On August 9, 2011, SCOR SE, a global reinsurer with offices in more than 31 countries, acquired substantially all of the life reinsurance business, operations and staff of Transamerica Reinsurance, the life reinsurance division of the AEGON companies. The business of Transamerica Reinsurance will now be conducted through the SCOR Global Life companies, and Transamerica Reinsurance is no longer affiliated with the AEGON companies.

While articles, treaties and some historic materials may continue to bear the Transamerica name, AEGON is no longer producing new reinsurance business.

PBA: Preparing for Big Changes in the Way We Do Business

For quite some time, the efforts to develop a principles-based approach (PBA) to statutory reserves have been led by a small number of key players. While many others have followed their progress closely, the life insurance industry at large has taken a wait-and-see approach. However, companies are now stepping up and preparing for the transition to a new regulatory regime. The coming changes will affect life insurers not only through the impact on reserves and capital but by the far reaching effects of PBA on operations and product design as well. This goes past compliance exercises: Companies that can manage capital and reserves better will have a competitive advantage over those that do not under the new regime.

PBA is part of a wider movement toward providing a better linkage of reserve and capital levels to all material policy risks. The need for this type of shift in regulatory philosophy first became apparent in the 1980s, as competitive pressures and technology improvements led to a wave of product innovations that added credit and other financial risks to life insurance products. The traditional solutions under the rules-based regime – regulators modifying or adding new rules – were unable to keep statutory reserves in line with the actual risks.

In the 1990s the NAIC began to explore different approaches such as Risk Based Capital (RBC) to improve matching of reserves and capital to policy risks. Concepts central to a PBA regulatory framework – risk analysis and risk management techniques, including stochastic modeling – began to take form during this time. In the 2000s the design and implementation of principles-based regulation began, starting with PBA for capital in the form of C3 Phase II for annuities in 2005 and C3 Phase III for life insurance anticipated by year-end 2010.

Focus on Life Reserves

The regulatory focus is now on PBA for reserves. Unlike the C3 guidelines for capital, PBA for reserves will not come into force until ratified by the states and will apply only to new business issued after the effective date of the Standard Valuation Law (SVL). The formulaic approach will continue to apply to legacy inforce business. This grade-in approach will give insurers time to build new processes, train personnel, improve experience studies and work out the internal management and external regulatory reporting details of PBA.

Companies have concerns about the new regulation and the challenges of the PBA adoption process. A number of substantive items in the SVL are still under consideration, among them proposals brought forward by the American Council of Life Insurers (ACLI). One proposal is to add a net premium reserve calculation to Valuation Manual section VM-20 on life reserves which could be finalized by August 2010.

Continued next page
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Reserve calculation to Valuation Manual section VM-20 on life reserves (see article on page 5), which could be finalized by August 2010.

Companies want modifications to the PBA reserving calculation. For most products, PBA reserves are expected to be less than existing rules-based guidelines. However a great deal of stochastic analysis is required to confidently define the amount of reserves needed to cover all material risks and guarantees associated with the contract. Potentially hundreds of stochastic scenarios covering up to 30 years or more of anticipated experience are involved. Discussion is currently underway regarding scenario reduction techniques.

**Volatility in Reserves**

PBA will cause significant changes in corporate governance as well. Capital issues already are escalated to senior management level quickly. The same will be true for reserves. Senior managers will be more involved because under the SVL, assumptions will be reviewed and updated. Furthermore, stochastic analysis will guide the provision for adverse deviation (PAD), based in part on the level of uncertainty in anticipated experience. This information – a reflection of a company’s risk management capabilities – will be transparent to regulators, rating agencies and other stakeholders.

Assumptions reviews will mean volatility in reserves. Presently, pricing and/or valuation actuarial set initial assumptions, and the change in cash flows is the most significant impact if

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**A Glossary of Common PBA Terms**

