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Small Company Strategies for Efficient Product Development—The Recap

By Ryan Stowe

In August 2014, the Smaller Insurance Company Section (SmallCo) and the Product Development Section co-sponsored the Small Company Strategies for Efficient Product Development webcast. The purpose of this webcast was to break down the product development (PD) process from start to finish, and provide a smaller insurance company perspective regarding how to address challenges that may arise. Key takeaways from the webinar include the following.

Process Management

As smaller company actuaries, we often wear many hats (not all of them actuarial in nature). Balancing the needs of all stakeholders (actuarial, product management, business finance, information technology (IT), sales & marketing, etc.) is important to managing the PD process efficiently. Overly aggressive timelines, or exclusion of key stakeholders, can lead to mispricing of the product, dreaded “day 2” IT projects that need to be cleaned up after product launch, and/or less effective marketing materials and sales results. Continued cycles of the PD process that are not managed effectively can create internal

friction between stakeholders and further extend the speed-to-market for future PD cycles.

Additional considerations should be made with regard to system constraints. This was framed from the perspective of the actuary and the IT service function (internally with policy administration systems, externally with agent or adviser sales platforms, etc.). Are there design elements in the product that are a “must have” and therefore need an IT solution to be figured out? Or can the product be designed in a different manner to reduce the IT effort and development cost without adding unnecessary risk to the product? Empathy for your fellow stakeholders will go a long way for the project at hand and likely be remembered down the road on new PD activities.

IT systems are not the only constraints that you may have to navigate through. Competitive and/or economic environment constraints can play a major role in the PD process. If the market segment you are trying to penetrate is highly competitive, profit margins may be lower, which mean the PD process needs to be as efficient as

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Chairperson's Corner

By Pam Hutchins

I am excited about the start of my year as chair of the Smaller Insurance Company Section (SmallCo). I feel fortunate and challenged to follow several great leaders as recent chairs of SmallCo—fortunate because we have a history of great organization and planning, and challenged because I want to continue that organization and bring new ideas and initiatives to your section.

The council had its annual “face-to-face” meeting in September 2014. As usual it was a great meeting with a great group of council members and friends of the council. We put together a plan for the next section year and I want to tell you about it and give you updated information on the council.

Council officers for 2015 are:

Chair	Pam Hutchins
Vice Chair	Ryan Stowe
Secretary/Treasurer	Brad Shepherd

Continuing council members are:

Tim Cardinal
Grant Hemphill
Mark Whitford

New council members are:

Bryan Amburn
Steven Chamberlin
Scott Haglund

A special thanks goes to council members who just “retired” from the council, but continue to actively volunteer as “friends” of the council.

Don Walker	Chair for 2014
Mark Rowley	Chair for 2013
Narayan Shankar	

PLANS FOR 2015

Webcasts

For 2015 our webcast coordinating committee, chaired by Mark Rowley, has planned four webcasts and there may be more. Watch for announcements with more information and make use of the coupon from your section membership when you register. Topics and dates are:

March 18

Actuarial Standards of Practice No. 1: Its Importance to Smaller Insurance Company Actuaries (professionalism webcast)

June 10

Investing and ALM in the Low Interest Rate Environment—co-sponsored with Investment Section

Aug. 26

Managing Actuarial Functions in a Smaller Company—co-sponsored with the International Section

Dec. 3

Financial Reporting Issues and Considerations for Year-End—co-sponsored with the Financial Reporting Section

Continued on **page 4**

SOA Meetings

Your section council works with the Society of Actuaries (SOA) meeting planner volunteers for several of the SOA national meetings. Look for sessions sponsored by SmallCo at the following SOA meetings:

Life and Annuity Symposium
Valuation Actuary Symposium
Annual Meeting & Exhibit

Consider attending the Smaller Insurance Company Actuaries Forum that the section sponsors at the Valuation Actuary Symposium each year. This session normally receives high marks from attendees and is an opportunity to spend time with other smaller company actuaries, discuss how they do things, and get up to date on current issues affecting smaller companies. We have changed the name of this forum this year to make it clear you don't have to be a chief actuary to attend. All small company actuaries would benefit from this forum.

Council Teams

Your council has several subgroups or teams that work on various subjects. Teams for 2015 are:

Research Team
Product Team
Regulatory Change Team
Low Interest Rate Team
Serving Canadian Members International Strategy
PBR Team

Newsletter

We continue to produce this newsletter twice per year. Mark Rowley and Grant Hemphill continue as co-editors and continue to produce a quality newsletter. You will find many interesting and timely articles as you peruse this edition.

Research

A couple of members of the Low Interest Rate Environment Team are participating on the project oversight group (POG) for the SOA Committee on Life Insurance Research (CLIR) project regarding the low interest rate environment. Two members of our Product Team are serving on the POG

for a research project to survey actuaries about product practices.

Web Page

Be sure to visit the SmallCo Web page regularly for updated information on various items, including updates on principle-based reserves (PBR) in the PBR Corner and access to electronic copies of this newsletter and past issues:

<https://www.soa.org/professional-interests/smaller-insurance-company/sic-smaller-insurance-company-section-detail.aspx>.

Interested in Volunteering?

Your section continues to thrive because of many volunteers willing to work on or give input to various section projects. It is not unusual for our monthly calls to have more "friends" of the council on the phone than actual council members, which means we are able to spread work over many people. We always welcome additional volunteers and will work with you to find a role of interest to you. I have found great friends and valuable contacts through being on the council and plan to continue involvement after my last year is over. I find that the time I put in generates more back to me and my company than I give. If you are interested in volunteering, our calls are usually on the third Thursday of each month between 2:00 and 3:00 p.m. Central time. Contact Jennifer Foster at the SOA for details and to be added to the contact list. Contact information for the section council members is on the SmallCo Web page.

Enjoy this edition of *Small Talk*. ●



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possible to minimize expenses without detracting benefits to the point where your product is uncompetitive in the market. Market conditions, such as historically low interest rates or high levels of volatility, can also affect the level of benefits that you can provide and drive different investment strategies. All of these factors need to be incorporated into the PD process.

Another key component to managing the PD process is obtaining appropriate market intelligence. This should not be limited to competitor product brochures. Having your ducks in a row not only includes knowing your competitors' marketing materials, but really getting to know how competitor products work so that you can design your product *the way you want it to work* (given constraints and managing other stakeholders' interests). That means reviewing competitor filings for contract language and actuarial memoranda. This can also include reading the prospectus for variable products. It seems silly to say out loud, but the more you know, the less you don't know. But beware; there will always be something that you didn't think about that emerges during PD or post-launch that you need to be ready to react to.

Great, you made it to product launch. Now you are done, right? Wrong. Managing post-launch activities is just as important as the pre-launch activities. Reviewing what went right and what went wrong is always good practice. Other activities that need to be addressed include experience study monitoring, financial reporting, and determination of nonguaranteed elements, if applicable, to the new product.

Product Development: Internal or External?

New PD efforts in smaller insurance companies often raise the question of whether the smaller company actuary has the expertise to develop the new product (or product enhancement) internally, or if external expertise should be pursued. Important factors to consider are the availability of data to set assumptions; the expertise in the product line to appropriately model, price and manage risks in the product; and appropriate expertise to provide peer review prior to launch. Failure to address any of these issues can lead to failed launches, uncompetitive products, and/or inappropriate assumptions leading to financial loss and/or compliance issues. There is no substitute for due diligence. If internal resources cannot support the PD process, external sources are available and should be considered.

Common resources include the use of consultants and/or reinsurers. Consultants bring a wide range of knowledge as they have worked with many companies—likely of all sizes, product lines and distribution channels. There is an incredible amount of experience study data that has been collected by consulting firms, from assumption setting for


new business to in-force management for existing business already written. Reinsurers have traditionally been utilized for risk transfer and capital management transactions, but have found new opportunities providing advice and expertise with PD activities as well. Think about it: Why wouldn't a reinsurer be a viable option to consider when looking at external options for PD? Reinsurers have PD actuaries on their staff and routinely engage in pricing activities for potential reinsurance deals. Any knowledge gained is a win for the ceding company as expertise can be built up and retained. Additional knowledge about the product obtained by the reinsurer may lead to more competitive pricing if reinsurance is utilized on new business sales. Not only do you get the benefit of risk-sharing with the reinsurer on business written, you can tap into their knowledge bank of actuarial talent on an ongoing basis because both parties have a mutual interest in the long-term viability and profitability of the business written.

Need More Information?

Presenters Pete Hitchcock, PW Calfas and Jean-Marc Fix walked through each of these topics (and others) from a smaller insurance company perspective. Their industry knowledge and smaller insurance company experiences provided insights into effective management of the PD process, including internal and external resources for project planning, assumption setting, pricing expertise, peer review and risk management processes. The purpose of this webinar was to expose actuaries at smaller insurance companies to challenges they may face and potential options available to them when tackling new PD projects. We can't always do it alone—the good news is that there is help available! If you missed the webinar, or had the opportunity to participate but want to view it again, you can order the recording at: <https://www.soa.org/Professional-Development/Webcast-and-Virtual-Session-Recordings/Small-Company-Strategies-for-Efficient-Product-Development.aspx>. ●

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Editorial

Expert Opinion, Heuristics and Small Company Actuaries

By Grant Hemphill

Why do we have a *Small Talk* newsletter? Why do we exist as a section? Why do other organizations with similar missions exist? [See the article on page 9 “Organizations That Support Smaller Insurance Companies.”] I want to mention some recent articles that I find pertinent to the highly regulated work of small company actuaries.

An announcement that Jean Tirole had won the 2014 Nobel Prize in Economics contained some interesting quotes. He was awarded the Nobel Prize for his analysis of market power and regulation. The focus of his work has been on the market power held by massive companies and how it should be controlled so that they work for consumers, and not the other way around. *He urges regulators to resist coming up with single regulatory regimes to cover very different types of businesses.* [My emphasis.] The announcement says Tirole’s work has been made more important by new forces that generated mega-companies. These forces are privatization, the Internet, and globalization. Tirole says companies with huge market share are not a problem—so long as the market is open. Like most economists, Tirole believes the consumer is best served by a free market—as originally defined. Regulators are a necessity to maintain a relatively free market. One aspect of that is the lack of barriers to entry and exit.

To me, it is normal and expected that successful companies will work to create barriers to entry. Economists tell us to expect this. Insurance, with its long-term promises, must always have barriers to exit. We can’t walk away from our long-term promises. Regulators should help

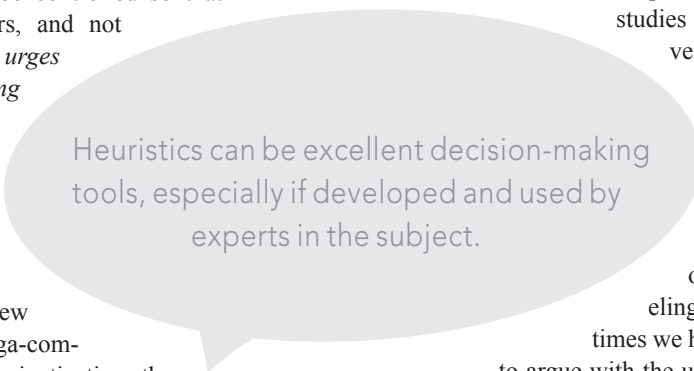
create a free market and not help build unnecessary barriers to entry.

