

Thursday, March 11, 2004: Life & Health Actuarial Task Force

Members present included AK, AR, CA, CT, FL, KS, MN, NE, NM, NY, OH, PA, SC and TX.

Update on C-3 Phase II Work and Variable Annuity Reserves Actuarial Guideline. LHATF heard three presentations – an Academy RBC update by Bob Brown, an Academy update on Variable Annuity reserves by Tom Campbell and a regulator’s view of the “standard scenario” by Dennis Lauzon of New York.

Brown gave a brief history of the RBC project. Phase I dealt with interest rate risk, which was completed in 2000. The current Phase II focuses on modeling of all interest-sensitive business. AAA has provided on its website about 10,000 scenarios and instructions on how to use them. Phase III will cover equity-indexed products.

Brown mentioned that the AAA task force had changed from using a 95th-percentile approach to a Conditional Tail Expectation (CTE) 95 approach (i.e., essentially take the average of the worst 5% of the scenarios). The methods are similar in many respects, but can differ if the tail is large.

The AAA will be requesting exposure of its report with the intention of having it adopted in June and effective in December. This group actually does not report to LHATF, but to the Capital Adequacy (E) Task Force, which meets after this meeting.

Doug Barnert, representing NALC (which has many smaller insurance company members), stated that there have been many changes since the last AAA document in September, 2003. Although he did not elaborate, he urged a thorough review before adoption.

Tom Campbell then summarized the AAA Variable Annuity Reserve Work Group’s (VARWG) March report on reserves. Brown’s group and Campbell’s group are addressing different aspects of variable annuities – RBC vs. reserves, but they work closely together and in fact have many members in common.

The basic approach is CTE(65) – i.e., looking at the worst 35% of the scenarios. VARWG has also proposed an Alternative Method (AM) for VAs with GMDBs but no VAGLBs. The AM is a formula-based approach applied on a seriatim basis instead of the modeling approach required by CTE. It would not be available if a company has previously used CTE. VARWG expects that AM will generally produce higher reserves than CTE because some of the benefits of aggregation in modeling are lost. AAA has AM spreadsheets on its website that can be downloaded.

Campbell remarked that FIT is ignored in projections and any discounting should use a pre-tax interest rate. However, the question of deductibility of reserves in excess of cash values is still open.

Timing was the next topic. Many companies find it difficult to perform all this testing at yearend, so VARWG identified two methods that could be implemented to use results from a point in time prior to December 31. There may be other acceptable methods. LHATF spent some time discussing whether the prior period should be limited to no earlier than September 30, but decided not to explicitly require this. LHATF members expect companies using earlier timing periods to ultimately do the modeling as of December 31 to improve estimation techniques.

Campbell discussed possible allocation methods of modeling results to a seriatim basis. VARWG believes that if it results in a reserve less than the cash value on a particular policy, then so be it, although that could have FIT implications.

VARWG has no position on whether a method to dampen volatility is justified or necessary.

To accommodate the issues outlined above, VARWG has redrafted the Actuarial Guideline.

Dennis Lauzon presented the conclusions of a LHATF subgroup (CA, FL, NY and TX) dealing with the Standard Scenario (SS). The SS would serve as a floor on the requirements otherwise calculated. There is one SS for RBC and one for reserves, with each specifying the assumptions for rate of return on various asset classes, persistency, mortality, expenses, reinsurance and other items.

The SS is not designed as a proxy for adequacy. RBC would be the maximum of SS, modeling, or 0.5% of Annual Statement reserves. Reserves would be the greater of SS adjusted for hedging or modeling. NY does not view this requirement as onerous because it will require additional reserves only if the benefits are substantially "in the money." Lauzon also stated that NY views these benefits as very dangerous if unhedged.

A lively discussion ensued. Campbell thought that if SS became the reserve it would be too conservative. Also, the effects on Guideline 33 should be considered. Brown stated that mortality for many companies is not anywhere near the SS proposal but Bill Carmello (NY) rebutted that that was anecdotal evidence.

Dave Sandberg proposed that SS results be disclosed to regulators but not used as a floor. Larry Gorski observed that deducting the value of hedging could result in an SS value different than the Annual Statement value. ACLI questioned why one more scenario is needed if a company is already using

10,000 scenarios in its modeling and thus will not support SS. Campbell noted that there already is a floor on the reserve of the present value of annuitization benefits.

AAA volunteered to analyze the effects of SS. The LHATF subgroup's proposal will be exposed for comments as part of the minutes of this meeting.

Finally, the ACLI remarked that its tax counsel had written to AAA that the reserve proposal is not tax effective, i.e., that reserves in excess of cash values might not be deductible. Also, its member companies might have problems complying by December, 2004.

After all the above, LHATF will try to schedule at least two conference calls of two hours each, and perhaps more calls if needed, to discuss all of the issues related to this project. A September adoption date by LHATF now seems optimistic.

Possible Areas of Revision to the Standard Valuation Law. LHATF has found that its piecemeal approach to addressing issues is not productive. Therefore it asked AAA to study and devise a global approach to basic reserves, with the primary consideration being consistency between products and companies. Life insurance, annuities, LTC and other health insurance should be considered in the project.

Sheldon Summers (CA) outlined his proposal for a "Valuation Manual". LHATF would adopt the Manual, and then each state could refer to it in its laws. Thus changes to the Manual adopted by LHATF would automatically apply to all such states. This could eliminate some model regulations and Actuarial Guidelines. A major issue is applicability of new developments to existing business, and phase-ins if needed.

