Actuaries' Club of the Southwest
Small Company Asset Adequacy

Revisions to the Actuarial Opinion and Memorandum Regulations

The Effect on Health Insurers

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NAIC Model Regulation 822

- Entitled "Actuarial Opinion and Memorandum Regulation"
- Incorporated into the *NAIC Accounting Practices and Procedures Manual*
  - Appendix A-822
- Applies to Life/Health Insurers
- Does not apply to HMOs and Blues

Major Revisions to AOMR

- Elimination of Section 7 Opinions
- Restricted State of Domicile Opinions
- Regulatory Asset Adequacy Issues Summary
- Elimination of Required Interest Rate Scenarios

Elimination of Section 7 Opinions

- All actuarial opinions must be based on asset adequacy analysis

- Companies with less than $500 million no longer exempted from asset analysis

Restricted State of Domicile Opinions

- Current – Meet the requirements of the state of domicile and at least as great as the minimum aggregate amounts in the state filed
- New – 3 Possible Alternatives

Restricted State of Domicile Opinions

- Alternatives
  1. Meet the formal written standards and conditions of the state of filing.
  2. Verify that a domiciliary opinion has been approved by the commissioner of state of filing (and conditions met)
  3. Comparison of nationwide reserves held versus codification reserves
     - May be able to do comparison tests each year rather than Cash Flow Testing

Restricted State of Domicile Opinions

- No memorandum if one state only and approved by commissioner
  - The Commissioner may ask for one within 60 days
- Eventually a company will only have to comply with domiciliary state if that state is accredited.
  - Will minimize the needed variations

Regulatory Asset Adequacy Issues Summary

- The summary should include:
  - Description of scenarios tested
    - Including whether stochastic or deterministic
  - Sensitivity Tests
  - Changes to prior year's assumptions
  - Comments on interim results
  - Impact of reinsurance
  - Satisfaction that the options whether explicit or embedded in asset or liability have been appropriately considered

Elimination of Required Interest Rate Scenarios

- No longer required to use New York 7
- Allows the appointed actuary to exercise judgment, guided by ASOPs

Applicable Actuarial Standards of Practice

- ASOP #22
  - Statements of Opinion Based on Asset Adequacy
- ASOP #7
  - Performing Cash Flow Testing for Insurers
- ASOP #28
  - Actuarial Opinions for HMDIs and HMOs

Actuarial Standards of Practice

- ASOP #22 (Effective April 15, 2002)
  - Statements of Opinion Based on Asset Adequacy
    - Guidance in analyzing reserves in light of supporting assets
    - Main steps in asset analysis
    - Different methodologies allowed
    - The amount of testing based on the degree of risk inherent in the contracts being sold

Actuarial Standards of Practice

- ASOP #7 (Updated in 2001)
  - – Analysis of Life, Health or Property Casualty Insurer Cash Flows
    - Guidance in analyzing asset and liability cash flows
    - How to perform the analysis
    - Documenting the analysis

Analysis Methods – Cash Flow Testing

- Should consider cash flow testing when:
  - variations in the underlying risks are likely to have a material impact on the expected cash flows in certain products or lines of business.
- Most likely to find a potential problem

Cash Flow Testing – Variations in Underlying Risk

- Asset Risks
  - Timing Risks (CMOs)
  - Below investment grade bonds
  - Illiquid Assets e.g. Real Estate
- Liabilities with long tail cash flows
- New or rapidly growing LOB
- Policyholders with anti-selective options e.g. book value surrenders

Asset Adequacy Analysis Methods – Cash Flow Testing Not Necessary

- CFT not needed when moderately adverse deviations in the investment rate of return risk assumptions are not likely to affect asset or liability values
- Products with short-term liabilities supported by short-term assets
- Not really asset adequacy – more like:
  - "Is my Liability set aside big enough?"
- May get more "credit" from rating agencies if CFT performed versus GPV or other

Alternatives to Cash Flow Testing

- Tests moderately adverse deviations in assumptions other than investment interest rate
- The actuary uses professional judgment in choosing the appropriate testing method
- The actuary uses professional judgment in determining which assumptions should be varied for a particular test
- May use different methods based on the type of products and LOBs

