



## Current Topics in Regulatory Reporting Southeastern Actuaries Conference

November 19, 2009

ADVISORY

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## Actuarial Guideline 43 – Overview

Actuarial Guideline 43 (AG43) which applies to VA reserves is effective for statutory financial statements as of 12/31/2009  
Entirely new approach based on company-specific modeling  
Aggregate AG 43 Reserve is greater of

***The Standard Scenario Amount  
(Defined Deterministic Assumptions)\****

OR

***The Conditional Tail Expectation Amount\*\*  
(Stochastic – Average of Worst 30% Scenarios, i.e. CTE 70)***



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## Actuarial Guideline 43 Overview - Significant Differences Between Standard Scenario and CTE 70

### Standard Scenario

- One deterministic scenario
- Assumptions defined by regulators (AG 43)
- Calculation performed on a seriatim (i.e., policy-by-policy) basis
- Allows the use of currently held hedges only

### CTE 70

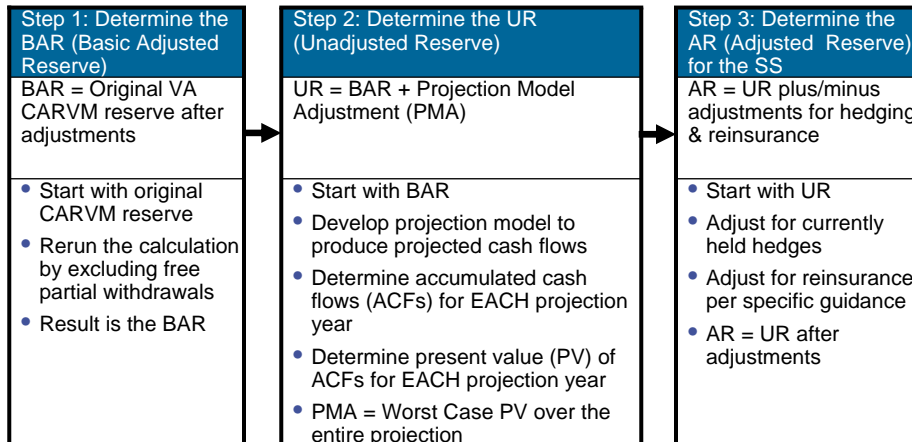
- Multiple stochastic scenarios (typically a minimum of 1,000)
- “Prudent Assumptions”, including margins, determined by company
- Calculations generally performed on a model point (i.e., grouped) basis due to run-time constraints
- Future hedges may be utilized if a clearly defined hedging strategy “CDHS” is in place



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## Standard Scenario (SS) – Approach “in a nutshell”



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## Stochastic Calculations – Overview

- Utilizes complex company-specific cash flow models
  - Models projected using multiple economic scenarios – must meet calibration requirements
  - Allows grouping of contracts to model points
- “Prudent estimate” assumptions
  - Best estimate plus margin
  - Sensitivity testing required
- Discount rates – three options given
- Hedges
  - Currently held hedges should be included
  - Future hedges may be included only if certain requirements are met
- Extensive certification requirements (around methods, assumptions and CDHS, if adopted)



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## Implementation Risks

### Risks

- Not in compliance with AG 43
- Inaccuracies or errors
- Lack of completeness
- Subjectivity (stochastic assumptions/ methodology)
- Improperly or insufficiently documented
- Lack of internal change controls
- Available resources are not appropriately skilled or knowledgeable

### Inputs

- ◆ Assumptions/margins
- ◆ Product features/ guarantees
- ◆ Model point grouping (CTE only)
- ◆ Hedging/reinsurance approaches
- ◆ Economic scenarios approach (CTE only)

### Model Calculations

- ◆ Standard scenario versus stochastic
- ◆ Valuation software
- ◆ Manual calculations outside the valuation model (e.g., CTE determination)
- ◆ Implementation of hedging and reinsurance
- ◆ Generation of economic scenarios (CTE only)

### Outputs

- ◆ Outputs to analyses
- ◆ Manual adjustments
- ◆ Analyses to general ledger
- ◆ Reserve determination – standard scenario versus stochastic



