

NAIC (A) Committee Meeting

August 22 and 23, 2005

Minneapolis

Purpose. To educate the (A) committee on reserve level issues relevant to life companies and to chart a course of action based on testimony received.

Attendance. At the front table were (A) Committee members, a quorum of LHATF members and NAIC staff, totaling about 25 people. In the audience were 60 interested parties, about 1/3 actuaries.

Monday afternoon

American Academy of Actuaries. AAA was represented by Barb Lautzenheiser, Dave Neve and Dave Sandburg. After introductory remarks by Barb, Dave N presented the UL working group's accomplishments. Key issues are governance, the labor of changing the SVL and integration with ACLI efforts. Dave S gave an update on the SVL 2 group's work. Dave talked about the need to educate regulators, executives, actuaries, accountants and reviewers. This type of principles-based valuation is working in Canada but Canada is more like one large state and doesn't have the complexities of the U.S. environment. Dave talked about a need for legal liability protection for the actuary.

Actuarial Standards Board. Cecil Bykerk gave a history of the ASOPs.

USAA Life. Chairman and CEO Bob Davis made an impassioned plea for immediate relief from high reserve standards. He cited that these reserve levels are having a detrimental impact on U.S. families. Current reserves are at least 3 times the amount needed, making term not a viable business product. All three options (increase premiums, constrict availability and reliance on external capital) are unappealing. The rating agencies see this too. When asked by the (A) Committee what would be a reasonable timetable for a remedy, Davis replied with ASAP for an interim solution with a permanent solution 3-5 years away. When asked what interim solution would work for USAA, Davis replied allowing to use pricing mortality (with its inherent rate classes) as the basis for reserving.



ACLI. Chief Actuary Paul Graham acknowledged that while in the past, the industry has slowed down innovative valuation solutions, it is solidly behind searching for a solution such as a principles-based approach. The ACLI is ready and able to work on an interim solution, leaving the long-term solution to the AAA. While a new mortality table will go a long ways in providing relief, the industry can't wait that long. Graham showed an organization chart as to how the ACLI would operate. One (A) Committee member acknowledged an instant replay of the 20 year timeframe it took to develop XXX was not acceptable. Mike Batte of LHATF commented that ACLI interim work should not consume the scarce LHATF resources devoted to the long-term solution. Laurie Lewis, ACLI tax counsel, talked about IRS issues. She is "cautiously optimistic" that tax issues can be satisfactorily addressed. She felt that while interest, mortality and method could be accommodated, the contract-by-contract comparison to the cash value floor would be a challenge to work out. They have already had one meeting with the IRS.

Tuesday morning

The President Elect of the NAIC was in attendance and introduced.

Johnny Johns, CEO Protective and Dennis Glas, CEO Jefferson Pilot. Nothing is more important than dealing with highly redundant reserves. This is creating unreliable financial statements. Terrible impact on consumers. Only downside for NAIC, showing they are out of step. Bad for industry; induces unlevel playing field as only big companies (say 250 million or more of redundant reserves) can play securitization game. The rest must exit the business or be merged. The only winners are offshore insurers and investment bankers. Relief is needed now as reinsurers are raising rates and have more power due to consolidation. Moody's is becoming the defacto regulator with its ability to review and rate these deals. Industry will do what it takes to get a realistic reserve system in place. Mark Greene asked where were you when we and the SoA was begging for mortality data? Reply: the industry is together now and will participate. Through the ACLI, the industry will get the job done.

John Adney, tax attorney. Nobody wants to take this to Congress or IRS; Congress and IRS don't want to take this on. Nothing in principles-based system seems insurmountable. Would Congress re-examine current laws? It does so only when revenue drops. The insurance industry has



been a good taxpayer recently. Adney suggested including rules to allocate results to individual contracts into the SVL. The rationale would be to accommodate insolvency laws which require that reserves be assigned to each contract. He also advocated calling the method CRVM and to continue publishing mortality tables.

Michael Taht, Tillinghast attempted to define redundancy. Tillinghast just completed an older age mortality study that showed recent experience to be 75% of what is in the 2001 Basic Valuation Table. He thought that companies priced to achieve around 12% roi and roe and that the costs of letters of credit (say 100 bps) translated to 4 to 5% of premium.

Bill Rosenblatt, attorney. He has participated in all securitization deals to date. He outlined the steps to do a deal. Costs for attorneys, bankers, actuaries and company management are substantial. To date there have been no a-XXX deals primarily due to length of redundant reserves.

Harry Panjer, professor, representing the Affordable Life Alliance. Harry discussed how reserves should be appropriate and capital be for extraordinary protection. Reserves and capital need to be determined on a consistent basis. He presented concepts of diversifiable and non-diversifiable risks. A principles-based system is a) completely prospective, b) uses up-to-date information, c) uses stochastic rather than single estimate and d) is risk-based (attach probabilities to outcomes). Implementation involves external assumptions, internal assumptions and a calculation engine. Software is not an issue, even for small companies. Should be able to back test to see if prior results were one of the plausible outcomes from an earlier study. A principles-based methodology will be consistent with Fair Value, the direction of the IASB.

Tuesday afternoon

Paul McCrossan, Eckler. Paul helped develop and monitor the Canadian principles-based system, in effect for over 10 years. He described its evolution. For reserves, how much is enough and how much is too much? Reserves should be one to 1.5 standard deviations above expected, or, in other words, adequate 75 to 85% of the time. The Canadian authorities felt that that low a level would produce too many failures. So, they looked to RBC for solvency. The sum of liability and surplus needed to be adequate 99.5% of the time, or



expected plus 3 standard deviations. Countries that have instituted principles-based reserves are: Canada, Australia, Hong Kong, Singapore, South Africa, Denmark, Finland and Holland. Prerequisites for a principles-based reserve system are a) strong standards of practice, b) peer review, c) industry support for credible experience studies, d) reasonable risk margins, e) regular stress testing, focused supervision and discrete public reports. There was a steep learning curve; practice improved dramatically. The best practices in year one didn't meet minimum standards in year three; best practices in year three; didn't meet minimum standards in year six. Of course, they didn't have the benefit of cash flow testing at that time. It would take two years for implementation: one year to install a system and a second year for a trial run.

Jim Poolman, (A) Committee Chair led the evaluation and next steps discussion. One Commissioner stated he was not impressed with the regulator's progress. The (A) Committee should take charge and determine how to implement, accepting the discomfort of dealing with the non-guaranteed world rather than continue to study. The ACLI said that it would take 15 months for a temporary solution (new mortality tables with underwriting classes) and principles-based reserves reported in 2008 / 2009. Jim Poolman instructed the LHATF to write two charges at their September meeting. The first is to start the process to change the SVL, leaving the methodology blank for the moment but to be filled in with principles-based methodology. The other charge was to develop a short-term solution for term insurance. Poolman asked if there was any more discussion, in particular any dissension from people at the front table. All were silent.

Tom Herget

24 August 2005