- Asthe discussion of migrating to a principles-based environment grows, someterms are becoming more prominent in the life insurance lexicon. Below are some of the more common ones and why they are important for managers to consider.
- **Adoption Process.** Adoption of the SVL represents a general regulatory framework that allows other formal or quasi-regulatory groups to stipulate the details and make amendments without a vote. Companies should expect more frequent changes as industry experience emerges and much faster implementation. For some companies, this may pose data and technology challenges.
- **Assumptions Management.** PBA requires frequent reviews of assumptions to justify reserve and capital levels. A resetting of assumptions likely will have immediate consequences for required reserves and capital. Any resetting of assumptions to factor in adverse experience will be transparent to stakeholders.
- **Conditional Tail Expectation.** CTE is used to measure the total assets required to cover a certain percentage of loss scenarios. The higher the percentage, the greater the range of extreme loss events (tail risks) covered. For example, CTE-90 is the average of the worst 10 percent of resulting output.
- **Convergence.** In the US, PBA for capital borrows from the European Union’s Solvency II. A fair value approach to US GAAP is driven in part to harmonize reporting under International Financial Reporting Standards.
- **Company Experience.** Insurers will weight their own and industry experience based on credibility. Company-specific experience will drive the amount of capital and reserves a company must hold instead of using industry experience as a benchmark. This will make accurate risk assessment and pricing imperative.
- **Industry Experience.** Industry experience will provide a general credible basis for reserve and capital formulation, including experience for adverse deviation (PAD) reflecting uncertainty in reported companies’ experience.
- **Net Premium Reserve Calculation (Proposed).** The original PBA proposal ensures that reserves cover tail risks in excess of the gross premium deterministic reserve calculation level up to a given CTE. (An example of tail risk would be variable interest rates on financial guarantees.) The ACLI has proposed an additional net premium reserve calculation, which for many products will set the reserve floor close to current formulaic reserve levels.
- **Principles vs. Rules.** The current rules-based system is formula driven and treats each company the same. PBA factors in seriatim information such as products, risk characteristics and experience to derive a reserves and capital amount that reflects each company’s unique risk profile at that point in time.
- **Seriatim Data.** PBA will require companies to maintain and report data on a policy contract level. The data, technology and time required to develop, preserve and capital needs may be burdensome for some companies, but the competitive advantages of having these processes in place can make it worthwhile.

The European Union program to develop principles-based capital and reserving guidelines for life insurance.

**Stochastic Modeling.** Stochastic modeling involves running projections under a variety of realistic assumptions and scenarios (the definition of which, following the financial crisis, has expanded greatly). Stochastic modeling will be a continuous and ongoing process to validate pricing assumptions.

**Total Asset Requirement (TAR).** The sum of reserves, developed according to the SVL framework, and minimum required capital, as defined by C3 guidelines. Modeling of required reserves and capital will introduce fluctuations that reflect the risks inherent in the business. As more tail risks are incorporated into the formulas, companies should expect TAR to increase.
actual results vary from expected experience. Under PBA, assumptions will be reviewed and could be revised on a quarterly basis, introducing the chance for large magnitude changes to capital and reserves. One possible effect of the ACLI’s net premium reserve proposal would be to make blocks of traditional business less sensitive to assumption resets. The ACLI is also asking for a reduction in the frequency of assumptions reviews, perhaps having them take place as part of the existing statutory reporting process which occurs on an annual basis.

Assumption reviews will transform actuarial practices. In the past valuation actuaries had little input on initial product design and pricing process. Under PBA, getting the assumptions right from the outset will be a competitive advantage. Working together, pricing actuaries will be able to identify tail risk scenarios, and valuation actuaries will be able to model the financial impact. In this fashion teams will collaborate to produce new product designs, priced to the underlying risks and structured to reduce the worst downside scenarios.

PBA reserves could prompt a scaling back in existing guarantees. After C3 Phase II was introduced, annuities writers responded more often by scaling back guarantees and benefits rather than by raising prices. Companies already are starting to reduce or phase out credit and financial risks on insurance products, such as secondary guarantees and return of premium (ROP) riders, due to market pressures and regulation. With financial risk more transparent under PBA, we may see more adjustments to product design, pricing and availability.

The new regime also opens up possibilities for product innovation. With changes to the regulatory regime, companies someday may be able to offer a life needs product with health, life and income features unique to each policyholder. The costs and challenges from a policy administration standpoint may make such a vision hard to realize. But in a PBA environment, it could be possible for insurers to apply the flexibility of the existing UL framework to support riders and options covering aspects of other product classes – long term care, disability income, whole life and annuities.

Summary

Many adjustments will be made to PBA before various sections of the Valuation Manual are finalized and the associated SVL is submitted to the states for ratification. Beyond that, PBA will continue to evolve for years to come. As the ACLI proposals reflect, life insurers have a lot to say about changes in the regulations. However, PBA is more than a rules change; it changes how companies conduct their business. Understandably, company leaders are concerned. However, life insurers thrive by offering valuable product features to their customers. Going forward they will do even better by adopting the tools and processes that PBA offers to improve their management of these additional risks.