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## AG VACARVM (aka AG 43) Share Forum

- KPMG hosted a Share Forum on AG 43 on June 24<sup>th</sup>, 2009 to discuss practical and theoretical topics related to AG 43
- Share forum attendees:
  - 28 people in attendance
  - Representatives from ten of the top 25 variable annuity writers
  - Company variable annuity assets ranged from approximately \$10 billion to over \$50 billion (nearly \$400 billion in total)
- An anonymous “real-time” survey was performed
  - Survey reflects one vote per company
  - Some of the results are shown in this presentation
- The survey results in no way reflect the views of KPMG in whole or in part, or of the companies that participated. These are solely the views of the participants (on an anonymous basis) at the AG 43 Share Forum.



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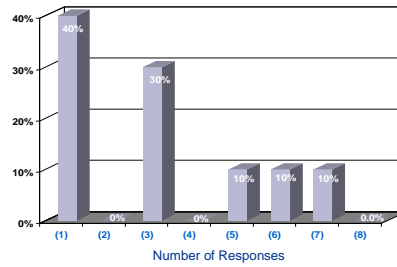
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## Key Areas of Focus for the Share Forum

**Which of the following topics is of greatest interest to you?  
(select top choice)**

- 1) Impact on reserves/capital levels
- 2) Modeling and valuation process implications
- 3) Hedging
- 4) Selection of economic scenarios
- 5) Assumptions/margins setting
- 6) Revenue sharing
- 7) Reinsurance considerations
- 8) Tax effects



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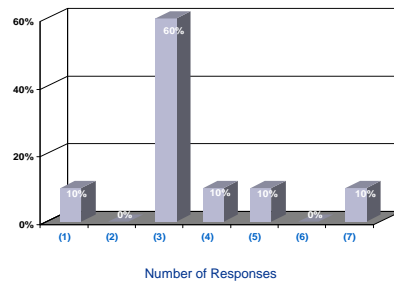
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## Potential Reserve Impacts

**What do you anticipate the impact on reserves to be under AG 43  
versus prior statutory valuation requirements (AG 33/34/39)?**

- 1) Decrease 0-25%
- 2) Decrease 25% +
- 3) Increase 0-25%
- 4) Increase 25-50%
- 5) Increase 50-100%
- 6) Increase 100% +
- 7) Haven't evaluated yet/ don't know



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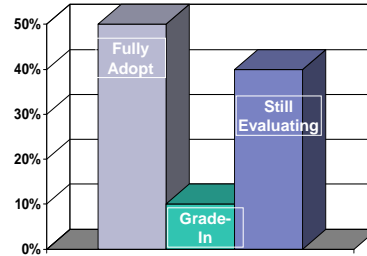


## First-Time Adoption Considerations

### Further commentary on first time adoption:

- An expectation that the Standard scenario is likely to dominate over the stochastic runs
  - Very dependent on future market changes
- Financial Reporting of Adoption within Exhibit 5 Still Under Debate
  - Should AG change be reflected as a normal change in reserve or change in basis?
  - How to determine opening adjustment?

What adoption approach do you expect to use?



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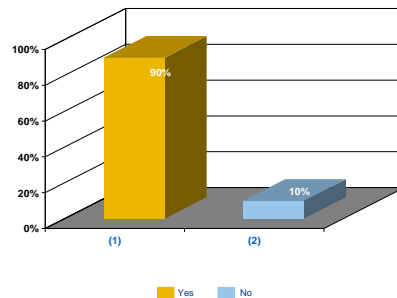


## Modeling-Related Considerations

### Further commentary on the model considerations:

- 90% surveyed expect to use the current C3P2 software, possibly with modifications
  - applies for both standard scenario and stochastic
- 90% surveyed expect to use vendor supplied software (as opposed to internally developed)

Is model run-time an issue that you are actively considering?



