NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research
CIPR newsletter

Revised AG 38 Adopted By NAIC

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This article is the third installment in our series on *Actuarial Guideline XXXVIII—The Application of the Valuation of Life Insurance Policies Model Regulation* (AG 38) in the interest of keeping you informed about the latest developments and regulatory efforts on this important policy initiative. The previous two articles appeared in the January 2012 and April 2012 CIPR newsletters.

On Sept. 12, 2012, the NAIC Executive (EX) Committee and Plenary adopted revisions to AG 38, which addressed certain reserving practices for universal life insurance products with shadow account secondary guarantees (ULSGs), including term universal life products with secondary guarantees. The Executive (EX) Committee had earlier formed the Joint (A/E) Working Group of the Life Insurance and Annuities (A) Committee and the Financial Condition (E) Committee to address these issues, because there was a perceived lack of consistency and uniformity among the states and the industry in setting reserves for these products. After much effort, which included a Draft Framework document outlining issues to be addressed and key decisions, the Joint (A/E) Working Group was able to achieve a universal compromise on these issues, which resulted in the revisions to AG 38.

Consistent with the Draft Framework, the AG 38 revisions take a bifurcated approach to in-force and prospective business. The new Section 8D of AG 38 deals with in-force business and applies to policies and certificates (i) issued on and after July 1, 2005; (ii) issued prior to Jan. 1, 2013; and (iii) in force on Dec. 31, 2012, or on any valuation date thereafter. New policies (prospective business), issued on or after Jan. 1, 2013, are covered under new Section 8E of the revised AG 38.

Section 8D describes the reserve requirements for in-force ULSGs and it provides specifics on whether they apply based on certain face amount levels of in-force business, various policy features and possible exemptions. Generally, most in-force ULSG policies fall under Section 8D,[1] unless the minimum gross premiums for policies are determined by applying charges and credits that produce the lowest premiums (regardless of the imposition of constraints, contingencies or conditions that would otherwise limit the application of those credits and charges).

The primary reserve methodology as it is spelled out in Section 8D uses a principle-based reserve (PBR) deterministic gross premium approach, except that it requires a projected net investment return from existing assets based on the lesser of (i) a portfolio of A-rated corporate bonds purchased in the same year the policies are issued with the yields at the year of the bonds' issuance; or (ii) the company's actual portfolio of invested assets. For the reinvestment assets, Section 8D uses a net reinvestment return rate assumption equal to the lesser of (i) the 12-month average *Standard Valuation Law* (#820) reference interest rate (the composite yield on seasoned corporate bonds published by Moody's Investor Services); or (ii) 7% per annum. The cash flows generated from the starting and reinvestment assets determine the future year-by-year net investment returns, which, in turn, are used to compute the reserve for the policies by discounting the applicable cash flows for those policies.

In addition to this annual reserve determination/valuation, for those companies using the primary reserve methodology, Section 8D also provides for a one-time (2012) reporting of the PBR deterministic gross premium reserve approach using a net reinvestment return rate not greater than the Model #820 maximum valuation interest rate for the year of issue of each policy (rather than the 12-month NAIC reference interest rate).

Section 8D also provides for the use of an alternative reserve methodology (in lieu of the primary reserve methodology) provided the reserves held by the company for the in-force business are at least as great as those determined in accordance with the Nov. 1, 2011, Life Actuarial (A) Task Force Statement on Actuarial Guideline XXXVIII (LATF Statement), subject to certain requirements applicable to the mortality and lapse assumptions used.

Section 8E of the guideline provides details for reserving for prospective business. The approach is consistent with the LATF Statement, as it applies to those policies that fall

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[1] USLGs with or without a shadow account, with multiple sets of interest rate or other credits (or multiple sets of cost-of-insurance, expense or other charges) that may become applicable to the calculation of the secondary guarantee measures in any one policy year.

within the three policy designs[2] described in Method I of Section 8E. It is anticipated that the majority of ULSG policy designs will fit within one of these specified policy designs. For policy designs that fall outside the three policy designs, Section 8E provides for a "greatest deficiency reserve" approach that would result to reserves at least as large as, and likely larger than, reserves determined following the LATF Statement.

The new sections of AG 38 provide for an important role for the NAIC Financial Analysis (E) Working Group (FAWG) in reviewing the reports on the appropriateness of the reserving methodologies submitted by the companies in confidential consultation with the domiciliary state that is ultimately responsible for the regulatory review and evaluation. The involvement of FAWG would also include the issuance of a confidential report sent to non-domiciliary states indicating whether a company's reserve calculations have been performed according to the requirements as they are spelled out in Section 8D or Section 8E. It was also noted many times during the adoption process that the revisions to AG 38 do not serve to delegate regulatory authority to the FAWG or the NAIC, and that these confidential reports are informational in nature and are not considered to be binding on the individual states.

Work continues on issues related to AG 38, and the Joint (A/E) Working Group hopes to have processes in place for the review of prospective business that will become effective as of Jan. 1, 2013, and the appropriate role of the Financial Analysis (E) Working Group in this process.

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[2] Policy Design #1: For a policy containing a secondary guarantee that uses a shadow account with a single set of charges and credits, the minimum gross premium for any policy year is the premium that, when paid into a policy with a zero shadow account value at the beginning of the policy year, produces a zero shadow account value at the end of the policy year, using the guaranteed shadow account charges and credits specified under the secondary guarantee.
Policy Design #2: For a policy that compares paid accumulated premiums to minimum required accumulated premiums (cumulative premium policy), with both accumulations based on a single set of charges and credits specified under the secondary guarantee, the minimum gross premium for any policy year is the premium that, when paid into a policy for which the accumulated premiums equals the minimum required accumulated premiums at the beginning of the policy year, results in the paid accumulated premiums being equal to the minimum required accumulated premiums at the end of the policy year.
Policy Design #3: If, for any policy year, a shadow account secondary guarantee, a cumulative premium secondary guarantee design, or other secondary guarantee design, provides for multiple sets of charges and / or credits, then the minimum gross premiums shall be determined by applying the set of charges and credits in that policy year that produces the lowest premiums, ignoring the constraint that such minimum premiums satisfy the secondary guarantee requirement and ignoring any contingencies or conditions that would otherwise limit the application of those charges and credits.

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