

POSITION ON ASSURANCE OF COMPANY RESERVES

**PRINCIPLES-BASED RESERVING
(EX) WORKING GROUP
OF THE NATIONAL ASSOCIATION
OF INSURANCE COMMISSIONERS**



National Association of Insurance Commissioners

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COMPANY RESERVES**

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Purpose & Objective of This Paper

This paper was developed by the Principles-Based Reserving (EX) Working Group to document a position taken by the Working Group on the issue of providing assurance of company reserves under a principle-based approach to reserving. The issue is specifically related to a request that the Working Group received on December 3, 2007, from the Life and Health Actuarial Task Force as follows:

In light of the deletion of the annual requirement of an opinion from an independent reviewing actuary, either consider charging the Task Force with the development of a centralized actuarial reviewing office to perform annual reviews to insure companies valuing business under a principles-based approach are in compliance with the valuation manual and the law or reinstate the annual requirement of an independent actuarial review with the regulator hiring the reviewing actuary.

The decision by the Life and Health Actuarial Task Force to remove this requirement was deemed appropriate given that the state can't rely upon work contracted by the insurer to meet its requirement to examine a company. On December 3, 2007, the Working Group discussed various options to address the issue raised by the Life and Health Actuarial Task Force. On December 21, 2007, a document was exposed by the Working Group that summarized the four options discussed during the December 3, 2007 meeting as well as related points. The following summarizes the four options included in that document:

- 1) Charging the Life and Health Actuarial Task Force with the development of a Centralized Actuarial Reviewing Office to perform annual reviews to insure companies valuing business under a principles-based approach are in compliance with the Valuation Manual and the Standard Valuation Law;
- 2) Developing a requirement for an independent reviewing actuary to be hired directly by the state insurance department;
- 3) Incorporating the requirements that would have existed for an independent reviewing actuary into the state's examination and analysis process;
- 4) Combination of Centralized Actuarial Reviewing Office and incorporation into examination process.

Discussions Leading to the Position in This Paper

On February 21, the Working Group held a conference call to discuss the comments received on the exposed document. During that call the Working Group agreed that option three, or a variation of that option, was the most appropriate means of providing the assurance needed. Following are some of the advantages and disadvantages of option three as discussed during the February 21 conference call.

- Advantages
 - A. Addresses issue that work must be performed by firm contracted with the state;
 - B. Helps reduce the need for any additional full time actuarial resources at each state;
 - C. No liability issues for the NAIC;
 - D. No significant NAIC resources needed.
- Disadvantages
 - A. Does not reduce annual costs to the insurer;
 - B. May require special provisions to obtain access to work papers;
 - C. Places reliance on each state to hire its own consultant;
 - D. Does not develop detail expertise at the regulator level;

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Since the February 21, 2008 conference call, the following more specific items have been noted with respect to the Advantages of the position taken:

- A. Builds upon existing state authority to examine companies, and does not create additional regulatory processes before a need for additional processes is demonstrated based on experience with principles-based approaches (“PBA”);
- B. Provides opportunities to learn what will be needed for assurance of reserve calculations while initial volumes and risks are relatively small, and to apply this experience in considering possible adjustments to existing processes;
- C. Provides for the depth and frequency of reviews to be determined by the states based on the circumstances of each company, consistent with the risk-focused surveillance approach to examinations of companies;
- D. Reflects an understanding that the need for such reviews (depth and frequency) are likely to change as regulators and companies gain more experience with PBA; and
- E. Notes the value in having a central process (yet to be defined fully) that could help states to improve the quality and uniformity of reviews.

Since the February 21, 2008 conference call, the following more specific items have been noted with respect to the Disadvantages of the position taken:

- A. As it pertains to annual costs to the insurers, companies will incur incremental costs to support regulatory assurance of PBA reserve calculations relative to current company costs (i.e., prior to implementation of PBA). However, it is believed that such incremental costs will be less than they would be with other “options” the Working Group considered, because the regulatory assurance would be provided through existing processes, which companies already must follow. It is believed it will be less costly, to companies and to regulatory authorities, to work within existing process rather than through new processes (such as those proposed in the other “options” that the Working Group considered);
- B. Will require no greater special provision to obtain access to work papers than would be required for the other “options” that the Working Group considered;
- C. Since its the State’s responsibility to determine the frequency and depth of the review, and whether to conduct the review through an independent actuary or an actuary of the state, its not really a disadvantage to place reliance on each state to hire its own consultant;
- D. Since each state will have the option of assigning reviews to independent actuaries or to actuaries of the state, the position allows each state the flexibility to how it establishes its own level of expertise; therefore this does not appear to be a disadvantage.