An article by Bruce Bower, “Less is More,” appeared in the Sept. 20, 2014 issue of *Science News* (SN). He compared decision-making with complex computer models and heuristics. That seemed familiar and led me back to Dave Ingram’s article “The Evolution of Thinking,” appearing in the February/March 2012 issue of *The Actuary*. Ingram described the history of research into two (or three) competing methods of making uncertain, complex decisions: heuristics, clinical opinion and computer models. (A heuristic may be roughly defined as a rule of thumb. Ingram’s second method, “expert judgment”

or “clinical opinion” was the subject of earlier studies of decision methods. It seems very close to advanced use of heuristics as he uses it.) We actuaries can enjoy some pride in that the researchers have long considered us to be on the forefront of the modelers. In fact, some of the researchers called modeling “the actuarial approach.” At times we have used our data and models

to argue with the underwriters or marketers who were armed only with heuristics. However, Ingram goes on to note that actuaries also use heuristics. Heuristics can be excellent decision-making tools, especially if developed and used by experts in the subject.

Ingram notes some research that favors the modeling approach over the heuristic and/or clinical opinion approaches. Heuristics and expert opinion must be updated with new information just as models are updated. However, in practice, the clinical psychologists (that were the subjects of the study) tended to stay with their heuristic without updating for new data or research. Ingram also notes that modeling can have the opposite problem—over-fitting to the new data. Ingram



Heuristics can be excellent decision-making tools, especially if developed and used by experts in the subject.

says a clash between modelers and experts relying on their judgment was behind the financial crisis of 2008. I wish he had elaborated on that.

I am a modeler, of course. When setting or updating my assumptions I am as hungry for more data as anyone. However, I know some of my assumptions fit good data well while other assumptions are set by my judgment or heuristics. Ingram says the actuary must be modeler, expert, and a wielder of heuristics. And that might be especially true of the small company actuary.

Bower's SN article more clearly favored the use of heuristics. "Simple rules of thumb may be best for complex financial decisions." "Yet heuristics can outperform number-crunching exercises in fields such as business, where many interconnected, often unknown factors can trigger unpredictable perils." "Given gigabytes of data, bankers and business managers want to use as much of it as possible to make crucial financial forecasts. Studies suggest, however, that less mental effort produces better judgments than complex calculations do in comparably uncertain situations...."

He goes on: "Bank of England economists have conducted simulations based on historical data. Their findings indicate that, when calculating how much money to keep in reserve to cover potential loan defaults, simple measures may be the way to go." "Several simple measures of banks' financial strength from 2006 ... slightly outperformed complex calculations in predicting which of the 116 international banks ended up failing during the global financial crisis in

2007-2009." "That crisis, partly fueled by bad bank loans justified by complex risk formulas, did much to inspire the bank's interest in simpler approaches."

Finally, friend and past chair of the Smaller Insurance Company Section Council, Jerry Enoch, shares this wisdom for discussing principle-based reserves (PBR) with state regulators and legislators: "PBR is designed to accommodate the most complex products available today or imaginable in the foreseeable future. It is not necessary for simpler products and not practical for smaller volumes of business." Tirole would appreciate that.

PBR may also lead to poorer decision-making than current, or other, simpler approaches. ●

A. Grant Hemphill, FSA, FCA, MAAA, is senior actuary for Bruce and Bruce Company in Lake Bluff, Ill. He can be reached at ghemphill@babco.us.com.



Get Ready for the Best Survey Ever

By Jerry Enoch

Well, that's what we're trying to make it. To help us know how to best meet the needs of our members, the Smaller Insurance Company Section (SmallCo) is preparing a survey of our members. We need your responses so we can improve, and we're trying to design the survey to make it easy for you. Our last survey was in late 2009—when people didn't expect interest rates to stay low and principle-based reserving (PBR) was going to be effective around 2013—so we're due for an update. We're even going to wait until spring to send it out, and we're going to give out \$10 gift cards to 10 randomly chosen people who complete the survey. There may not be a pot of gold at the end of the rainbow, but there may be a joke at the end of the survey. If you send a joke to jenoch@alfains.com, and we use your joke in the survey, we'll send you a \$10 gift card. So watch for our survey, and please complete it. We're working to make it a good experience for you.

Jerry Enoch, FSA, MAAA, is vice president and chief actuary for Alfa Life Insurance Corp. in Montgomery, Ala. He can be reached at JEnoch@alfains.com.



LIVING to 100

SOCIETY OF ACTUARIES
INTERNATIONAL SYMPOSIUM

2014 Living to 100 Symposium Monograph

Presentations from the 2014 Living to 100 Symposium are now in an online monograph at livingto100.soa.org. The symposium brought together thought leaders to discuss the latest theories, research and implications on longevity and quality of life. Topics discussed included:

- The evolution of retirement;
- Work flexibility for a graying workforce;
- Business implications of living longer;
- Lifestyle and longevity; and
- Mortality trends and projection methods of older age.

The Living to 100 Symposium featured actuaries, demographers, physicians, academics, gerontologists, economists, financial planners, researchers and other professionals. This monograph will help to continue the conversation about how to address living longer, the impact to social support systems and the needs of advanced-age populations.



Visit livingto100.soa.org to learn more.



Organizations That Support Smaller Insurance Companies

By Grant Hemphill, Norm Hill, Mark Rowley and Don Walker

We hope this is a useful article for you. It is in keeping with the purpose of the Smaller Insurance Company Section to disseminate useful information to small company actuaries. It is an article about various organizations that may be of assistance to you as a small company actuary.

A considerable number of trade and related associations exist in the life/health insurance industry.

American Farm Bureau Federation (AFBF)

The AFBF is a national organization made up of state Farm Bureaus; many of the states in the AFBF have affiliated insurance operations that have grown beyond the boundaries of the membership. Most states started with a property/casualty (P/C) insurer under their own control; several of them added life companies along the way. The P/C companies jointly own a P/C reinsurer—American Agricultural Insurance Company (AAIC); AAIC undertakes to organize annual cross-company conferences for all of the major disciplines, including underwriting and actuarial.

There are currently eight Farm Bureau-affiliated life insurance companies. Three are large, multistate operations; five others serve individual states. There is an annual Farm Bureau Actuarial Conference that rotates among the states; it is a three-day affair with one day devoted to general (cross-discipline) topics and two days where life actuaries and P/C actuaries separate into their own groups. The actuaries do their own meeting planning, select their own topics, and recruit their own speakers. On the life side, the three big companies are still culturally close to their five smaller brethren, and the meetings definitely have a smaller company tone.

The Farm Bureau life underwriters also gather annually, usually as a one-day adjunct to the annual meeting of the Association of Home Officer Underwriters (AHOU). Similarly, Farm Bureau insurance CEOs gather at their own annual conference. Finally, the chief operating officers of the single-state Farm Bureau life companies have their

own meeting. All of these meetings promote discussion of common issues and concerns.

American Fraternal Alliance (Alliance)

The Alliance is a trade association that represents over 70 fraternal benefit societies operating in the United States and Canada that provide life and annuities products to their members. The Alliance strengthens and supports its members and the fraternal benefit sector of the financial services industry by its leadership in advocacy, policy, information, education and member services.

The Alliance works to strengthen and support the fraternal business model by supporting policy positions that promote fair and effective competition and allow fraternal benefit societies the opportunity to fulfill their financial services and community services missions. The Alliance values collaboration with industry, policymakers and non-profit community service organizations. The Alliance also provides its members with meaningful education, information, networking and knowledge-sharing opportunities at the many meetings and webinars it conducts for its members. In particular, the Alliance has an Actuarial Section that meets annually and covers general actuarial topics as well as the specifics of fraternal societies.

The website is fraternalalliance.org.

National Association of Life Insurance Companies (NALC)

This trade association started in the 1950s and was mostly merged into the American Council of Life Insurers (ACLI) in 1992. At one time, it represented hundreds of smaller insurers, located all over the United States, with some concentration in the Southeast and headquarters in Atlanta. By the 1990s, it had accumulated a considerable lobbying fund.

For some years up to 1992, due to mergers, acquisitions, and costs of dealing with systems expansion and regulatory demands, the total number of life insurers in the country

Continued on **page 10**

had been diminishing. This membership decline led to merger negotiations with ACLI, which culminated in the 1992 merger. The meeting to approve the merger was contentious, and led some members to reject the merger and start over on their own.

National Alliance of Life Companies (NALC)

This organization is the successor to the original NALC. Some members who rejected the merger formed this new trade association in 1992. As before, its members are mostly small insurers; but some larger companies have also joined, such as Aflac and Jackson National.

Among other activities, NALC has been very active in protecting interests of small-face-amount policies, such as preneed and final expense. Also, it is committed to preserving state regulation of insurance, and rejects any approach of an optional/required federal charter.

At one point, NALC headquarters were in Rosemont, Ill., a Chicago suburb. After that, it relocated to Sarasota, Fla. It holds two meetings per year, to discuss issues and hear guest presentations. Also, during each year, it holds a number of conference calls on matters related to small-face-amount policies.

This organization's website is www.nalc.net.

Life Insurers Council (LIC) and Life Office Management Association (LOMA)

The LIC organization, headquartered in Atlanta, has, since its 1910 founding, represented home service and true debit industrial life companies. In 1997, LIC merged with LOMA.

Since LOMA is committed to educational programs, such as unit expense studies, it opposes taking advocacy positions. Especially in recent years, this has caused strains with LIC, who by nature feels tied to advocacy of certain legal positions and of lobbying for those positions. This has led some members to join other organizations, although LIC still exists with LOMA.

Each year, LOMA holds numerous conferences, workshops and seminars, including one annual conference and an LIC annual conference.

These organizations' website is www.loma.org.

Life Insurance Marketing Research Association (LIMRA)

The stated mission for LIMRA of Windsor, Conn., is to help members "solve marketing problems through cooperative research ... consultation and educational services." It aids in conducting studies such as persistency of specified products.

LIMRA holds an annual conference that covers its activities.

This organization's website is www.limra.org.

Forum 500

Founded in 1992, Forum 500 is a unique subset of the ACLI. Presumably, its status within ACLI was intended to address sensibilities of former NALC members.

The Forum has its own board of directors and officers. At least one Forum officer has served on the main ACLI board. For a while, it still held its own conventions. Gradually, the Forum seems to have been integrated into the ACLI mainstream.

Complexities of life and health insurance, and its importance to the U.S. economy, dictate that a variety of trade and related associations exist to represent the industry and aid in education and research.

American Council of Life Insurers (ACLI)

This Washington, D.C.-based trade association is by far the biggest U.S. life organization of its kind. Total numbers indicate that it represents over 300 life insurers, with over 90 percent of assets and premiums of life and annuity products. In addition, ACLI covers long-term care and disability income issues.

