Exposure of APF 2019-52

Standard for Selecting Material Risks

Note that the APF is focused on setting a standard for the selection of material risks, as opposed to setting a standard for materiality based on percentage of a PBR reserves or some similar base amount.

Exposed for public comment through May 24, 2019

Comments can be sent to Reggie Mazyck ([RMazyck@NAIC.Org](mailto:RMazyck@NAIC.Org))

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| --- | --- | --- | --- |
| **Dates:** Received | Reviewed by Staff | Distributed | Considered |
|  |  |  |  |
| 4/30/19 |  |  |  |
| **Notes:** **VM APF 2019-52 (CA APF BR)** | | | |

**Life Actuarial (A) Task Force/ Health Actuarial (B) Task Force**

**Amendment Proposal Form**

1. Identify yourself, your affiliation and a very brief description (title) of the issue.

This APF was prepared jointly by NAIC Support Staff and the Office of Principle-Based Reserving,   
 California Department of Insurance. The APF addresses VAWG recommendation #5.

This APF is also meant to clarify how to identify a material risk for PBR, rather than introduce new requirements.  In addition, specific to VM-20 Section 9.B.1, this APF is re-categorizing some risks that were previously “generally considered material” to being material risks “in some cases.”

2. Identify the document, including the date if the document is “released for comment,” and the location in the document where the amendment is proposed:

Valuation Manual (January 1, 2019 edition, as amended by APF 2018-66):  
Section I Overview of Reserve Concepts, VM-01, VM-20, and VM-31

Note: Amendments proposed to VM-31 Section 3.C in this APF include the amendments proposed to the same section in the original exposure of APF 2019-28.

3. Show what changes are needed by providing a red-line version of the original verbiage with deletions and identify the verbiage to be deleted, inserted or changed by providing a red-line (turn on “track changes” in Word®) version of the verbiage. (You may do this through an attachment.)

See attached Appendix.

4. State the reason for the proposed amendment? (You may do this through an attachment.)

See attached Appendix.

NAIC Staff Comments:

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#### Appendix

#### ISSUE:

A concern that arose from the review of the 2017 PBR Actuarial Reports was that a number of companies set a materiality standard based on a percentage of total company reserves or surplus. Effectively this means that an item impacting PBR would not be considered material unless the dollar impact was much greater than the PBR reserve itself.

VAWG Recommendation #5 is to require a more appropriate standard for selecting material risks.

#### SECTIONS:

Overview of Reserve Concepts under Section I, VM-01, VM-20, VM-31

#### REDLINE:

**Section I, Introduction**

**Authority and Applicability**

**|**

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**Overview of Reserve Concepts**

A principle-based valuation must reflect material risks. These are the risks that:

1. Are associated with the policies or contracts being valued, or their supporting assets, and

2. Have any of the following attributes:

a. The risk has been determined to be capable of materially affecting the relative size of the reserve,

b. The risk has a prescribed margin, or

c. The risk is stochastically modeled.

**VM-01**

* The term “margin” means an amount included in the assumptions used to determine the modeled reserve that incorporates conservatism in the calculated value consistent with the requirements of the various sections of the *Valuation Manual*. It is intended to provide for estimation error and adverse deviation.

**(New) VM-20 Section 2.H**

1. The company shall establish for the DR and SR, a standard containing the criteria for determining whether an assumption, risk factor or other element of the principle-based valuation has a material impact on the relative size of the reserve. This standard shall be applied when identifying material risks pursuant to the Overview of Reserve Concepts under Section I, *Introduction*. Such a standard shall also apply to the NPR with respect to VM-20 Section 2.G.

**Guidance Note:** For example, the standard may be expressed as an impact of more than X dollars or Y% of the reserve, whichever is greater, where X and Y are chosen in a manner that is meant to stand the test of time and not need periodic revision.

The standard is based on the impact relative to the size of the NPR, DR, and SR as opposed to the impact relative to the overall financial statement (e.g. total company reserves or surplus). Reviewing items that may lead to a material misstatement of the financial statement in the current year is appropriate in its own context, but it is not appropriate for identifying material risks for PBR, which itself is an emerging risk.