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## Hedging Considerations

- Standard Scenario
  - Currently held hedges are modeled for one year
  - No future hedges may be modeled
- CTE Calculations
  - Currently held hedges are modeled - some debate over whether modeled to maturity or earlier
  - Future hedges may be modeled only if satisfy the requirements for a clearly defined hedging strategy



## Hedging Considerations Clearly Defined Hedging Strategy

70% of companies surveyed expect a MODERATE COST if use a Clearly Defined Hedging Strategy (CDHS) in the CTE 70 calculations – the remaining 30% are still evaluating impacts

Do you plan to implement a CDHS within your CTE 70 calculations?	
30%	Yes
50%	Maybe – still evaluating the costs/benefits
20%	No – costs/benefits are limited

If CDHS is elected, how will you implement it within your models?	
30%	In the same model as the liability valuation
40%	Using an outside hedging model and then combining
10%	Unsure
20%	Not Electing

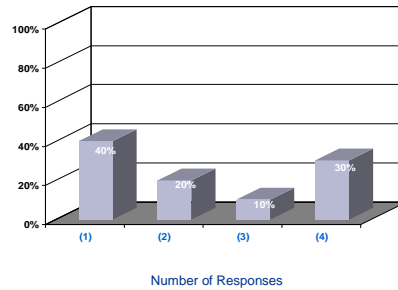




## Setting of Prudent-Estimate Assumptions Stochastic Runs Only

**How will you be setting your base best-estimate/before margins non-economic assumptions (i.e., reflecting anticipated experience)?**

- 1) Same as RBC C3 Phase II
- 2) Same as GAAP DAC
- 3) Same as Asset Adequacy Testing
- 4) All of the above



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## Setting of Key Assumptions – Industry Perspectives Stochastic Runs Only

**How will you determine the discount rates for AG 43?**

50%	Swap Curve
20%	C3P2 Interest and Equity Scenarios
20%	Stochastic Projections (scenario/path dependent)
10%	Path dependent portfolio rates

**Do you plan to use dynamic lapses in your stochastic projections?**

0%	No
40%	Yes – living benefits only
0%	Yes – death benefits only
60%	Yes – living and death benefits
0%	Unsure



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## Setting of Margins – Industry Perspectives Stochastic Runs Only

### Further commentary on the margins:

- 70% surveyed expect to use a bottom-up risk factor approach
- 20% surveyed expect to use a top-down approach
- 10% were unsure

What do you anticipate will be the overall impact of the margins on the CTE 70 amounts over and above the CSV?

0%	Less than 5%
50%	5% but less than 10%
40%	10% but less than 15%
0%	15% but less than 25%
10%	25% but less than 50%
0%	More than 50%



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## Revenue Sharing

Have you reviewed your current arrangements for  
“contractual” revenue sharing?

30%	Yes – all agreements have a signed contractual obligation
10%	Yes – some agreements have been revised/signed to confirm a contractual obligation
50%	Yes – some agreements do not have a contractual obligation – we will reflect these at 100% grading down to 50% by year 6
0%	Yes – some agreements do not have a contractual obligation – we will reflect these at 100% now and in the future
10%	Currently being evaluated
0%	Not evaluated/unsure



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## Tax Considerations Current Thoughts – Subject To Change

- Standard scenario likely to be used for tax purposes
  - Treasury concerns include the deductibility of the excess of stochastic over standard scenario
- Changes in assumptions are more appropriately changes in methodology and not subject to a 10-year spread (current view)
- Assumptions
  - Tax valuation rate likely to be the greater of the prescribed standard scenario discount rate (DR) or the applicable federal interest rate (AFIR)
- AG VACARVM applies to policies issued in 1981 and later; IRC rules will apply on a prospective basis to newly issued contracts
- Potential adjustment
  - Current tax law - calculations at the end of the contract year
  - AG VACARVM specifies calendar year-end

*Further guidance is expected from the Treasury this year*



## Tax Considerations

Have you evaluated the tax consequences of the differing tax reserving and AG 43 reserving?		
Inforce	New Business	
20%	0%	Yes – anticipate negative
20%	40%	No – but anticipate negative
50%	40%	Evaluating – anticipate negative
0%	0%	Yes – anticipate positive
0%	10%	No – but anticipate positive
10%	10%	Evaluating – anticipate positive



## Other Strategic Considerations or Decisions

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- Inputs
- Model Calculations
- Other



## Other Strategic Decisions Inputs

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- Data
  - Use year-end inforce data or as of a prior date?
  - Use year-end asset data or as of a prior date?
  - When/how to adjust if prior?
- Assumptions for stochastic CTE
  - Base non-economic assumptions – Determination/documentation/support/certification?
  - Level of margin – Determination/documentation/support/certification?
  - Discount rate – Determination/documentation? Consistency with RBC?