Officially, ACLI supports optional federal charters for life companies. This position appears to have been heavily influenced by the ACLI's larger companies, such as Prudential. However, ACLI remains very active in state regulatory matters and dealing with the National Association of Insurance Commissioners (NAIC).

Some of its member companies are in other trade associations as well, such as NALC and LIC.

Often, the organization has to walk a fine line to balance diverse interests of its members. In earlier years, this was emphasized by different federal income tax concerns of stock versus mutual insurers. Today, problems often arise from officially supporting optional federal charters and still representing many members who are strongly committed to retaining state regulation.

Interests of members with different product concentrations and devices often cause sensitive situations. Products include universal life with secondary guarantees (ULSG) or competitive term versus more traditional life varieties. Many ACLI members have formed captive subsidiaries and demand coverage of their types of concerns. Company size sometimes enters the equation, since members range from very large companies to Forum 500 members.

ACLI holds numerous meetings and roundtables, along with an annual convention, each year.

This organization's website is www.acli.org.

Health Insurance Association of America (HIAA)

This trade organization of health insurers no longer exists. It was basically supplanted by America's Health Insurance Plans (AHIP). HIAA represented companies who sold both individual and group plans. Companies such as Mutual of Omaha were very active in HIAA.

In 1994, HIAA actively resisted the congressional proposal for national health insurance, known as "Hillarycare." Its ads, known as "Harry and Louise," were well-done and were considered very effective in rejecting the proposal in Congress.

American Health Insurance Plans (AHIP)

Besides conventional individual and group insurers, member companies of this successor trade association include some Blue Cross plans and others who have combined managed-care companies, HMOs and acquisitions of health operations of traditional life insurers.

Some AHIP members were known to complain about its seeming embrace of the Affordable Care Act ("Obamacare") of 2010, rather than the active resistance of predecessor HIAA.

AHIP holds numerous conferences around the country.

This organization's website is www.ahip.org.

Life Affiliates

The Life Affiliates is a group of life insurance companies who are affiliated with a P/C company. Its main function is to hold an annual conference. At the conference there are many roundtable discussions, and, depending on the host's preference, some outside speakers are invited. There is a large focus on networking, and emails are exchanged during the year to get input on various topics. There are not a lot of actuaries who actively participate; it is focused on other insurance personnel. Any company who has an affiliation with a P/C company is welcome to participate.

The 2015 conference is being hosted by ALFA Insurance in Montgomery, Ala.

If you are interested in more information on the 2015 conference, contact Rob Robison of ALFA Insurance. His contact information is 334.613.4275; rrobison@alfains.com.

Life Insurance Conference

This annual conference is jointly sponsored by LIMRA, LOMA, and the Society of Actuaries each year, and has sessions of interest to small company actuaries.

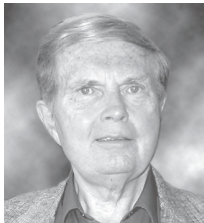
Summary

Complexities of life and health insurance, and its importance to the U.S. economy, dictate that a variety of trade and related associations exist to represent the industry and aid in education and research. ●

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Donald M. Walker, ASA, MAAA, has recently retired from the position of director, Life Actuarial Department at Farm Bureau Life of Michigan in Lansing, Mich. However, he is still an active SOA volunteer, and he can be reached at dmawalker@aol.com.





YIELD

Higher-Yielding Investment Strategies for Small Insurance Companies: Worth the Risk?

By Mark Whitford, with contributions from Sara Pealy

For many insurance companies with investment portfolios under \$5 billion, the current interest rate environment has apparently limited how chief financial officers (CFOs) and investment teams construct their fixed-income portfolios. We are now seeing examples of organizations that have historically invested in fixed income utilize one of two general strategies, neither of which we think is universally appealing.

- 1. Maintain the Status Quo.** Many insurance companies are keeping the yield curve short and sticking to tried-and-true investment types (government agencies, municipal bonds, short-term bonds, money market funds, etc.). However, this strategy tempers prospects for returns, and in some cases, requires that companies lower their expectations for yield.
- 2. Seek Higher Yield.** Insurers can seek higher yield either by (a) lengthening portfolio duration or b) broadening the asset allocation mix to include nontraditional asset classes like syndicated loans, options, limited partnerships, real estate investment trusts (REITs) and mortgage loans. However, such yield-seeking strategies increase exposure to risk—sometimes significantly.

Without question, risks as well as potential rewards are associated with each strategy. The future direction of interest rates is unclear. Will low rates persist? Will they spike? Will there be a gradual rise? Given the uncertainty, committing to either strategy can be difficult.

Ultimately, many insurance companies are simply too conservative—often for good reason—to consider any approach other than the status quo for their own portfolios. Among their CFOs and investment teams, nontraditional asset classes are often perceived as undesirable, either because of the inherent risk or the accompanying operational complexity of accounting and regulatory reporting.

But is this really the case—can the potential benefits of a higher yield strategy be worth the operational and strategic risks? This paper will attempt to provide some information by examining the accounting implications, investment risks and reporting challenges for select nontraditional asset classes.

Background: Results from Clearwater's 2014 Benchmark Survey

In 2014, Clearwater Analytics, a Software-as-a-Service (SaaS) provider of investment accounting, reporting and analytics, conducted research to find out how the investment climate was affecting U.S. insurers' current portfolio allocations as well as asset classes under consideration for the future.¹

The usual suspects were represented on the list of asset classes included in insurers' portfolios, led by government agencies (88 percent) and followed by corporate debt (85 percent), municipal bonds (79 percent), mortgage-backed securities (79 percent), short-term bonds (76 percent) and money market funds (74 percent). In contrast, working capital finance notes (3 percent) represented the least common asset class, followed by forwards (9 percent), futures (10 percent), swaps (11 percent), commingled funds (12 percent) and options (12 percent).

We feel that this data suggests that, under pressure to generate higher returns, many investment professionals either already include, or have expressed a willingness to explore, alternatives to traditional fixed-income securities. To illustrate: Just five years ago, bank loans were uncommon investments among insurers. Today, 24 percent of insurance companies are investing in them, and another 9 percent are considering them as potential investments. Our analysis is that as insurance companies increasingly seek more yield, their exposure to nontraditional asset classes is growing. For example, the survey revealed that 7 percent of insurers are considering, or are already invested in, working capital

finance notes (WCFI), which were only added as an admitted asset in late 2013.

Implications for Accounting and Reporting

It is important for CFOs and investment teams considering these asset classes to understand the accounting and reporting implications. Below, we examine five nontraditional asset classes—syndicated loans, options, limited partnerships, REITS and mortgage loans—and certain associated accounting and regulatory challenges for each.

Syndicated Loans

Overview

As an alternative to traditional fixed-income securities, syndicated loans (commonly referred to as bank loans) are designed to provide companies with an alternative source of funding outside of traditional fixed-income securities. This market also provides funding access for issuers who may not be able to borrow in the traditional fixed-income markets. The issuers in this market are of lower credit quality and all are below-investment-grade-rated.

Bank loans are senior in the capital structure, which can provide more security in the event of default. Bank loans typically provide a higher level of income with an additional feature of a floating rate coupon. Bank loans are typically structured on five distinct levels:

Level 1: Issuer—Provides information about the entity borrowing the funds.

Level 2: Agent Bank—Provides information about the bank organizing and syndicating the loan.

Level 3: Deal—Outlines the general terms and conditions of the overall loan, including the global loan amount, underwriters and basic covenant information.

Level 4: Facility—Defines the details surrounding maturity date, various fees, and type of facility, including revolver, delayed draw, term loan and others.

Level 5: Contract—At the contract level, lenders have the ability to negotiate specific terms and conditions such as floating-rate indexes, accruals and float spreads.

Certain Accounting Implications

Statutory Financial Reporting (STAT): Unlike corporate bonds, for which terms and conditions are fixed once issued, syndicated loan contracts are updated and re-signed on a fairly regular basis (typically quarterly). Updates may be immaterial, such as place of notice, or material, such as information about rate changes, amount outstanding, or tenure. When details of a re-signed loan are deemed materially different, old facilities are exchanged for new ones.

Syndicated loans trade flat with long, sometimes unpredictable settlement dates. As such, they do not accrue until the trade settles. Best practices allow for private placements to be recorded as of the date the security is recognized as legally changing hands. Because syndicated loans are often treated as private placements with respect to reporting, they too are recorded as of the date they legally change hands.

Due to the tiered structure of syndicated loans, data provided at the most granular level most accurately reflects security information. Contract-level information is preferable, but if unavailable, facility level is sufficient for accounting needs.

Ultimately, many insurance companies are simply too conservative—often for good reason—to consider any approach other than the status quo for their own portfolios.

Third-party data tends to be limited for these securities. Wall Street Office (WSO) is currently seen as the premier data source and trading platform for syndicated loans, though some other data providers offer third-party data as well. Available third-party data (including that from WSO) is typically facility-level data rather than contract-level data.

Since syndicated loans are not registered with the SEC, they do not require a mandatory, standardized security identifier. However, many issuers do take advantage of traditional CUSIP assignments by the CUSIP Bureau.

International Financial Reporting Standards (IFRS): Currently, syndicated loans are covered under IAS 39 Financial Instruments: Recognition and Measurement. Over the next few years, we believe most companies will convert to IFRS; although, in the United States, IFRS may not be required of many small insurance companies. Once completed, the accounting treatment of bank loans will be covered under IFRS 9, which requires that assets pass the business model test and cash flow test in order to be reported at amortized cost. If the asset does not qualify for amortized cost, it may be measured at fair value—Other

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Comprehensive Income (OCI), but only if it passes the cash flow test, and if assets are managed to achieve the business model objectives through both the collection of contractual cash flows and sales. Interest income using the effective interest rate method and impairment losses (and reversals) is recognized in profit and loss, and the net cumulative fair value gain or loss is recognized in OCI.

GAAP: FAS115 (also known as ASC-320) is the pronouncement that covers these assets and addresses accounting and reporting for all investments in debt securities. Classification of securities by ability and intent as trading, available for sale, or held to maturity becomes relevant when determining the treatment of unrealized gain or loss impact on income, and in conjunction with the balance sheet representation. Further information about this pronouncement can be found in Clearwater Analytics' Market Insight Paper "FAS 115-2: A Practical Analysis."²

Investment Risk

As previously mentioned, syndicated loans are a fixed-income asset class with a below-investment-grade rating and are not securitized. They pay interest on a floating rate basis, typically LIBOR plus a spread. Oftentimes there is a LIBOR floor in the structure that provides a minimum level of income. This floating-rate nature reduces interest rate risk versus other areas of fixed income. Therefore, the primary risk inherent in bank loans is credit risk as the borrowers tend to be lower in quality than other areas of fixed income. Additionally, bank loans tend to have a higher level of liquidity risk as the market is entirely private and trades differently than other areas of fixed income. Therefore, robust back office operations are required to manage liquidity risk as well as recognition of the longer settlement periods.