Note that the criteria apply to the NPR, DR, and SR, and not just the final reported reserve. For example, if the DR is less than the NPR, the criteria still apply to the DR.

The standard also applies to exclusion tests, as they are an element of the principle-based valuation.

**VM-20 Section 9.A.1**

1. General Assumption Requirements
2. The company shall use prudent estimate assumptions in compliance with this section for each risk factor that is not stochastically modeled by applying a margin to the anticipated experience assumption for the risk factor, if such risk factor has been categorized as a material risk.

**VM-20 Section 9.A.7**

7. The company shall sensitivity test risk factors that are not stochastically modeled and examine the impact on the modeled reserve. The company shall update the sensitivity tests periodically as appropriate. The company may update the tests less frequently when the tests show less sensitivity of the modeled reserve to changes in the assumptions being tested or the experience is not changing rapidly. Providing there is no material impact on the results of the sensitivity testing, the company may perform sensitivity testing:

* 1. Using samples of the policies in force rather than performing the entire valuation for each alternative assumption set.
  2. Using data from prior periods.

**Guidance Note:** Sensitivity testing every risk factor on an annual basis is not required.

For some risk factors, it may be reasonable, in lieu of sensitivity testing, to employ statistical measures for margins, such as adding one or more standard deviations to the anticipated experience assumption.

**VM-20 Section 9.B.1**

1. The company shall determine an explicit set of initial margins for each material risk independently (that is, without regard to any margins in other risk factors and ignoring any correlation among risk factors). Next, if applicable, the level of a particular initial margin may be adjusted to take into account the fact that risk factors are not normally 100% correlated. However, in recognition that risk factors may become more heavily correlated as circumstances become more adverse, the initially determined margin may only be reduced to the extent the company can demonstrate that the method used to justify such a reduction is reasonable, considering the range of scenarios contributing to the CTE calculation or considering the scenario used to calculate the deterministic reserve as applicable or considering appropriate adverse circumstances for risk factors not stochastically modeled. It is not permissible to adjust the initial margin to recognize, in whole or in part, implicit or prescribed margins that are present, or are believed to be present, in other risk factors.

Risks that are stochastically modeled (e.g., interest rates, equity returns) or have prescribed margins (e.g., mortality, revenue sharing), shall be considered material risks. Other risks generally considered to be material include lapses/premium persistency, YRT premiums, maintenance expenses, and inflation. In some cases, the list of material risks may also include morbidity, acquisition expenses, partial withdrawals, policy loans, term conversions, non-guaranteed elements, and/or option elections that contain an element of anti-selection.

**VM-20 Section 9.B.4**

1. A margin is permitted but not required for assumptions that do not represent material risks pursuant to Section I, Overview of Reserve Concepts and VM-20 Section 9.B.1.

**VM-31 Section 3.C**

1. VM-20 Materiality – The standard established by the company pursuant to VM-20 Section 2.H.

2. Monitored Risks and Findings or Concerns – A summary of:

a. The material risks within the principle-based valuation under VM-20 and other risks that are subject to close monitoring by the board, the company, the qualified actuary, or any regulators in jurisdictions in which the company is licensed. , and

b. Any significant unresolved issues regarding the principle-based valuation under VM-20 in accordance with VM-G Section 4.A.5.

**Guidance Note:** Risks that are subject to close monitoring include items pursuant to VM-G Section 3.A that necessitate a heightened degree of oversight for the implementation or ongoing operation of the principle-based valuation function under VM-20. These may include risks relating to a process, procedure, control, or resource. An example might be that the company is closely monitoring the adequacy of resources and level of knowledge for PBR.

3. Changes in Reserve Amounts – A description of the changes in reserve amounts from the prior year to the current year and why the changes are reasonable.

**VM-31 Section 3.C.9.b**

b. NGE Margins – Description of the approach to establish a margin for conservatism, if applicable.

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#### REASONING:

See the Issue section above.