## Other Strategic Decisions Model Calculations

- Model complexity and run time
  - How to manage risk? Manage new controls? Extend existing C3 models? Build new models? Buy/ implement vendor models?
  - Purchase more computer power? Up resources?
  - Simplify liability model points or assets?
- Economic Scenarios
  - Use AAA in full or subset? Own generated?
  - Method for testing sufficiency of number of scenarios? Method for testing calibration?



## Other Strategic Decisions

- Reporting close calendar
  - Are timetables still achievable?
  - Extent to which the VA CARVM process is fully embedded?
  - Have new analytics and proper review time been considered?
- Peer review
  - 90% of companies surveyed will use an external peer reviewer other than their external auditors
  - Will you use a peer reviewer? Have you built in adequate time for that process to occur?





## Other Strategic Decisions

- Heightened scrutiny by external parties
  - How/extent of external auditors involvement?
  - Regulator and rating agency reaction?
- RBC
  - Interaction between models?
  - Assumptions consistency (e.g. discount rates)?



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## Return of Premium Term (ROP Term)

- ROP Term has been a popular product in the general term market:
  - “Money-back term”
  - “Win-win coverage”
- ROP Term has appeal in certain sales situation such as mortgage funding and college tuition funding
- The product generally promises a return of the accumulated premium to date after a certain number of years if the policy holder survives
- Provides an increasing percentage of accumulated premium on surrender in earlier years
- Coverage continues after the ROP period
- It has an appeal to agents as well as consumers – higher premium levels translate to higher commissions



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## Product Design Issues

- Provides an increasing percentage of accumulated premium on surrender in earlier years. The percentage can depend on how each company interprets the Standard Non-forfeiture Law. A company may choose to not offer any interim cash values and only pay a full return of premium at the end of the term period.
- The ROP benefit can take the form of a rider on a regular term policy or can be in the form of an integrated policy
- The rider form has been perceived by some in the marketplace as an approach to circumvent the Standard Non-forfeiture Law as well as the requirements of Regulation XXX
- This has led to a perceived unfairness in the marketplace



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## Actuarial Guideline CCC/AG XLV

- Actuarial Guideline CCC developed to address the inconsistency in the market with ROP Term products
- Guideline also provides guidance on the calculation of Cash Values
  - Provides a standard interpretation under the SNFL
  - Requires recognition of the endowment
- Requires that ROP riders be treated the same as integrated products
  - No longer can value riders separately, driving down reserves
- Applies to any life policy with an endowment benefit less than the face amount
- Effective for policy forms filed after 12/31/2008 and policies issued after 12/31/2009



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## Potential Impacts

- There should be greater consistency in product designs across states. Getting policy form approval across states should be easier.
- ROP Term has historically been a simple product. Introduction of AG XLV is expected to significantly increase the complexity of cash value calculations. Many calculations are required at each duration of the product. Systems may need to be updated
- Impact on lapse rates:
  - Lapse rates continue to decline. Actual rates coming in lower than pricing at many companies.
  - However, companies may see increased lapses after the larger CV increases driven by AG XLV. This may lead to overall increases in ROP premiums in the marketplace



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## Potential Impacts

- ROP Term reserves generally have a higher, steeper peak than regular level term products. Introduction of AG XLV, including the need to recognize the endowment at the end of the term will likely increase the reserve requirement.
- Companies will need to comply with XXX Section 6D on *Unusual Patterns of Cash Surrender Value*
- Capital requirements will likely increase for many companies
- Capacity constraints may need to be considered
- As a result, the marketplace may see more fully integrated products
- However, as the appeal to the customer grows, the appeal to the company diminishes



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