Reporting Challenges

From a STAT perspective, syndicated loans are fairly straightforward in concept. Non-fund direct investments are treated like a traditional corporate bond and reported on a firm's Schedule DB Part 1. As noted elsewhere, however, the private placement nature of bank loans limits the availability of third-party data to investors for reporting purposes; consequently, the largest challenges tend to be primarily data-related.

The stratified nature of these securities naturally leads to hierarchical data collection. Priority is given to data collected at lower levels, but also allows for potential inheritance of data from higher-level modeling. Multiple feeds for both

security master data and reconciliation data are required. Without a system of daily data validation, this added layer of reporting complexity (not seen with traditional corporate bonds) can cause data errors and reporting delays. In addition, data may not be available or finalized at the time the reporting cycle comes due. To compensate for missing data the reporting system may need to be able to default to more conservative approaches while simultaneously incorporating the updated data when available.

Data is not only difficult to obtain; it can come at a premium cost. Data providers for these securities are few, and many insurers, especially at the smaller end of the market, may only have access to the data through their asset manager. Consequently, a special data feed may need to be built by the asset manager or other provider for security characteristics more commonly obtained through conventional third-party data providers. A system that can interface with a variety of systems and data formats is needed to provide the necessary flexibility.

Options

Overview

Options are derivative securities. Their value is based on the performance of an underlying asset or basket of assets such as equities, indexes, commodities and currencies. Though often considered a risky investment, the right option strategy in the right hands has the potential to help an insurer significantly mitigate risk as well as generate income. Based on regulatory requirements, however, insurance companies are not to buy options for speculative reasons but only to hedge an existing risk.

"Plain vanilla" options, which are the most basic options available to investors, typically lack any special characteristics and are quite simple. Option contracts involve two parties: the writer (the party selling the option) and the holder (the buyer of the option). Option writers maintain short positions and are obligated to either purchase or sell the underlying asset, depending on the nature of the contract. Conversely, holders maintain long positions and have the right, but not the obligation, to sell or purchase the underlying asset.

Contracts fall into two basic categories: "puts" and "calls."

Put option: The holder has the right to force the writer to purchase the underlying asset from the holder (that is, "put" the asset to the writer).

Call option: The holder has the right to force the writer to sell the underlying asset to the holder (“call” the asset from the writer).

Whether “plain vanilla” or a more complex variety, options are issued with a strike price (also called an exercise price), which is effectively the break point at which an option either becomes valuable or loses value with respect to the current market price of the underlying asset. When exercising an option, holders need to be aware of three stages:

In the money: If exercised, the holder stands to benefit financially.

At the money: If exercised, there is no benefit or loss to the holder.

Out of the money: The holder loses money exercising the option.

In the case of both “at-the-money” and “out-of-the-money” options, the holder is highly unlikely to exercise the option.

Accounting Implications

Insurers have two ways of accounting for options: hedge accounting and fair value accounting. The qualitative nature of hedge accounting requires a greater degree of manual intervention by the individual or firm preparing the financial statements, making it difficult to automate. Conversely, fair value accounting for options behaves much like traditional accounting for equities; it is quite simple from a reporting standpoint and easier to automate. When fair value accounting is used, changes in the fair value of the option during the holding period will flow through unrealized valuation gain or loss in statutory accounting, which ultimately affects surplus.

The default treatment for both GAAP and IFRS accounting standards requires that changes in fair value during the holding period flow through net income.

Investment Risk

Options are typically used in an effort to offset investment risks of other asset classes. For example, options may be purchased with the goal of offsetting the unwanted risk in

the movement of interest rates. With options, there is the risk to lose your entire investment as they will not always mature “in the money.”

Reporting Challenges

Nearly all insurers, large and small, choose to use the fair value approach when accounting for their derivative exposure because hedge accounting is completely voluntary. With options, this becomes an especially important distinction for two reasons. First, most small- to medium-sized insurers employ an income generation strategy in conjunction with an equity portfolio, which is not considered an effective hedge strategy; therefore, hedge accounting becomes inapplicable. Second, hedge effectiveness testing (required for treatment of the derivative under hedge accounting) is difficult to complete and demands arbitrary judgment on behalf of the individual or firm preparing the statements. In the absence of a standard for classifying the effectiveness of a hedge, this type of

accounting carries a large amount of audit risk for what typically results in nonmaterial differences. In short, the cost/benefit payoff of hedge accounting is not worth the headache for most insurers.

Though often considered a risky investment, the right option strategy in the right hands has the potential to help an insurer significantly mitigate risk as well as generate income.

Limited Partnerships

Overview

Limited partnerships are defined in Statement of Statutory Accounting Principles (SSAP) No. 48—Joint Ventures, Partnerships and Limited Liability Companies as partnerships having two outstanding classes of partners: (a) general partners, who manage the partnership and have a personal liability in the general obligations of the partnership (i.e., active investors who can be held fiscally liable for outstanding obligations of the partnership); and (b) limited partners, who are restricted in the scope of their involvement and cannot be held personally liable for fiscal obligations of the partnership (i.e., passive investors). These partnerships are basic in structure and are classified as admitted assets under SSAP No. 4 – Assets and Non-Admitted Assets.

Accounting Implications

Limited partnership shareholders holding 10 percent or less (minority ownership) should account for their partnership interest based on the underlying audited GAAP equity of

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the investee. If the audited GAAP financial statements are unavailable, the value of the limited partnership may be recorded based on the underlying U.S. tax-basis equity.

Shareholders with 10 percent or more interest in the partnership are directed to value the partnership in one of three ways: market valuation (subject to paragraph 8.a. of SSAP No. 97), U.S. GAAP (subject to paragraph 8.b. of SSAP No. 97), or U.S. statutory accounting (subject to paragraph 9 of SSAP No. 97).

For the purposes of SSAP Nos. 48 and 97, affiliated entities maintaining separate ownership in a limited partnership are determined to each hold the sum of the ownership. For example, if entity A is a 5 percent shareholder in a limited partnership, and entity B (an affiliate of entity A) is an 8 percent shareholder in the same partnership, then each entity is presumed to control 13 percent of the partnership. In this case they would each surpass the 10 percent threshold and therefore value the partnership according to SSAP No. 97.

Investment Risk

For income-oriented investors, master limited partnerships (MLPs) have the potential to provide an attractive source of after-tax yield along with potential for capital appreciation. Exchange-traded MLPs are subject to equity market volatility. Over 80 percent of exchange-traded MLPs are in the energy sector and may include exploration and production, pipelines, and processing and storage facilities. While industry concentration risk is a factor, potential upside is possible as the asset class is “repriced” due to increased demand from institutional investors. Institutional investors must consider that MLPs typically generate unrelated business taxable income (UBTI). Many MLPs may provide for disproportionate economic sharing of cash distributions and entity valuations between general partnerships (GPs) and limited partnerships (LPs). In addition, the favorable pass-through tax treatment of MLPs may be subject to unpredictable changes in U.S. tax laws.

Reporting Challenges

Investments in limited partnership are filed on Schedule BA, which has special reporting requirements that can present a challenge for insurers. Transactions involving Schedule BA assets must be tracked separately from other acquisitions on regulatory reporting schedules. Moreover, certain fields require judgment from the insurer and are not necessarily applicable to other investment types. For example, Column 9 of Schedule BA requires that insurers declare the type and strategy associated with the partnership investment, of which there are 13 possible arbitrary designations.

REITS

Overview

REITs are trusts, corporations or associations managed by one or more trustees or directors, where beneficial ownership may be transferred to investors through shares or certificates of beneficial interest.

REITs would otherwise be taxable as a domestic corporation, except that (a) they are neither a financial institution nor an insurance company, (b) there are 100 or more beneficial owners, (c) the trust, corporation or association is not closely held, and (d) it meets certain legal requirements with respect to distributions, interest, income generation and tax elections on an annual basis.

For investment reporting purposes, direct investments in REITs are treated as equities irrespective of whether they are publicly traded or privately held, so long as they meet the designations set forth in 26 US Code § 856. Tax treatment of REITs is unlike traditional equities, although equally straightforward. To maintain REIT status, the U.S. tax code requires that an REIT distribute at least 90 percent of its capital gains. Distributions may be allocated to ordinary income, capital gains or return of capital, depending on the election of the shareholder.

One of the primary benefits of this structure is that REITs do not pay corporate taxes. Though investors are taxed on capital gains, they avoid the double taxation that typically accompanies traditional corporate equities and fixed-income securities.

Insurers can also gain access to this market indirectly through debt issued by an REIT, commonly in the form of senior secured debt, which is treated much like a corporate bond.

Accounting Implications

The accounting treatment for REITs is fairly straightforward. The key consideration is that acquisition and disposition of a publicly traded REIT must be reported on trade date, much like any other common stock. Like similar private-placement transactions, insurers record transactions in private REIT securities as of the funding date. Both publicly traded and private placement REIT investments are recorded at fair value, inclusive of any associated brokerage fees. Reporting entities entering into a subscription agreement commit to purchasing an equity or equity-type security (such as an REIT), but cannot fund and settle the purchase until the actual security is issued and the trans-

action has been ruled to be settled, either by the Financial Industry Regulatory Agency (FINRA) or the listing exchange.

Investment Risk

Listed REITs are exchange-traded and are subject to equity market volatility. Risk factors include:

- Potential changes in the regulatory environment and other equity risk factors such as activities or changes in company management;
- Underlying supply and demand fundamentals;
- Macroeconomic factors such as changes in interest rates; and
- Changes to the 1960 Act of Congress that introduced REITs and their favorable tax treatment.

Across the industry, dividend yields have recently ranged between 3 and 4 percent, and dividend payments have grown significantly over the past 20 years. Dividend yields vary by property sector and individual company. The table below illustrates the historical returns of REITs in the context of the broader U.S. equity and fixed-income markets. All data is as of Dec. 30, 2014.

Indexes	5 Yr. Annl Return	5 Yr. Std Dev	5 Yr. Sharpe Ratio	10 Yr. Annl Return	10 Yr. Std Dev	10 Yr. Sharpe Ratio	20 Yr. Annl Return	20 Yr. Std Dev	20 Yr. Sharpe Ratio
FTSE NAREIT All Equity REITs Total Return	16.9%	16.1%	1.04	8.3%	25.3%	0.27	11.5%	20.1%	0.44
S&P 500	15.5%	12.9%	1.19	7.7%	14.6%	0.43	9.9%	15.1%	0.47
Barclays U.S. Aggregate	4.4%	2.7%	1.64	4.7%	3.2%	1.01	6.2%	3.6%	0.98
Barclays U.S. Treasury— Bills	0.1%	0.0%	1.84	1.6%	0.6%	0.25	2.9%	0.7%	0.25

Source: FactSet as of Dec. 30, 2014.

Private REITs are an illiquid asset class with moderate to high investment risk. They are available in two varieties: one for retail investors and the other for institutional investors (often in lieu of a commingled fund or partnership structure). Dividend yields for retail-distributed private REITs are typically in the 5 to 6 percent range. Private REITs tend to exhibit less price volatility than listed REITs, but liquidity is poor and management is frequently less active. Agency conflicts in private REITs are an ongoing risk.

