**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.

Joint submission by NAIC staff and Staff of Office of Principle-Based Reserving, California Department of Insurance – Clarify areas of confusion relating to the topic of materiality.

1. 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, 2021 edition), VM-20 Section 2.H, new Section 2.I, and Section 7.E.1.g

1. 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.

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

See attached Appendix.

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NAIC Staff Comments:

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| --- | --- | --- | --- |
| **Dates:** Received | Reviewed by Staff | Distributed | Considered |
|  09/21/20 |  RM |  |  |
| APF 2020-02 rev. 09/21/20 |

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#### Appendix

#### ISSUE:

Skipping steps in VM-20 is not allowed on grounds of immateriality. Some companies are skipping some VM-20 requirements altogether, without providing a simplification, approximation, or modeling technique that satisfies the VM-20 Section 2.G requirement that such simplifications neither materially understate nor downwardly bias the reserves. Simply skipping portions of the requirements, such as not computing an NPR, or not computing the DR and/or SR when exclusion tests have not been performed, inherently bias the reserve downward since their omission can only be neutral or decrease the resulting reserve. Without computing even a simplified model for Section 2.G analysis that shows there is not a decrease in the final reserve, this makes the skipping of the step violate Section 2.G. This APF clarifies that these types of omissions are not allowed. This has always been the case, but perhaps needs more emphasis in the *Valuation Manual*.

#### SECTION:

VM-20 Section 2.H and new Section 2.I, and VM-20 Section 7.E.1.g

#### REDLINE:

VM-20 Section 2.H

 H. 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 size of the reserve. This standard shall be applied when identifying material risks under VM-20 Section 9.B.1. 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.

(new) VM-20 Section 2.I

1. Section 2.G and Section 2.H provide companies some flexibility in assumption setting and modeling methodologies, but they do not allow for skipping mandated steps without providing a valid approximation, simplification, or modeling technique under Section 2.G that neither materially understates nor downwardly biases the reserve.

 Examples of omissions that would not satisfy VM-20 Section 2.G: not computing even a simplified NPR, not computing even a simplified DR or SR without having passed the relevant exclusion test(s), omitting prescribed mortality margins, not establishing any lapse margins, not building even a simplified asset model for the DR, using the alternative investment strategy without first determining that it produces a higher reserve than the company investment strategy, and ignoring post-level term losses.

**Guidance Note:** The issue here is not the use of approximations; it is about skipping mandated VM-20 requirements. Thus, for example, this does not rule out the use of a relatively simple asset model that is acceptable pursuant to VM-20 Section 7.E.1.a, nor the judicious use of the previous year’s assumption development work to save time and effort.

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VM-20 Section 7.E.1.g Guidance Note

**Guidance Note:** VM-31 requires a demonstration of compliance with VM-20 Section 7.E.1.g. In many cases, particularly if the model investment strategy does not involve callable assets, it is expected that the demonstration of compliance will not require running the reserve calculation twice. For example, an analysis of the weighted average net reinvestment spread on new purchases by projection year (gross spread minus prescribed default costs minus investment expenses) of the model investment strategy compared to the weighted average net reinvestment spreads by projection year of the alternative strategy may suffice. The assumed mix of asset types, asset credit quality or the levels of non-prescribed spreads for other fixed income investments may need to be adjusted to achieve compliance. Or, the company may be able to rely on a previous year’s determination as to which strategy produces a higher reserve, if the assets and strategy have not changed very substantially since then.

#### REASONING:

#### Some companies have mistakenly believed that it was permissible to skip certain significant steps outlined in VM-20, without using a valid approximation or simplification that they have shown does not materially understate or bias reserves in a downward direction.

Note: Comment letters were received on an earlier draft of this APF, in response to which this newer version has eliminated any mention of PIMR and has made it clearer that a simplified asset model may in some circumstances be acceptable and that a full-blown run of both the actual investment strategy and the alternative investment strategy is not necessarily something that has to be done every year.