.[2] The issue at hand was over recent NAIC decisions that may be diverging too far from a true principle-based system.

Since the March Denver LHATF meeting, there has been some progress (several of the expressed concerns, particularly two major concerns, have been addressed).[3] The LPC is encouraged by these recent actions; nevertheless, we remain concerned that LHATF might adopt an overly conservative and complex rule-based framework that does not and may never achieve the objectives and goals of a principle-based system because of the accumulation of prescriptive requirements, more than any one in particular. The more prescription, the further the process

---

[2] A list of the concerns expressed March 24, 2010 is provided in an attachment.

[3] Full aggregation is allowed in the stochastic calculation but the issue has not been fully addressed in the stochastic exclusion test. Until the aggregation levels are the same in both the test and the calculation of reserves it is difficult to consider the entire approach principle-based.

deviates from a “company’s own risk assessment” and the more difficult it will be to demonstrate non-correlation effects that would be appropriately taken into account in getting to a reasonable total reserve.

Finally, and of equal concern to the LPC, is an aspect of PBA that has not yet been acted upon. As companies and regulators begin to implement the components of a principle-based approach, the LPC expects that a learning curve period will be necessary to test and validate the real outcomes of a movement to a principle-based approach. We continue to believe that a feedback loop is critical to evaluate the effectiveness of the system and to provide for a regular dialogue between regulators, industry, and other important constituencies, allowing for modifications to the approach as needed.[4] The feedback loop is a foundation for gathering the information to evaluate the effectiveness of the PBA framework. And, with certain “guardrails” suggested as part of the PBA implementation, such as minimum floors and prescribed ranges on margins, the feedback loop will be essential to determine if/when the guardrails can be removed from PBA.

As always, the LPC welcomes any questions you may have on our comments in this letter. We look forward to continuing to provide actuarial guidance to the NAIC to implement a risk-based reserve and capital framework that meets the objectives of regulators and achieves the objectives of a principle-based system.

Sincerely,

Arthur V. Panighetti
Vice President
Life Practice Council
American Academy of Actuaries

cc:
NAIC PBR (Ex) Committee
NAIC Solvency Modernization Initiative Task Force
NAIC Life & Annuities (A) Committee
NAIC Life & Health Actuarial Task Force
NAIC Capital Adequacy Task Force
NAIC Life Risk-Based Capital Working Group
Terri Vaughan – NAIC Chief Executive Officer
Jolie Matthews, NAIC Senior Health Policy Advisor and Counsel
John Engelhardt, NAIC Chief Managing Actuary, Life/Health
Dan Swanson, NAIC Capital Adequacy Program Manager

[4] Technical requirements alone are not sufficient. Without a feedback loop, regulation will remain focused on verification of correct reported values. If regulators cannot speak meaningfully to or be aware of emerging risks, they will be unable to manage the safety of an industry when the economic climate is in severe stress.

Attachment

[Presented to LHATF March 24, 2010]
Talking Points on PBA to LHATF
From the Life Financial Soundness and Risk Management Committee
Donna R. Claire, FSA, MAAA, CERA, Chair of the LFS/RM Committee

1. The Life Financial Soundness and Risk Management Committee (and LPC) would like to share with LHATF a growing concern among our committee members regarding the current direction of PBA. This concern has been growing for several years, but recent decisions by LHATF have accelerated this concern.

2. Before we share the specifics of our concerns, let me emphasize that we continue to strongly support the concepts underlying the Principle Based Approach as initially envisioned when we began this journey nearly 10 years ago. These concepts include:
   - We believe that a core value of PBA is to align financial reporting with management tools that measure the true risks of options in contracts and assets. As such, a key goal of PBA is that reserve and capital requirements will not simply be a regulatory exercise that must be completed, but rather, will be embedded within the risk management and decision making of the company.
   - We recognize that PBA adds a new dimension to the regulatory review process. It is no longer sufficient for the regulator to just verify that numbers have been reported correctly and reflect past activity. The regulatory reviewer needs to be able to understand the risk exposures faced by the company in the future and how those risks will be managed.
   - We believe that PBA is good for the consumers – for some products, reserves could go down, so premiums could go down, and consumers could have more coverage for less money; for some richer products, the reserves would legitimately go up, but that is because the true cost of the options would be reflected.
3. We support the changes to the SVL, and support much of the work in the Valuation Manual but the SVL will not be complete until a formal process is also established to evaluate risk through a feedback loop that includes regular dialogue between industry, regulators and consultants (perhaps in their function as independent peer reviewers). This formal process needs to include a specific regulatory risk function that is different in scope and mandate than the regulatory compliance functions
   - We believe that auditability is important, and believe that the standardized reports in VM-31 will provide manageable ways to see what companies are using, and to compare the assumptions with those used with other similar companies.
   - The SOA has offered to assist in developing tables of actual experience that companies can use for assumption-setting if their own experience is not credible

4. BUT we are concerned that PBR as it has changed over the last couple of years, is becoming "Just another regulatory requirement" –
    - This would marginalize its use with company management as a tool to measure risk
    - It would be expensive to implement, with little or no gain to the regulators or industry
5. Two major concerns we'd like to highlight that reflect a movement away from a principle-based system to a rule-based system include: :
    - Prescribing margins for each assumption in VM-20:
        - This approach will not allow the reflection of the actual risk levels of a company and effectively results in a PBA reserve that is simply a much more complex formula reserve
        - We do support margins for uncertainty and volatility, but believe that the actuary can determine the margin that makes sense for their company's products and risk structure
    - Another problem is that aggregation between products was recently eliminated in VM-20
        - One reason this is bad is because the company may manage the business in different product groups together, and eliminating aggregation would eliminate some natural hedging offsets. An example of this is a block of deferred annuities and another block of payout annuities.
        - If it is felt that product group detail is needed for auditability, information on a product group basis can be included in the Actuarial report
6. .Other concerns include:
    - Prescribed defaults costs
    - Economic Scenario Generator calibration change
    - Elimination of the option to use a company's own stochastic generator
    - Arbitrary haircuts on revenue sharing
    - Including amounts in NGE that do not arise from experience of the policy
    - Maintaining the risk transfer rule for reinsurance.
    - C3 Ph 2 report
    - No organizational movement or steps to create or define a chief risk/actuarial role to manage the feedback loop process.

7. In summary, in an effort to cover every contingency, we feel there has been a drift away from the focus of developing a true principle-based system, where each company identifies and measures their risks, and sets reserves to cover these risks, including reasonable margins for conservatism Instead, we appear to be developing a very complex rule-based framework that is overly conservative, which will not achieve the objectives and goals of a true principle-based system.

8. We welcome your comments.