Reporting Challenges

As with many other nontraditional assets, access to third-party data can be limited for REITs, especially in privately placed REIT investments. Further, while the accounting requirements for these instruments are often quite simple and do not require the abundance of inputs associated with other security types, the risk exposure in an REIT investment may be fairly high and the transparency of the underlying assets may be inadequate.

Mortgage Loans

Overview

Mortgage loans are direct (whole) mortgage loans (e.g., commercial mortgage loans), as opposed to mortgage-backed securities (MBS). Because the investor purchases the whole loan rather than shares, they are not considered securities by the National Association of Insurance Commissioners (NAIC) (where a security is a share, interest or participation), although they meet the definition of an “admitted asset” under SSAP No. 4.

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Mortgage loans are typically non-recourse loans secured by mortgages on real estate (buildings, shopping centers, etc.). In the event of a default, asset sales—rather than builder or owner finances—are used to repay the lender.

Accounting Implications

The NAIC addresses accounting for mortgage loans in SSAP No.37, which states that all costs associated with the purchase (including origination, acquisition, or commitment to purchase) are to be charged to expense as incurred, and that mortgage loans are to be assessed at fair value. A common practice among insurers is to originate a mortgage loan for an asset such as a building and report it on the Schedule B. Companies engaging in this practice are required to report the loan net of any commitment and origination fees associated with the origination of the loan. Loans originated by an entity other than the reporting entity are to be recorded at the amount paid to the seller, which sometimes results in a difference between the actual amount paid and the principal amount.

SSAP No. 37 also requires that amortization of these loans be recognized as an adjustment of yield over the life of the loan in order to produce a constant yield. Insurers that maintain a large portfolio of similarly priced and valued loans, with reasonably predictable repayment schedules, are to include estimates of future prepayments. Any adjustments to yield are to be credited or charged to interest income.

Other important accounting implications include (a) recognizing prepayments as liabilities, with prepayment penalties assessed to the borrower recorded as investment income; and (b) understanding when and how to report a loan as impaired. Mortgage loans are considered impaired when the reporting entity can reasonably assume they will not be repaid. The value of the impairment is the difference between the net value of the collateral and the reporting entity's investment in the loan. Reporting entities required to maintain an asset valuation reserve (AVR) must include the unrealized gain or loss on the impairment in the AVR calculation.

Investment Risk

Mortgage loans are a highly rated, illiquid asset class that we believe has historically provided compelling risk-adjusted returns. The relative high yields, versus other similarly rated securities, tend to be stable, paid current and call-protected. However, additional risks to consider before investing in whole loans include:

- Adverse changes in international, national or local economics or demographics
- Reduction or change in sources of debt or equity financing, including changes in interest rates
- Increases in real estate taxes and/or operating expenses, including energy prices
- Adverse changes in law, regulations or government policies, including environmental and zoning laws
- Portfolio concentration risk as it relates to property type or geographic mix
- Natural and unnatural disasters, including terrorism.

In the hands of a skilled manager adhering to a disciplined investment process that includes stringent risk oversight, we believe the risks inherent in higher-yielding investments are both manageable and worthwhile.

Reporting Challenges

Automation of reconciliation and data acquisition can be problematic for direct mortgage loan reporting. All too frequently, insufficient third-party data means servicers or servicing departments within an insurer must provide the data. This creates singular challenges if the position is entered at either a premium or discount, as the amortization schedule is necessary for calculating yield and amortization expense or accretion income. Another common pain point for insurers is that a lack of reporting infrastructure requires them to complete the Schedule B regulatory reports required for direct mortgage loans by hand. Companies with a high number of these investments (usually life insurers) may have systems that support the origination or servicing of the loans, but not the regulatory reporting. In many cases, the evaluation and reporting infrastructure for these securities is separated from the rest of their portfolio. For a full portfolio view, insurers must manually aggregate their mortgage loan investments. Ideally, a single system would be used for both the investment activity and the mortgage loan activity.

Other Key Considerations: Asset Class Reporting Schedules, Classifications and Risk-Based Capital (RBC) Charges

	Reporting Schedule and Classification	RBC Charges and Projection
Syndicated Loans	Reported on Schedule DB Part 1 as "Long-Term Bonds Owned December 31 of Current Year." Classification depends on the investment quality of the security and is similar to that of a long-term bond.	Treated as long-term bonds with a relatively low RBC charge.
Options	Reported on Schedule DB Part A.	Relatively low RBC charges.
Limited Partnerships (LPs)	Reported on Schedule BA as "Other Long-Term Invested Assets Owned December 31 of Current Year." Classification depends on the investment quality of the security and is similar to that of a long-term bond.	LPs tend to have a higher RBC charge depending on the underlying asset, the type of insurance company, and the NAIC designation, as it is often difficult to accurately determine the investment risk.
REITs	Reported on Schedule D Part 2 as "Common Stock Owned December 31 of Current Year." These are treated and classified as equities.	Treatment as an equity (Common Stock—Unaffiliated) results in a high RBC charge that may be between 15 and 45 percent, depending on the entity and whether the entity will be making tax (AVR) adjustments.
Mortgage Loans	Reported on Schedule B as "Mortgage Loans Owned December 31 of Current Year." Classification of these assets is largely dependent on the type of mortgage purchased.	Mortgages in good standing generally have a relatively low RBC charge (with the exception of Farm Mortgages and Commercial Mortgages—Other, both of which will have higher RBC charges). Mortgages that are not in good standing (for example, those that are more than 90 days past due/are delinquent) will be assessed a higher RBC charge.

Conclusion

The current low-interest-rate environment has apparently compelled many insurance companies to actively seek a more diverse set of investment strategies in an attempt to offset the loss of investment income from traditional asset classes. However, these diversified investment strategies inherently lead to riskier investments.

With this caveat in mind, some of the asset classes discussed in this paper potentially lend themselves to greater return with proportionately less risk. For example, syndicated loans have historically behaved much like a traditional fixed-income security and are somewhat more familiar to investors. In addition to their classification as senior debt of the issuer, these investments often carry the financial backing of their agent bank or banks, which in the event of a default can offer a greater likelihood that the lender will be repaid.

Options—in particular those of the exchange-traded variety—are another class of investments with a risk/reward structure that may be more palatable for investors. Similar to other exchange-traded securities, the counterparty risk in an exchange-traded option investment is significantly lower than that of an over-the-counter offer, thereby removing a significant portion of uncertainty for investors. Of course, this does not remove the risk inherent in options investments; rather, it should render virtually irrelevant the question of whether the counterparty will uphold its end of the contract.

The equity-like treatment of REITs means investors maintain an ownership right in the company or trust. In the event of a default, they are not personally liable for any repayment of debt on behalf of the issuer. However, this also means they are the last to be repaid (assuming there is enough money to make any repayments to investors and creditors), and could potentially lose their entire investment.

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Limited partnerships and commercial mortgage loans are often considered riskier than syndicated loans, options and REITS, largely due to their structure. Contracts may lack the safeguards of the aforementioned investments unless the investor has been diligent throughout the negotiation process. In the event of a default, investors run a significantly higher risk of losing their invested capital. However, they hold the potential for a higher return compared to more traditional investments. For investors with an appetite and tolerance for the risk involved, these investments may be a worthwhile addition to the portfolio.

In the hands of a skilled manager adhering to a disciplined investment process that includes stringent risk oversight, we believe the risks inherent in higher-yielding investments are both manageable and worthwhile. With no clear direction for interest rates in sight, it is our view that nontraditional asset classes warrant thoughtful consideration by insurance companies for inclusion in their investment portfolios.

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ENDNOTE

¹ The 2014 Insurance Peer Benchmark Survey polled finance and accounting professionals from a broad range of insurance companies in 2014. Responses were received from over 400 participants.

² <http://info.clearwater-analytics.com/fas115-2-practical-analysis>.

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VM Reporting Requirements for a Company with Low-Risk-Profile Products

By Bryan Amburn, Stefanie Harder and Tim Cardinal

Introduction

The advent of principle-based reserves (PBR) will undoubtedly herald many changes for companies. There already has been a lot of discussion around what PBR requires for stochastic reserves, deterministic reserves (and the exclusion tests for both), and of course the net premium reserve (NPR). Many small companies subscribe to the view that the increased reserving work is not commensurate with the risk entailed in their mundane insurance portfolio. There will be some relief to this work if the American Council of Life Insurers' (ACLI's) proposal to allow cash flow testing (CFT) models to be utilized to perform the deterministic exclusion test (DET) and stochastic exclusion test (SET) is adopted.

Even with the ability to “kill two birds with one stone” with your CFT model, there are still reporting requirements embedded in the Valuation Manual (VM) that must be addressed, in particular VM-31: “PBR Report Requirements for Business Subject to a Principle-Based Reserve Valuation.” A read-through of this section of the VM can be pretty daunting. The good news is, if you work for a small company and are already complying with the Actuarial Opinion and Memorandum Regulation (AOMR, now contained in VM-30), then you have done most of the work already. With a few adjustments to the AOMR, you can have a report that satisfies VM-31.

This article assumes that the ACLI's proposal to use the CFT model for performing the SET and DET is adopted into VM-20. The rest of this article is directed at providing the simplest path for a small company that has passed the DET and SET. Thus, stochastic and deterministic reserves do not need to be calculated and hence not documented. There is an argument that a company that passes the SET and DET does not have to comply with VM-31. Unfortunately, the VM provides conflicting guidance in different sections. It is assumed that VM-31 will apply to companies that hold the net premium valuation (NPV) reserve and have done the

work to pass the SET and DET (otherwise, this would be a really short article). The simplest path is to start with your AOMR and make the appropriate modifications to develop the principle-based reserve actuarial report (PBRAR). There will be sections that are different, but whenever possible we identify where the same verbiage can be used simultaneously for both reports to minimize future maintenance.

Summary Comparison

Figure 1 compares and maps the AOMR requirements alongside the VM-31 PBRAR requirements into the categories of equivalent, similar and new. Some items might be new in VM-31 but not new to your AOMR. Your AOMR may contain descriptions and content that VM-30 does not explicitly require. VM-31 makes these requirements explicit.

Sections 3.A.1-3, 3.A.7-12, 3.B.1-6 in VM-30 are specific to the AOMR and are not applicable to the PBRAR. Most of the Other Disclosure Items in VM-31 Section 3.E and a few items regarding assets and investment strategies in Section 3.C are newly introduced in VM-31 and the PBRAR.

The single largest distinction between the AOMR and the PBRAR can be captured by the words transparency and disclosure. VM-30 requires the AOMR to disclose, i.e., what is used. What are the mortality rates? What are the lapse rates? VM-31 requires more details in the PBRAR regarding how and why: descriptions of methods, development, rationale, impact/quantification of choices, demonstrations, and underlying data comparing actual to expected results. In various places VM-20 allows the actuary to exercise judgment. VM-31 requires that judgment be made transparent.