5 Alternatives to CFT

1. Gross Premium Reserve Valuation
   - Major Medical
   - Usually requires justification of assumptions
2. Demonstration of High Degree of Conservatism
   - AD&D
   - Comparison to Standards
3. Demonstration of Limited Variation Due to Product Design
   - Hospital Indemnity
   - Illustration of limitations

5 Alternatives to CFT

4. Risk Theory Techniques
   - Small number of large individual claims
   - Accidental Death
   - Documentation of methods
5. Loss Ratio Methods
   - Short Duration liabilities and assets
   - ASOP #5
   - Show that the amount lost from claims is less than what assumed in Vs

Gross Premium Valuation

- Currently performed whenever a significant doubt exists as to reserve adequacy with respect to blocks of contracts or the health business as a whole
  - NAIC Model 010 – Health Insurance Reserves Model Regulation (HIRMR)
  - NAIC Health Reserve Guidance Manual
    - Guidance for calculating and documenting of health reserves for statutory financial statements described in HIRMR

Gross Premium Valuation

- Test Current Reserve Adequacy by Calculating:
  - The Sum of:
    - Current Contract and Claim Reserve
    - PV of future premiums
    - Current Accrual of future expenses
  - Minus the Sum of:
    - PV of future paid claims
    - PV of future expenses
    - PV of Reserves at end of period (additional future claims)

GPV - Assumptions

- Based on NAIC Health Reserve Guidance Manual, the assumptions should be realistic for a GPV
- However, assumptions for asset adequacy asset analysis must meet "moderately adverse conditions"

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GPV - Assumptions

- Enrollment
  - S/b reasonable and tied to rate increases
- Premium Rate Increases
  - Reasonable and should consider future levels of claim costs
  - Consider market and regulatory restrictions
- Claim Trends
  - Durational wear-off and adverse selection resulting from premium increases and plan design

GPV - Assumptions

- Risk Sharing Assumptions
  - Collectible amounts from providers to share in losses
- Expenses
  - Reasonable allocation of company's expenses
  - If overhead can be covered elsewhere, then only direct costs need to be considered

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GPV - Assumptions

- Interest
  - Discount Rates for NPV
  - Should be reasonable based upon the period of deficiency
  - Earned Rates on investments
- Taxes
  - S/b calculated on a pre-tax basis
  - Any tax impact due to the establishment of deficiency reserves s/b incorporated into the calculation of deferred tax assets/liabilities

GPV – Key Issues

- Grouping of products/LOBs/group size
- Time Period of Calculation
  - Valuation date is the beginning of time period to project financial losses and gains
  - Ending of period based on actuarial judgment based on products
    - Until profitability restored or completely lapsed
- Scenario Testing of Assumptions
- Additional reserves should closely correspond to the anticipated risk to the insurer

Forming an Opinion

- Based on "moderately adverse deviations"
  - Defined as conditions that include one or more unfavorable, but not extreme, events that have reasonable probability of occurring during the testing period.
- Failing a scenario does not necessarily imply that additional reserves are required

Summary - AOMR Biggest Challenges

- Requirement of Asset Adequacy Analysis
- Coping with requirements based on the state of filing
- Reverse Effect May Occur – Big companies may try to show that CFT not necessary if conservatism can be shown, etc.

Summary

- Allows appointed actuary to utilize professional judgment in developing the actuarial opinion and supporting memoranda
- Supports the principle that the level of reserve analysis should be based on the risks associated with the products and supporting investments rather than on the size of the company
- Allows the commissioner to accept the valuation of a foreign insurer

Summary

- The availability of a range of methods will allow each company to choose the one (or combination) which bests fits its circumstances, thereby minimizing the expense incurred in fulfilling the asset adequacy analysis requirement
- Even if not necessary, may use CFT due to added benefits:
  - Budget Models, Pricing Models
  - Appraisals, Actual to Expected Analysis

Advice

- Communicate with each state's managing actuary and/or commissioner
  - Pre-planning for the analysis needed for each particular state if necessary
  - Can discuss which are the preferred alternatives