Lastly, David Neve presented an AAA report on deficiency reserves based upon a survey of life insurers. The insurers believed that deficiency reserves do not match up well with basic reserves, resulting in strange patterns of reserves. Also, they are too conservative (surprise!), and many companies worry about Letter of Credit capacity and availability in the reinsurance market.

There was no other discussion, perhaps reflecting that AAA will now be formally addressing the project.

Development of a Regulation and Other Topics Pertaining to Nonforfeiture for Individual Deferred Annuities. AAA has developed two versions of a model regulation, one with premium buckets (i.e., funds having different minimum interest rates in a single contract) and one without buckets. Regulators were not enamored of the bucket approach, so LHATF ultimately voted to have no buckets.

AAA also proposed a “value-triggered” method of changing guaranteed interest rates upon reset. The method would keep the minimum nonforfeiture interest rate on a contract constant unless the benchmark interest rate changed, either up or down, by a specified trigger amount. Regulators were not opposed to this method but believed that minimum and maximum trigger amounts are necessary. The sentiment seems to favor 25 basis points as both the minimum and maximum.

A redrafted regulation reflecting no buckets and a 25 b.p. trigger amount will be exposed for comment.

LHATF had been asked to respond to a letter from an AAA group about what minimum interest rates to use to project annuity nonforfeiture benefits for CARVM reserves. LHATF directed NAIC staff to draft a Guideline specifying 3%.

General Nonforfeiture Project. Noel Abkemeier presented an AAA report that listed a number of products that could be made available if the law were more flexible, including no cash value life insurance, multiple benefit policies (i.e., combinations of life, health and annuities) and market value adjusted life insurance.

However, AAA enlisted four life insurance tax specialists to comment on potential tax treatment. They concluded that favorable treatment of inside buildup is most threatened by no cash value permanent life insurance.

Barbara Lautzenheiser opined that allowing no cash value life insurance could actually raise the value to many consumers of cash value life insurance. ACLI indicated that it would not support any proposal that would require guarantees where none are now required. The AAA Life Practice Council considers this an important project.

The majority of interested parties favor a broad revision, with tax risks being dealt with as they surface, rather than a narrow focus on changes carrying little risk of adverse tax treatment.

Friday morning, March 12, 2004: Accident & Health Working Group

Did not attend; see the first item of the afternoon session below.

Friday afternoon, March 12, 2004: Life & Health Actuarial Task Force

Members present included AK, AR, CA, CT, FL, KS, MN, NE, NM, NY, OH, OK, PA, SC and TX.

Report of the A&H Working Group. The WG discussed the following topics:

1. Medicare Supplement premium refund/HR1 impact: AAA task force is working on establishing benchmarks, which will continue. Impacts of HR1, which is the new Medicare drug benefit recently passed by Congress, will be incorporated into the benchmarks.
2. LTC issues referral working group continues to review a long list of issues.
3. Blanks consistency: Two conference calls will be scheduled to continue discussion. The A&H Policy Experience Exhibit is likely to be revised.
4. The premium deficiency reserve subgroup (formerly called HMO/HMDI consistency) has requested AAA input.
5. Instructions for the allocation of claim adjustment expenses project has been referred to the Blanks Task Force.
6. AAA Rate Filing Task Force anticipates a final report at the June meeting.
7. WG will ask the SOA to update the 1985 Cancer Tables.

Credit Insurance Mortality Table. LHATF adopted the December, 2003 draft of the credit insurance table.

Implementation of the Recommendations of the Life Liquidity Risk Working Group. One recommendation is to add an exhibit to the Annual Statement regarding institutional funds. The exhibit would disclose fund demand exposure by period (0-7 days, 8-14 days, 15-30 days, etc.). Institutional funds are essentially products with cash values over \$10 million controlled by a single entity. The other recommendation is for an officer to certify that the company has the financial flexibility to manage stress liquidity risks.

LHATF approved the recommendations for exposure. A conference call will be scheduled with the goal being approval by May so that inclusion will occur in the 2005 Annual Statement blank.

Reserving and Nonforfeiture for "Return of Premium" Term Insurance. The NAIC had taken a detailed survey of LHATF member states to determine how they responded to the filing of these policies. The survey is too voluminous to even summarize here, but the net result is that LHATF will take no action. Instead it will let each state handle it according to its own law and requirements.

Update on Status of GRET Project. An SOA Committee will report in June whether GRET needs to be updated. GRET, or Generally Recognized Expense Tables, are permitted but not required for use with the Illustration Regulation.

Review Procedures for Disseminating LHATF Documents and Announcements. The main issue is the length of time prior to a meeting or conference call that material must be distributed. The NAIC staff will research how to get documents available on the website in a timely manner. Discussion will continue.

Number and Prioritization of LHATF Projects. There was a lot of discussion but not much was decided. LHATF is trying to get a better handle on how to frame its purpose, strategic mission and long-term strategic planning. Discussion will continue.

Other Matters. These matters have been raised by various parties. Discussion will continue at future meetings.

1. LHATF has been asked to provide guidance for determining the fair price of viatical settlements.
2. The (A) Committee has asked if the Variable Annuity Model Regulation and the Interest Indexed Annuity Model Regulation are still appropriate. LHATF added the Modified Guaranteed Annuity Model Regulation to the list.
3. Some LHATF members fret that certain shadow account designs exist merely to get around the requirements of AXXX. Basically, the designs try to minimize the funding ratios, which in turn lowers reserves. LHATF will schedule a conference call to discuss.
4. Kerry Krantz (FL) is looking for volunteers at the annual meeting of the SOA for "U.S. Statutory Update." There will be a panel discussion and a follow-up workshop. Contact Kerry directly to volunteer for either or both.

Donald P. Maves, FSA, MAAA

15 March 2004