AOMR and PBRAR Section-by-Section Comparison

The AOMR and PBRAR can be organized into the following sections:

Continued on page 24

Figure 1: Comparison—Actuarial Opinion and Memorandum (VM-30) and Principle-Based Reserve Actuarial Report (VM-31)

AOMR Requirements	No PBR Equivalent	PBR Equivalent	Similar PBR Requirement	New PBR Requirement	Section
3.A.1.a-f	X				
3.A.2	X				
3.A.3	X				
3.A.4		3.C.1			Other Disclosure Items
3.B.9.a-c			3.C.2, 3.C.5		Overview/ Summary
3.A.5			3.C.3-4		Results
3.A.6		3.C.6			Other Disclosure Items
3.A.7-12	X				
3.B.1-3	X				
3.B.4	X				
3.B.5-6	X				
3.B.9.e		3.E.3.h			Prod Assumption
3.B.9.f			3.E.3.i-j		Assets
3.B.9.g			3.C.7.a-c		Prod Assumption
3.B.10			3.C.8, 3.E.3.k		Assets
				3.C.7.d-g	Prod Assumption
3.B.12.a			3.E.2		Other Disclosure Items
3.B.12.b-c			3.E.1.a-c		Results
3.B.11			3.C.10		Other Disclosure Items
3.B.13	X				
				3.C.9	Assets
				3.C.11	Other Disclosure Items
				3.E.3.a	Other Disclosure Items
				3.E.3.b-d	Other Disclosure Items
				3.E.3.l	Assets
				3.E.3.m-n	Other Disclosure Items
				3.E.3.e	Other Disclosure Items
				3.E.3.f	Other Disclosure Items
				3.E.3.g	Prod Assumption
				3.E.4-6	Prod Assumption
				3.E.7	Assets
				3.E.8	Prod Assumption
				3.E.9	Prod Assumption
				3.E.10	Prod Assumption
				3.E.12	Prod Assumption
				3.E.13-14	Other Disclosure Items

Overview/Executive Summary
 Product Assumptions
 Assets
 Other Disclosure Items
 Results

Below, each section is organized into subsections. This is simply a representative structure. The reports could be organized differently.

Overview

The overview pertains to AOM/VM-30 3.A and PBRAR/VM-31 3.C. Topics can be organized into subsections as:

- Introduction
- Product Descriptions
- Description of Cash Flow Model
- Valuation Assumptions and Margins
- Reinsurance
- Derivative Programs
- Process to Monitor Changes in Experience
- Interest Rate and Equity Performance Scenarios
- Use of Modeling Date That Precedes Valuation Date
- Stochastic Modeling Exclusion
- Summary of Reserve Results
- Signature Section

VM-30: Section 3.B.9.a-c vs. VM-31: Sections 3.C.2, 3.C.5

3.B.9.a-c of the AOMR has requirements to provide product descriptions including market description, underwriting and other aspects of a risk profile and the specific risks the appointed actuary deems significant, along with the source of the liability in force, and the reserve method and basis. This section of the AOMR would need to be revised to reflect the reserving method and basis of VM-20 and 21, matching the PBR requirements of section 3.C.2. Section 3.C.5 requires the actuary to describe material risks associated with policies subject to PBR valuation. The AOMR risk descriptions in 3.B.9.a should be tailored to meet this requirement.

Product Assumptions

Product assumptions can be organized as:

- Mortality Assumptions
- Premium Persistency
- Lapse
- Dynamic Lapse Formula
- Competitor Rate
- Variable Account Assumption
- Interest Crediting
- Expenses

VM-30: Section 3.B.9.g vs. VM-31: Section 3.C.7.a-c
 Already contained in the AOMR is documentation of the assumptions used for lapse rates (both base and excess), interest crediting rate strategy, mortality, policyholder dividend strategy, competitor or market interest rate, annuitization rates, commissions and expenses, and morbidity. The level of documentation is such that another actuary should be able to take the documentation and reproduce the results contained in the memo. PBR documentation requires the actuary to go one step further and document how those assumptions were developed; i.e., experience vs. judgment, and the source of the experience. You'll also need to disclose any changes from the previous year in the method of determining assumptions and the plan to monitor experience for future assumption-setting.

VM-30: Section 3.B.9.e vs. VM-31: Sections 3.E.3.h, 3.E.9

The requirements for disclosing how reinsurance cash flows are modeled are pretty consistent between VM-30 and VM-31. Paragraph 3.E.9 of VM-31 requires more explicit documentation of the treatment of reinsurance in establishing PBR reserves. As the CFT model will be used in the exclusion tests, the reinsurance documentation necessary has already been documented.

VM-31: Section 3.C.7.d-g

These requirements revolve around the assumption margins. These will not be applicable given the CFT model will be used for the exclusion tests.

VM-31: Section 3.E.3.g

While loan treatment and assumptions are not called out specifically in the requirements of VM-30, cash flows resulting from loan treatment are likely material and have been included in the CFT model and documented. VM-31 specifically calls for loan modeling documentation.

VM-31: Sections 3.E.4-6

VM-31 paragraphs 3.E.4, 3.E.5 and 3.E.6 deal with PBR-prescribed assumptions for mortality, policyholder behavior and expenses, respectively. The CFT model assumptions will be used for the exclusion tests, and the documentation of those respective assumptions is already covered.

VM-31: Section 3.E.8

This paragraph of VM-31 covers revenue-sharing assumptions for establishing PBR reserves. As the CFT model will be used for exclusion tests, this section is not applicable.

VM-31: Section 3.E.10

This paragraph specifically concerns the treatment of non-guaranteed elements (NGEs) for determining PBR

reserves. Like the previous paragraphs, this will not apply as the CFT model will be used for exclusion tests, and has been covered in the documentation specific to the CFT model (namely from VM-30: Section 3.B.9.g and VM-31: Section 3.C.7.a-c above).

VM-31: Section 3.E.11

Paragraph 3.E.11 documents the results of the DET and SET.

Section 3.E.11.a identifies each group of policies that used both the DET and SET.

Section 3.E.11.b documents the groups of policies that pass the SET, and discusses the SET used. There are three SETs available: passing the stochastic exclusion ratio test, the stochastic exclusion demonstration test, or certification that the group of policies does not contain material interest, tail or asset risk.

Section 3.E.11.c displays results of any stochastic exclusion ratio tests.

Section 3.E.11.d documents the rationale for using the stochastic exclusion demonstration test(s) and the demonstration, itself.

The demonstration method requires the use of a modified deterministic reserve, with projections for the current and two subsequent calendar years of this, given exposure to sufficient adverse deterministic scenarios. The demonstration method, if chosen, must be repeated at least once every three calendar years after electing the method.

Section 3.E.11.e documents support for the certification method of stochastic exclusion.

Section 3.E.11.f documents the group of policies that pass the SET, and if stochastic reserves are not chosen as the method, the results of the DET for each group of policies.

VM-31: Section 3.E.12

Paragraph 3.E.12 deals with the impact of margins on the deterministic and stochastic reserves. These will not be relevant upon passing the DET and SET.

Assets

Topics can be organized into subsections as:

- Portfolio Description
- Model Segments and Starting Assets
- Investment Assumptions
- Disinvestment Assumptions
- Asset Valuation Basis
- Description of Assets
- Default Assumption
- Prepayments
- Calls
- Puts
- Separate Account

VM-30: Section 3.B.10 vs. VM-31: Sections 3.C.8, 3.E.3.k, 3.E.7

The good news is, if you work for a small company and are already complying with the Actuarial Opinion and Memorandum Regulation (AOMR, now contained in VM-30), then you have done most of the work already.

The AOMR will already contain documentation on the quality, distribution, and types of assets, including the investment and disinvestment assumptions (including market value (MV) determination of sold assets and yield on purchased assets), source of asset data, asset valuation bases, default costs, call options, and prepayment functions. Consistent with the general migration of mere disclosure in the AOMR to transparency in the PBR report, expanding these sections to include the rationale for the assumptions used should be completed for the PBR report. PBR requirements also add the rationale for dividing the total portfolio into sub-segments. This will be specific to the purpose of how the sub-segments were chosen to perform the DET and SET.

VM-30: Section 3.B.9.f vs. VM-31: Section 3.E.3.i-j

The AOMR requirements laid out in 3.B.9.f revolve around disclosing the relationship between general account and separate account assets and the guarantees for the policy. The PBR requirements are a bit more specific in asking the actuary to disclose the rationale for grouping the assets in the manner done, and how the grouped assets are tied to product liabilities for purposes of establishing crediting rates.

Continued on page 26

VM-31: Section 3.C.9

This requirement hinges around describing the hedging modeled. With the overall assumption that this document is applicable to small companies with simplistic products that have passed the DET and SET, there is a good chance that this paragraph will not apply.

VM-31: Section 3.E.3.l

This paragraph contains documentation of prescriptions for the investment strategy for determining PBR reserves. This will not be applicable to policies that pass the DET and SET as the CFT model will be used.

Other Disclosure Items

Topics can be organized into subsections as:

- Impact of Assumption Margins
- Material Risks Not in Cash Flow Model
- Impact of Aggregation
- Embedded Spread on Starting Assets
- Test of Consistency of Discount Rates

VM-30: Section 3.A.4 vs. VM-31: Section 3.C.1

These sections are basically identical in requiring an opening paragraph identifying the qualified actuary, with qualifications and relationship to the company.

VM-30: Section 3.A.6 vs. VM-31: Section 3.C.6

Both VM-30 and VM-31 require the disclosure of reliance. These reliance statements are pretty consistent between VM-30 and VM-31.

VM-30: Section 3.B.12.a vs. VM-31: Section 3.E.2

Both VM-30 and VM-31 require disclosures on any material changes in assumptions from the previous valuation. This respective VM-31 paragraph also requires a listing of the margins for major risk factors. This latter component will not be applicable as the CFT model will be used for the SET and DET.

VM-30: Section 3.B.11 vs. VM-31: Section 3.C.10

Paragraph 3.B.11 of the AOMR is focused on disclosing the rationale for determining the measure and degree of analysis of risk for determining asset adequacy. Paragraph 3.C.10 of VM-31 similarly requires the disclosure of the rationale for determining whether an element of the PBR calculation is material. As the CFT model is being used for the DET and SET, documentation and disclosure of the elements the actuary deems relevant to the respective results would be appropriate.

VM-31: Section 3.C.11

This section requires a paragraph stating that the reserves are calculated in accordance with VM-05 and VM-20, and assumptions are prudent estimates.

VM-31: Section 3.E.3.a

The modeling system used for projections is probably already contained in your AOM, but this paragraph of VM-31 specifically requires you to detail it.

VM-31: Section 3.E.3.b-d

In performing the SET and DET using the cash flow model, there will need to be segmentation of assets and liabilities for the tests. The liabilities will probably be pretty straightforward, though the rationale for the asset selection will need to be disclosed.

VM-31: Section 3.E.3.m-n

These paragraphs refer to the number of scenarios in the stochastic reserve runs. These will not be applicable to companies passing the SET.

VM-31: Section 3.E.3.e

This paragraph of VM-31 requires a description of the approach to validate the deterministic and stochastic models. While not explicit in the requirements of the AOMR, the AOMR may already contain documentation of the validation of the CFT model. If not, an additional section describing the validation work will become necessary.

