



# AMERICAN ACADEMY *of* ACTUARIES

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## **Report on Considerations for Application of Principle-Based Reserving to Inforce Blocks from the American Academy of Actuaries' Life Reserves Work Group**

### **Presented to the National Association of Insurance Commissioners' Life and Health Actuarial Task Force**

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## Considerations for Application of Principle-Based Reserving to Inforce Blocks

The Principles-Based Reserve (PBR) system will either be applied only to new business, or applied to both new business and inforce business. If applied to inforce business, it may be applied to all inforce business or to only some inforce business. In either case, the PBR may be applied immediately as of the effective date of the PBR, or may be phased in.

### Arguments For the Application of PBR to All Inforce Contracts:

- Measures the risks of a company more appropriately than current formulaic reserves
  - a. Provides a consistent methodology for all business.
  - b. Consistent with international actuarial and accounting directions
  - c. Constitutes a more rigorous approach for all blocks of business
  - d. Provides better information for regulators
- Reduces those reserves that are redundant under current regulation and strengthens those reserves that are inadequate under current regulation
  - a. Will tend to lessen dependence on complex reinsurance and financing solutions;
  - b. Will increase confidence in adequacy of reserves held for 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. The reserve will allow for offset of covariant risks; and
  - c. Reserves are set using the 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, reducing the subjectivity involved in allocating assets between PBR and non-PBR liabilities.
- Mitigates the change in the pattern of margins under PBR as compared to the current formulaic approach
- Potentially reduces *on-going* costs by not requiring companies to maintain multiple reserve approaches for statutory purposes. However, companies would still have to calculate tax reserves on the basis current at issue.

### Arguments Against the Application of PBR to Inforce Contracts:

- Potential for large reserve discontinuity if inforce block is large relative to new business
- May have significant tax implications
  - 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 IRC 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. This is a “whipsaw” effect.
  - c. Current valuation systems would have to be maintained for as long as currently 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 as long a “learning period” with respect to the overall application, systems, and peer review before the approach is applied to a large block of business
  - a. Starting with a smaller block of business will enable companies and peer reviewers to get comfortable with the process and better identify problems.
  - 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 of enhancements to valuation techniques after the effective date will have a greater effect on PBR reserve levels from year to year as companies adjust to the process (compared to only impacting new issues after the effective date).
  - c. 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.
- Most, but not all, past changes in reserve methodology have not been applied to inforce business.
- 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.

## **Application of PBR to Some, but not All, Inforce Contracts, or Phased-in Application of PBR to All or Some Inforce Contracts:**

By limiting the application to inforce contracts to certain contract types (e.g., only those subject to Actuarial Guideline 38 (AXXX) and/or Valuation of Life Insurance Policies Model Regulation (XXX) reserving) or to a particular date (e.g., July 1, 2005), some of the arguments against the application to inforce contracts are mitigated; however, it also weakens some of the arguments in favor of application to inforce contracts.

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

- January 1, 2000 (or the date of adoption of XXX in each state) for products subject to XXX (and AXXX) reserves;
- January 1, 2003 for 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 to phase-in 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 or the initial change in reserve levels may be spread out over a period of years.

The following are additional considerations particular to partial application to inforce blocks 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 the application of inforce contracts, certain product types, and some dates 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 the application of inforce contracts to a particular product type(s) probably helps 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.
- Limiting the application of inforce contracts to certain products or to a particular date will still create issues around how companies manage and allocate assets.
- Tax implications are not eliminated by limiting the application to inforce contracts to certain plans or time periods.

### **Other Considerations:**

- The application to inforce contracts may not apply uniformly to all companies because of contract language that may require using specific valuation tables or interest rates.
- If RBC is applied to all or a portion of inforce contracts, is consistency between RBC and reserves desirable?