December 15, 1999

TO:
ALL CHIEF ACTUARIES OF LIFE INSURANCE COMPANIES AND FRATERNAL ORGANIZATIONS LICENSED IN ILLINOIS

FROM:
LARRY M. GORSKI, FSA, MAAA

RE:
COMMENTS CONCERNING ACTUARIAL MEMORANDA, REGULATION XXX, EQUITY INDEXED ANNUITIES, ET. AL. (CB # 99-9)

Asset Adequacy Analysis (AAA) Issues

Due to some questionable practices used in the modeling of expense cash flows in cash flow testing, we have been putting more emphasis on reviewing those assumptions. For example, it has not been uncommon for appointed actuaries to exclude a fair amount of overhead expenses from their testing by allocating them to earnings on surplus. We are quite skeptical of this practice and believe instead that future expected overhead cash outflows should be allocated between existing business (and therefore included in AAA) and future new business (and therefore not included in the AAA). Any such allocation must of course be reasonable and supportable, and should be discussed in the Actuarial Memorandum required by the Actuarial Opinion and Memorandum Regulation (AOMR) [50 Il. Adm. Code 1408 et. seq.].

The AOMR requires that the reserve method and basis used for reserves be included in the Memorandum [50 Il. Adm. Code 1408.80(b)(1)(C)]. This is especially important with regard to products where the legal requirements are not clearly defined. Examples are variable products and products that combine more than one type of benefit (e.g. a life insurance benefit and a long term care benefit).

This year we are requesting that the Appointed Actuary submit a Regulatory Asset Adequacy Issues Summary (RAAIS) to us by March 15, 2000. This document is required by the current draft of the NAIC Model AOMR (see attached for the most recent draft language which differs from the 9/7/99 version). The RAAIS is considered a confidential document by our Department, and will be destroyed each year upon receipt and review of the following year's RAAIS. Because it is considered confidential, the RAAIS should not be sent with the annual statement, but should be submitted directly to Mr. Bruce Sartain, ASA, of the Illinois Insurance Department in Springfield. The request for an RAAIS is a standing request.
Regulation XXX

The new version of XXX (Part 1409, Valuation of Life Insurance Policies Including the Use of Select Mortality Factors) is expected to be adopted in December and become effective on 1/1/2000. The "Shadow Cash Value" policy design came to our attention while we were drafting the regulation for Illinois, and there was language added in Section 1409.60 to deal with that policy design. First, we clarified that the secondary guarantees mentioned are examples and secondary guarantees are in no way limited to the two examples listed. Second, language was added to the definition of "specified premiums" to indicate that shadow cash values should be thought of as giving rise to "imputed specified premiums", not "minimum premiums". We realize that this wording does not completely clarify the valuation issues surrounding policy designs with shadow cash values specifically or with secondary guarantees in general. Due to the creativity shown in creating different types of secondary guarantees, we are asking companies to contact us with valuation questions in this area. We will decide on appropriate valuation methods on a case by case basis after reviewing the contract language as well as all advertising, marketing, and illustration material.

Our department will be putting a great deal of emphasis on compliance with the provisions of Regulation XXX that deal with the so-called "X factor." While XXX imposes certain requirements and limitations on the "X factor", the requirements are defined in terms of expectations. We intend to review the procedures used by the actuary to determine the reasonableness of the "X factor" in light of actual emerging experience. Our view is that the "X factor" should be based on sound, statistical analysis of all relevant actual experience, even if of limited volume.

Equity Indexed Annuities

Actuarial Guideline 35 (formerly Actuarial Guideline ZZZ) was adopted by the NAIC at the December 1998 meeting. Most, if not all, equity indexed annuity filings that were filed in Illinois were approved only after an agreement was reached over an acceptable statutory reserving methodology. Actuarial Guideline 35 was at the foundation of our review and approval procedure. We expect all companies that write directly or reinsure equity indexed annuities to comply with Actuarial Guideline 35. Compliance with this actuarial guideline includes submitting the appropriate actuarial certification to the Illinois Department of Insurance. The actuarial certification required depends on whether a Type 1 or Type 2 method is used. Actuarial certifications should be submitted on a quarterly basis to Larry M. Gorski, FSA, of the Illinois Department of Insurance in Springfield. For a detailed description of the acceptable reserving methods and the specific language of the actuarial certifications, please consult NAIC Actuarial Guideline 35.

Other Statutory Reserve Issues

There are a few areas in which there may be some confusion regarding Illinois' reserving requirements, and therefore we would like to clarify our positions. First, in the application of the Commisioners annuity reserve valuation method (CARVM) [215 ILCS 5/223(5)], continuous rather than curtate CARVM should be used on all annuities that are subject to CARVM, not just CD annuities (see CB 89-57). Second, Section 223(6)(c)(C)(3) of the Illinois Insurance Code refers to the ability to increase weighting factors by .05 if the applicable contracts "do not guarantee interest on considerations received more than one year after issue or purchase". We interpret this to mean any guaranteed interest, not just if that guaranteed interest is greater than the long life rate. Therefore flexible premium deferred annuities would not be eligible for the .05

increase. Lastly, with regard to credit life, our minimum reserve standards are 1980 CET for mortality, and dynamic interest rates for the interest rate assumption.

Should any of the issues discussed herein raise questions, do not hesitate to contact me at (217)-782-1794 or email me at Larry_Gorski@ins.state.il.us.

Attachment

November99.lwp Attachment
C. Details of the Regulatory Asset Adequacy Issues Summary

(1) When an actuarial opinion under Section 8 is provided, the regulatory asset adequacy issues summary shall also be provided. It shall specify:

(a) For each of the required interest rate scenarios which produce negative ending surplus values in the aggregate as defined in Section 10.A, the amount of additional reserve as of the valuation date which, if held, would eliminate such negative aggregate surplus values. Ending surplus values must be determined by either extending the projection period until the in-force and associated assets and liabilities at the end of the projection period are immaterial or by adjusting the surplus amount at the end of the projection period by an amount which appropriately estimates the value which can reasonably be expected to arise from the assets and liabilities remaining in force.

(b) The extent to which the appointed actuary uses assumptions in the asset adequacy analysis that are materially different than the assumptions used in the previous asset adequacy analysis;

(c) The amount of reserves and the identity of the product lines that had been subjected to asset adequacy analysis in the prior opinion but were not subject to analysis for the current opinion;

(d) The number of additional interest rate scenarios tested identifying separately the number of deterministic scenarios and stochastic scenarios;

(e) If sensitivity testing was performed, identify the assumptions tested;

(f) Comments shall be provided on any interim results that may be of significant concern to the appointed actuary;

(g) The methods used by the actuary to recognize the impact of reinsurance on the company's cash flows, including both assets and liabilities, under each of the scenarios tested;

(h) Whether the actuary has been satisfied that all options affecting cash flows embedded in fixed income securities and equity-like features in any investments have been appropriately considered in the asset adequacy analysis.

(2) The regulatory asset adequacy issues summary shall contain the name of the insurance company for which the regulatory asset adequacy issues summary is being supplied and shall be signed by the appointed actuary rendering the opinion.