VM-31: Section 3.E.3.f

Paragraph 3.E.3.f is a requirement that mirrors Actuarial Standard of Practice (ASOP) 22 3.3.4.b that says, "Asset adequacy should be tested over a period that extends to a point at which, in the actuary's professional judgment, the use of a longer period would not materially affect the analysis." There is a chance that the AOMR already contains language detailing the length of the projection and why it was deemed sufficient.

VM-31: Sections 3.E.13-14

There are two certifications required by VM-31. The first is from the investment officer stating the modeled investment strategy is consistent with the company's current investment strategy. The second is from senior management certifying the PBR valuation complies with VM_G.

Results

Topics can be organized into subsections as:

- Basic Results
- Sensitivity Tests
- Margins

VM-30: Section 3.A.5 vs. VM-31: Sections 3.C.3-4
The tables accompanying the AOM will have been revised to add the category of PBR reserves to the normal exhibit 5 through 8 tables. For the values that are subject to PBR reserves, VM-31 requires there to be tables containing a more granular breakdown of policy types with face amount, premium, and whether or not this is the first year the line was subject to PBR.

VM-30: Section 3.B.12.b-c vs. VM-31: Section 3.E.1.a-c

The requirements in the AOMR for disclosing results are very broad—namely, the actuary just needs to summarize them. VM-31 paragraphs 3.E.1.a-c have specific tables dedicated to summarizing results by the deterministic reserve, the stochastic reserve, and the NPR, respectively. As the exclusion tests are assumed to be passed for the DET and SET, the only result that will need to be included is a table of the NPR by product line. ●

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On The Research Front

VBT RECOMMENDATION RELEASED ON MORTALITY IMPROVEMENT RATES

The SOA released a recommendation from the Preferred Mortality Project Oversight Group's Valuation Basic Table (VBT) Team for a set of improvement factors that vary by gender and attained age to be used in conjunction with the 2008 VBT for AG-38 purposes for year-end 2014. Excel files are available on the smoothed rates and the mortality improvement rates smoothed and rounded.

<http://www.soa.org/Research/Experience-Study/Ind-Life/Valuation/research-2014-mort-improve-rates-ag-38-year-end-2014.aspx>

Navigating the NAIC

By Mark Birdsall

Why should you care about navigating the National Association of Insurance Commissioners (NAIC)? Isn't that what the trade organizations are for to which your company pays dues?

In my four years as a regulatory actuary for Kansas and participating in the NAIC process, it has struck me that the results are shaped by those who participate. The NAIC is primarily a consensus-building organization and, increasingly, it does its work by conference calls and email. The three NAIC national meetings, while very important at the committee level, are less important at the task force, working group and subgroup levels. The primary work of the NAIC is done by task forces, working groups and subgroups, with ratifying approval by the committees, particularly the plenary, which consists of NAIC members representing all U.S. regulatory jurisdictions, including states and territories.

The NAIC consists of its "members," the commissioners, directors and superintendents of the various U.S. states and territories.

The NAIC organization is based primarily on committees, including the Executive Committee (designated EX) and the "lettered" committees A through G. Each committee is chaired by a member (i.e., commissioner) of the NAIC, usually with a vice chair. The following is a list of the lettered committees:

- Life Insurance and Annuities (A) Committee*
- Health Insurance and Managed Care (B) Committee*
- Property and Casualty Insurance (C) Committee*
- Market Regulation and Consumer Affairs (D) Committee*
- Financial Condition (E) Committee*
- Financial Regulation Standards and Accreditation (F) Committee*
- International Insurance Relations (G) Committee*

There are also several liaison committees. NAIC staff supports each of these committees, together with their respective task forces, working groups and subgroups. The name of each of these groups includes the letter committee to which it ultimately reports. For example, the Life Actuarial (A) Task Force reports to the A Committee, the Health Actuarial (B) Task Force reports to the B Committee, and the Casualty Actuarial and Statistical (C) Task Force reports to the C Committee. In some instances, there are joint groups that report to multiple lettered committees, such as the C-3 Phase 2/AG 43 (E/A) Subgroup, whose "parents" are the Life Risk-Based Capital (E) Working Group and the Life Actuarial (A) Task Force. The Financial

Condition (E) Committee oversees the largest number of NAIC groups, including those related to risk-based capital and implementing principle-based reserves.

The chairs and members of the various task forces, working groups and subgroups represent their respective commissioners. Each of

these groups works according to the charges approved by its parent group. In some cases, the charges come down from the parent group, and in other cases the charges are recommended by the group itself and approved by its parent. There also can be referrals from one NAIC group to another, which referrals can become part of the group charges. The chairs and members participate in discussions, make motions, and vote on various matters pursuant to the charges. NAIC staff is responsible for preparing detailed minutes for most meetings, and those minutes serve as a record that can be referenced in future deliberations. The NAIC officers (president, president-elect, vice president, secretary-treasurer) are elected for a calendar year, and the various committees, task forces, etc. are reauthorized by the NAIC, usually at a commissioners meeting

Remember that because the NAIC is primarily a consensus-building organization, the outcome of an NAIC proposal is usually shaped by those who participate.

held in February. During this reauthorization process, there may be changes in the membership of the various NAIC groups, including the chairs.

If you are interested in a particular issue, such as indexed universal life (IUL) illustrations (a current “hot topic” at the NAIC), what can you do to get up to speed and participate? The best place to start might be www.naic.org. Go to the “Committees and Activities” tab (near the top under the pictures of the current NAIC officers). The list of NAIC committees is on the right of the screen. Since IUL illustrations is a life insurance issue, you could drill down to the A Committee and then the Life Actuarial (A) Task Force. On LATF’s page you might see several things: an upcoming LATF conference call, materials for the conference call, exposure drafts, and an NAIC staff person (Reggie Mazyck).

One simple way to participate in the discussion of an issue is to provide a written comment on an exposure draft of interest to your company. Once the exposure period is completed, there is usually a conference call held during which the written comments received are discussed. The written comments will be provided as materials for the call and the commenters will usually be invited by the chair to discuss their comments, though no discussion is required. My experience has been that thoughtful comments can have an important impact on the discussions.

You can also participate by contacting NAIC staff listed for each NAIC group on its Web page, members of the NAIC group, or by simply speaking up on the conference calls. If a new agenda item is needed, contact the chair or NAIC staff member. A lot of useful communication happens outside of NAIC conference calls and meetings, and you can avail yourself of that opportunity. Remember that because the NAIC is primarily a consensus-building organization, the outcome of an NAIC proposal is usually shaped by those who participate.

A final thought about participating in the NAIC process: While no one is completely objective, discussion points put forward that are self-serving, misleading or simply obstructionist tend to cause the person or organization putting them forth to lose credibility. Build your credibility with regulators and your input will be appreciated in the NAIC process. ●

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Regulatory Update for 2014

By Norman E. Hill

This material is prepared as of Dec. 19, 2014. Since events in the insurance industry remain volatile and dynamic, readers are strongly encouraged to read email blasts from the Society of Actuaries (SOA), its Smaller Insurance Company Section Council and other industry publications, up to the date of *Small Talk* publication.

Opinions expressed in this article are solely those of the author, and not necessarily those of *Small Talk* or the SOA.

Principle-Based Reserving Implementation Task Force (PBRITF) This time, there was more intense discussion than at the preceding Life Actuarial Task Force (LATF).

-Small Company Exemption (SCE)

On an Oct. 28 call, LATF members approved the SCE amendment to the Valuation Manual, so it could be sent up to PBRITF. They left to PBRITF the decision whether to review the amendment in five years.

However, to my surprise, they also left to the parent the decision on whether to lower the premium threshold for exemption. Currently, it is \$300 million ordinary life direct plus assumed premiums for a company and \$600 million premiums for a group. One possibility suggested would be to lower the threshold to \$200 million and \$400 million for company and group, respectively.

With this proposed level of exemption, \$300 million/\$600 million, about 362 life companies out of 630 would be exempted from principle-based reserve (PBR) requirements. A table was provided, showing what companies fell into which one of defined premium buckets, starting with \$10 million, going up to \$300 million. Premium volume exempted would be from 4 to 5 percent of industry premium totals. Only companies with premiums greater than zero and with risk-based capital (RBC) levels at least 450 percent were included in the table.

As before, this would not affect exemption from mandatory experience reporting. There is still a \$50 million premi-

um threshold for this exemption, as well as the intention expressed in VM51 to include only 80 percent of industry premium volume for data calls on a given experience line.

Steve Ostlund of Alabama pointed out that some of these companies have \$0 premiums; some are preneed, already exempt; some are partially preneed, etc. He proposed that, in a closed session, PBRITF review all 362 companies. Maybe in this way, regulators on PBRITF could be comfortable with the volume of exemption.

Based on 2013 Annual Statement data (from the National Association of Insurance Commissioners (NAIC)), several comparisons can be made between various premium thresholds. With a \$600 million group premium threshold, 57.5 percent of total companies would be exempt. If the threshold was reduced to \$400 million, the percentage would reduce only slightly, down to 55.4 percent. But based on total company premium volumes, the exempt amount at \$600 million is 4.6 percent of total industry volume of \$195+ billion. At a \$400 million threshold, the percentage would reduce to 4.35 percent.

John Bruins of the American Council of Life Insurers (ACLI) reminded the task force that Oklahoma has already passed the Valuation Law with SCE included. In fact, Oklahoma's group premium threshold is even higher, at \$1 billion premiums. Also, another state is close to passing the new law on the same basis. Several other states are considering such a move.

It was left that PBRITF would have a closed call as soon as possible. On Dec. 10, they announced a request for comments on a proposed reduction to the exemption thresholds down to \$50 million premiums per company and \$300 million for a group. Comments are due by Jan. 15, 2015. Several actuaries in industry have made inquiries of regulators who were on the call, but have not discerned any reason for this change. In my opinion, such an extreme reduction is sure to draw many comments.

-Captives and Actuarial Guideline 48 (AG48)

Although this topic does not directly affect most small companies, it is taking up the bulk of PBRITF members' time, and therefore taking their time away from SCE.

The guideline involves division of reinsured assets in a captive, covering preferred term and universal life with secondary guarantees (ULSG). Assets allocated to these products would be divided between "Primary Securities" and "Other Securities." Primary Securities would be regular admissible NAIC securities except for contingent notes and similar assets. However, if the reinsurance between the ceding parent and captive is funds withheld or MODCO, certain other assets can also be held (good-standing commercial loans, policy loans, and derivatives in the normal course of business).

Other Securities would often be evergreen letters of credit actually held as an asset, or other assets approved by the domestic department.

Total PBR reserves would be held. The amount of reserves that would determine the amount of Primary Securities would be calculated by a quasi-PBR threshold reserve (calculated according to the "Actuarial Method") that, at least initially, would be less than regular PBR reserves. This reserve would not be held in financial statements or shown in federal income tax returns. It would be based on updated deterministic or stochastic reserves, as described below, with a special floor, as described below.