The remainder of this document summarizes the agreed upon approach as well as related considerations from the Working Group on the issue.

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Incorporating the Requirements into the State's Examination and Analysis Process

1. This document sets forth the position of the Principles-Based Working Group on providing assurance of company reserves. This document is intended to provide direction to the NAICs technical groups in accordance with the Working Group's charges. This document contemplates action that would need to be taken up by technical groups as those groups contemplate the changes that are necessary in their area for principles-based reserves. Included in this paper is the Working Group's belief that the Life and Health Actuarial Task Force should develop a format and scope of a report that represents an "opinion" from the reviewing actuary regarding the assessment of the insurer's methods, models, assumptions and margins for principles-based reserves included in the financial statements. This opinion will be separate from any type of examination report that is typically produced as a result of an examination. Also included is the Working Group's belief that procedures will need to be developed by the Examination Oversight (E) Task Force and the Life and Health Actuarial Task Force for the regulators use in making an assessment of principles-based reserves, whether all procedures are performed by the state, or where some procedures are performed by the CPA firm and tested by the state.

Examination Statute Authority

2. All state insurance departments are required to have the authority to examine companies whenever it is deemed necessary. Under such authority, the state may conduct an examination of any company as often as the commissioner deems appropriate, but all companies are required to be examined at least once every five years. The commissioner is given the flexibility to decide the scope of each examination based upon the particular attributes of the company to be examined. This includes the authority to conduct routine financial analysis or any other means to determine the financial condition of the company.

Risk-Focused Examination Approach

3. In 2006, the NAIC adopted changes to the NAIC *Financial Condition Examiners Handbook* to reflect a revised risk-focused approach. The revised approach is effective January 1, 2010, and will better incorporate prospective risk assessment in identifying insurers that have or will encounter solvency issues and bring focus to the broader issue of the ability of management to identify, assess and manage the business risks of the insurer.

Risk-Focused Examination for Principles-Based Reserving

4. The Working Group believes that the approach for providing company assurance on principles-based reserves fits well into the risk-focused examination. More specifically, the Working Group believes that a risk-focused approach should be applied to both the companies considered for review, the frequency, and depth of that review.

Companies Considered for Review

5. A risk focused approach used in determining the companies considered for review would likely depend upon who is writing certain types of life products that are perceived to have a higher amount of reserving risk. This would include but may not be limited to variable annuities with secondary guarantees, universal life with secondary guarantees, term insurance with level premiums, and life insurance products where the reserves under the current system are significantly less than the interest-adjusted value of expected future net cash flows. Those companies that write a higher amount or percentage of this type of business would be perceived to have a higher amount of reserving risk, and should be subject to such a review.

Frequency, Depth and Timing of Review

6. As the amount of reserving risk increases, the likelihood of more periodic reviews would also increase as well as the likelihood of a more in depth review. Some members of the industry expressed concern about the impact the principles-based reserving would have on smaller companies; but since they may not be as likely to sell the products that have more inherent risks, a risk-focused approach seemed to address those concerns.

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7. Another factor in determining the frequency and depth of a review is the overall uncertainty associated with the risk factor, which in this case is the use of principle-based reserving approaches. That uncertainty is the result of various items including the 1) difficulty in developing such reserves for the particular product; 2) newness associated with the new methodologies that will be used for these products; 3) processes used by the company. Each of these factors can change over time and can therefore factor into the frequency and depth of a review by the state. For example, in the early years of principles-based reserving, the uncertainty associated with principles-based reserves and the process used by insurers to establish such reserves will be high. Consequently, during the early years, on insurers with higher principles-based reserving risk, the review may take place annually, and may occur before the publication of the year-end financial results. The timing of this review may require much of the work leading up to the issuance of a reviewing actuary's report to begin as early as the Spring prior to the valuation date, but no later than the Fall prior to the valuation date. This timing allows appropriate dialog and also allows modifications to be made to the assumptions and the models if agreed to by the reporting entity and the state. As the uncertainty associated with the reserves decreases, the frequency and depth of the review may decrease as well as the number of companies that are selected for such reviews. However, the Working Group acknowledged that for some companies, an examination of its principles-based reserves may need to occur more frequently than the current examination cycle, particularly in the first few years that the requirements are effective. For most life products, the principles-based approach (PBA) is prospective only, so in the early years the amount of PBA reserves will be relatively small.

Responsibility for the Review

8. The manner in which the principles-based reserves review is conducted would be at the discretion of the state. In some cases, the review would be performed by an independent actuary hired directly by the Insurance Department, but in other cases the review may be performed by an actuary of the state. However, it will be the individual state's responsibility for making this determination. The Working Group did not believe it would be appropriate for such reviews to be performed by NAIC staff, as the responsibility for the examination and analysis of the company rests with the domestic regulator. Regulators of other states in which the particular company does business that is subject to PBA for reserve determination may use existing processes and mechanisms for examinations and analysis that are led by the domestic regulators.

Standards to Increase Uniformity & Reduce Potential Duplication of Duties

9. Although the Working Group was unanimous that the responsibility of the review rests with the state of domicile, it was noted that some type of central process that performs a peer review of the work of the various states may be appropriate. This central process would not perform the reviews, but rather would compare the reviews or review process utilized by the various states in order to bring consistency to the process. It was also noted that the experience gathered by the states during the review process will help to establish the uniformity needed. Details regarding tasks to be performed through the central process are expected to be further defined by the Life and Health Actuarial Task Force at a future date, but should be based upon the initial purpose of providing uniformity. Ultimately, such a process might be used to develop, with input from interested parties, a modeling tool that would enable reasonableness testing of companies' models.

10. The Working Group discussed the need for standards to be developed for the review of principles-based reserves. These standards would increase uniformity and eliminate the potential duplication of duties performed by the reviewing actuary, the opining actuary, the examiner and the CPA firm. Some members of the industry noted their support for a well-designed disclosure document, with the format to be determined by Life and Health Actuarial Task Force. At least one member of the Working Group believed that the format should include a narrative section to explain the process and changes in simple terms. This document would not identify the source of all possible problems in a company's process, but if there are issues, it would identify if an area needs to be looked at in more detail. The Working Group noted it would also be necessary to make changes to the existing examination and analysis procedures to allow for minimal duplication of efforts and these procedures should exist

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for use in the initial year of implementation of principle-based reserves. However, the Working Group believes that the reviewing actuary's role will be much different than the analyst's role of reviewing the information that is available on all insurers in the basic financial statements or the data repository.

11. As it relates to the requirement of CPA firms, all state insurance departments are required to have the authority to require an annual audit by an independent certified public accountant. The auditor is required to conform to the standards of his or her profession as contained in the Code of Professional Ethics and pronouncements of the AICPA and the Rules of Professional Conduct of their state. Although the examination and independent audit are separate processes, it is believed that as CPA firms modify their procedures to address new auditing standards, it is likely that the testing performed by the CPA firm will more closely match the risk-focused surveillance approach used in the revised risk-focused examination handbook, and can therefore be utilized more frequently. It was noted that this work could be utilized more frequently in the examination and analysis process if the CPAs workpapers, which are prepared by actuaries who have appropriate qualifications and who are employed or otherwise retained by the audit firm, include assumptions used by the valuation actuary. This is not to suggest that the state can rely solely upon the work of the CPA firm in the oversight of principles-based reserving. Instead, similar to other areas where work is performed by the CPA firm that matches the work to be completed for the examination, if the state is able to access, view and test the work performed by the CPA, it may help to reduce the amount of similar work that needs to be performed during the examination by the state. However, the Working Group is not suggesting that CPA firms modify their audit approaches simply to support examination needs.

Closing

12. The Working Group supports the idea of moving the assurance needed on reserves calculated using principles-based reserves into the examination and analysis function. State examination statutes allow the commissioner flexibility to decide the scope of each examination based upon the particular attributes of the company to be examined. The Working Group acknowledges that standards and changes to existing examination and analysis procedures will be necessary to increase uniformity and reduce duplication of duties.

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