The net premium reserve (NPR) floor then would be based on a percentage of regular NPR, ranging from about 60 to 80 percent, depending on sex and smoking status. Eventually, the ACLI will re-compute NPRs for these products, to achieve the same percentage results. These recomputed NPRs will be proposed as an amendment to VM20 of the Valuation Manual, to replace current NPRs for preferred term and ULSG products.

The mortality table for deterministic or stochastic reserves would be based on 2014 CSO (equal to 2014 VBT with margins, which would be updated into the Valuation Manual anyway).

Several people on PBRITF and their consultant have stated that this approach would provide additional benefit to writers of preferred term and ULSG. With amended NPRs, these quasi-PBR reserves would soon become regular PBR reserves for these products. Captives could be integrated into their parent companies. Therefore, the need for cap-

tives should soon disappear. Others, during the meeting, stated that this view is much too optimistic.

After this contentious discussion, PBRITF voted to expose the Nov. 7 version of AG48 for further industry comments. As before, New York voted no. In the Dec. 17 NAIC NewsWire, the announcement was made that the NAIC itself (meaning both PBRITF and Executive Committee) had voted to approve AG48, effective for 2015. This approval includes standards for reinsurance itself between parents and captives, dealing with preferred term and ULSG products.

-PBR—State Adoption

Based on a Dec. 4, 2014 calendar, the legislative adoption process for the new Valuation Law has hardly changed since the summer NAIC meeting. Eighteen states comprising about 26 percent of national premiums have adopted the law and at least 10 others are considering it. From another source, I learned that California has agreed with the ACLI to adopt the new law—if they can assess companies for amounts that they need to hire consultants and staff to audit results. It remains to be seen exactly what companies would be assessed.

Oklahoma has already adopted the new law, but including SCE with \$1 billion group premium threshold. Of the 10 states considering adoption, Michigan and Illinois are including SCE—Michigan with \$500 million/\$1 billion thresholds and Illinois with \$300 million/\$1 billion thresholds.

Task force co-chairmen indicated that the most likely date for PBR implementation after necessary state adoptions is Jan. 1, 2017, with the optional three-year deferral for designated products.

-LATF

There was considerable discussion on new industry mortality tables, 2014 VBT and 2014 CSO. The former basic table is in the final stages of testing and should be available by June 2015. Adding margins for the CSO version is trickier. Instead of a complex quadratic equation, with the denominator based on expectation of life, the SOA group working on margins is considering flat percentage additions, varying by attained age.

LATF adopted several long-pending amendments and updates to VM20 of the valuation law. One is the Table of Spreads on interest rates as of Sept. 30, 2014, needed for the investment income assumption for certain products.

Continued on **page 32**

This had been exposed at the November NAIC meeting. Second was a clarification, stating that assumptions for asset adequacy testing do not have to be the same as those used in PBR reserves.

New York objected to the pattern of spreads that reflected current low interest rates, but were projected upward in future years. The exposure was adopted with this pattern.

Also, LATF narrowly approved a change in the required threshold percentage in the Stochastic Exclusion Test from 4.5 percent to 6 percent. The main reason for a more liberal threshold is uncertainty over test results for non-par permanent products. However, because of the closeness of the vote, LATF asked the ACLI to provide additional test results before sending the amendment upstairs.

Larry Bruning of the NAIC announced that they intend to hire five to seven additional actuaries to handle reviews of new PBR reserve filings.

-State Insurance Department Letters

For some time, certain large states have issued letters, sometimes called “Halloween letters,” outlining several provisions, analyses and data they wished to see in year-end Actuarial Opinion and Memorandum filings. All companies in the states, large and small, are affected. This year, New York, Illinois and California letters were mentioned in a communication from the Smaller Insurance Company Section of the SOA.

-Non-Variable Annuities

Several field tests have been continued, primarily on policies with guaranteed living benefits. The LATF subgroup for these products repeated that the goal for PBR is the greater of: a floor reserve equal to the cash value; and “model reserves” (deterministic reserves) whose assumptions must still be worked out.

-Illustrations for Indexed Universal Life

This topic is probably of minimal interest to small companies, but it is worth noting that it has caused a division within the ACLI. There is a mainstream ACLI recommendation for these illustrations and an opposing view, made up of giant companies such as Northwestern Mutual and New York Life (known as the “Coalition”). Most of one morning’s meeting was devoted to these discussions.

-Revisions to Reserves for Synthetic Guaranteed Investment Contracts (GICs)

This topic is also of minimal interest to small companies, but LATF spent a fair amount of time discussing it.

-Potential Increases in C1 Bond Factors

The American Academy of Actuaries (the “Academy”) has gone further in its recalculation of bond factors. Indications are that these would substantially increase life company RBC charges for the C1 component. They will probably have definite recommendations by the summer of 2015.

The ACLI has reviewed the Academy’s preliminary assumptions and modeling and indicated they question some of them. John Bruins from ACLI pointed out that total C1 charges for life insurers, before co-variance adjustments, comprise about 60 percent of total industry RBC. Therefore, Academy calculations affect the entire industry.

Bill Weller of America’s Health Insurance Plans (AHIP) pointed out that the average duration of bond investments for health companies may be only about half of that for life companies. Therefore, revised C1 factors for life insurers may not be appropriate for health writers.

In a Dec. 1, 2014 conference call, Weller added that the Academy representative had informed him that a change of bond duration would require restructuring the model from scratch.

-International Negotiations

The main NAIC working group here is the “Comframe Development and Analysis Working Group” (pronounced “sea-dog”). They are actively working with the International Association of Insurance Supervisors (IAIS) on insurance regulatory matters. So far, these discussions only affect large companies that deal in several countries (“Internationally Active Insurance Groups,” or IAIGs) One indication of NAIC difficulties is that IAIS has decided to keep all its meetings closed.

Key issues discussed include global capital requirements, not just RBC for weakly capitalized companies, and various accounting bases, such as U.S. GAAP, international GAAP (IFRS) and GAAP for several other countries. As indicated, there is no move yet to expand any such requirements to small companies or to threaten U.S. statutory accounting.

-Executive and Plenary Developments

The last session at the fall NAIC involved approval of a significant Model Law and Regulation. Starting in 2016, due by June 1, 2016, all companies must file with their domestic departments a plan of group corporate governance and management procedures.

The Executive Committee approved new GRET factors for unit expenses for 2015, completing the approval chain that

had started with LATF. This year, the SOA made a significant change from 2014 by redefining official distribution channels. New categories are Independent, Career, Direct, Niche (applying to products like preneed, final expense and home service) and Other. This change could cause difficulties in adjusting from the seven categories previously used (Branch Office, Direct Marketing, Home Service, Career General Agency, Brokerage, PPGA and Multiline).

In a subsequent closed conference call, the Executive Committee approved revisions to the Insurance Holding Company System Regulatory Act. It clarifies group-wide regulatory supervision for defined classes of IAIGs. Also, it defines the lead state in regulation of such domestic IAIGs.

In this same call, the Executive Committee approved three new nations (besides four previously approved) eligible for reduced collateral involving reinsurance with U.S. companies—Japan, Ireland, France, and, earlier, Bermuda, Germany, Switzerland and the United Kingdom.

At the fall session, one commissioner stated that the NAIC may develop its own Model Law on Unclaimed Property. This would be compared to an existing bill prepared by the National Conference of Insurance Legislators (NCOIL) already adopted with various amendments in 15 states. No actual session on this topic was held at the fall meeting.

As stated before, the issue involves required insurer matching of the Death Master File (DMF) of the Social Security Administration against its in-force file. So far, at least 40 of the largest life insurers have been audited by special firms hired by secretaries of state or state attorneys general, rather than state insurance departments.

Two issues that have concerned some small insurers involve:

1. So-called “fuzzy matching”; when Social Security numbers or names on the DMF are close, but not exactly equal to those on the insurers’ file, the matter should always be resolved in favor of the policyholder; in many cases, this would mean turning over the claim to state escheat files.
2. Each year, matching the entire insurer in-force against DMF, instead of matching only new entrants to DMF.

Summary

Each time, new and old complex issues and new wrinkles on each combine to require close attention of small insurers. ●

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ValAct 2014—SmallCo in the Big Apple

By Roger Brown

The Smaller Insurance Company Section (SmallCo) hosted a trio of excellent sessions at the 2014 Valuation Actuary (ValAct) Symposium in New York. Two of the three sessions were the long-running Smaller Company Issues (“Buzz Group”) and the Smaller Insurance Company Chief and Corporate Actuaries Forum (CAF). The third touched on a very relevant topic—Own Risk and Solvency Assessment (ORSA)—and how it could impact smaller insurance companies.

At the Buzz Group and CAF, a small group of table leaders facilitated discussion about issues that were on the mind of small company actuaries. For those who have never had the good fortune to attend either one of these first-rate sessions, both offer engaging and valuable interaction. The CAF benefits from a longer time slot that affords more networking opportunities and a slightly more relaxed format. Some of the topics covered included:

- *The continued impact of low interest rates on asset adequacy testing.* There was good dialogue on what scenarios companies test, at what level results are aggregated and the new internal reporting requirements. The impact of low rates on product development and in-force management also came up. Companies are facing decisions on how to manage lower interest rate spreads and the resulting shift in product focus.
- *Principle-Based Reserves (PBR).* This perennial topic had some renewed excitement as a possible small company exemption was under consideration. There was also some discussion about using asset adequacy documentation and procedures as a starting point to implementing PBR.

- *Working with regulators and auditors.* As time is a precious commodity, much discussion centered on the increased time that actuaries now have to devote to audits. Ideas to improve communication were tossed around as were other tips to make the audit process more efficient.
- *Staffing.* Since hiring more actuaries is generally not an option, participants at this table talked about how roles and responsibilities are organized, the use of temps and non-actuarial associates, and when to reach out to consultants.
- *Small company survival.* Several discussion threads were started on this topic. Most centered on best practices that small company actuaries employ to try to position their firms in the best possible manner to not just survive, but to thrive. Given how the insurance industry has evolved with more regulations, more data requirements, more analytical challenges, more everything ... this is no easy task.

Special thanks are due to the following SmallCo volunteers who helped coordinate and lead these sessions: *Buzz Group*—Bryan Amburn, Stefanie Harder, Norm Hill, Mike Kaster and Terry Long; *CAF*—Mark Rowley, Pam Hutchins, Tim Cardinal, Stefanie Harder and Mike Kaster.

SmallCo was also well-represented by a superb session on the looming ORSA requirements. The presenters did a fine job giving an overview of what ORSA will require, breaking down the report components, detailing the status of ORSA within the National Association of Insurance Commissioners (NAIC), and discussing where ORSA fits into a company’s broader enterprise risk management framework. Stefanie Harder, Terry Long and Mark Yu then facilitated a question-and-answer segment that sparked some very lively discussion.

Kudos to all SmallCo members who helped make this year’s ValAct a success!

Please save the date now for the 2015 edition of the Valuation Actuary Symposium to be held in Boston on Aug. 31–Sept. 1. ●



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