Small Talk

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Recent Developments on Principle-Based Reserves (PBR)

By Norman E. Hill

As always, this topic is extremely volatile and subject to change. It is highly recommended that readers keep up with email blasts from the Small Insurer Council (SIC).

PBR Implementation Task Force (TF) Call, June 21, 2013

The TF is working with two portions of the Legislative Packet, a Legislative Brief and an Educational Packet. The intent is to use the packet in lobbying for PBR with state legislatures.

Co-Chairman Joseph Torti said some significant improvements and simplified language, such as that pertaining to incentives for "workarounds," have been made. Nancy Bennett spoke on behalf of the American Academy of Actuaries (AAA). They had worked extensively on the impact of PBR on reserves. They included numerous caveats for their section of the brief. They included a statement on impact without numbers. While retaining lengthy caveats in the Educational portion, they also included numbers on product impacts with these caveats.

A key Educational question is: "Is PBR more or less conservative?" No simple answer exists, so AAA , as stated above, showed impact by product. Also, they showed benefits resulting from this methodology change. Torti thanked AAA, but admitted their answer is longer than he had hoped.

Rob Easton of the New York Insurance Department (NYID) said they are generally satisfied with the Educational part. On the brief, under Background, there is a statement that the reserve impact is "small." He moves to strike "small." I believe this change was approved. The Packet, both portions, was adopted by TF, although NYID still abstained. The point was made that Plenary in August must still adopt.

Next, the PBR Implementation Plan itself was discussed. The goal on the call was to complete review of all sections of the plan.

On Section 6, Accreditation, a new key point was raised by NYID. Easton said that if a state doesn't adopt the Valuation Manual (VM), but retains a formulaic reserve approach that is more conservative than PBR, it is fulfilling accreditation requirements. Torti replied that, since PBR's impact will include "ups and downs," the effect would have to be reviewed by the National Association of Insurance Commissioners' (NAIC's) Accreditation Committee.

I believe that Torti's argument may be refuted. New formulaic valuation tables, such as the 2014 version for non-variable annuities, and pending life tables for limited underwritten or guaranteed issue life, are in process, all with higher reserves. They may well be in place before PBR.

I believe that Easton's comment is very significant. It could provide states with effective defenses if they don't go along and adopt PBR.

Section 1 is Review Process and Timing. First, Easton of NYID commented on p. 5, the collection of data for the Experience Reporting process. He proposed to say, "Expense mechanics will be developed." NYID is concerned that the state's domestics that participated in their study don't bear an unfair amount of the cost. He's addressing the interim period, not merely the final approval period. The American Council of Life Insurers (ACLI) agreed and said that, for the long term, there should be a sentence addressing who will pay the costs. Co-Chairman Julie Mix McPeak asked whether in the interim period the NAIC could bind anyone on costs. If Kansas' goal in its data call is successful in covering 80 percent of the industry, including New York, will this satisfy NYID? Easton replied that, since they're not ready to adopt PBR, they still wanted to ensure that concerns of their domestics on costs are addressed. So McPeak agreed to go with "will be developed," subject to presentations in August, say, from NYID and Kansas, on the big cost issues.

Still in Section 1, the ACLI asked what is meant by a "working document." Next, on p. 7, the ACLI brought up the subject of the VAWG, the Valuation Analysis Working Group, and its access to confidential information. Torti pointed out that another NAIC group, the Financial Analysis Working Group (FAWG), also accesses confidential information. But John Bruins said that, for PBR, confidentiality has been a lightning rod.

On Section 2, Pre-Implementation Training, no comments were made.

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For Sections 3 and 4, on Valuation, Actuarial and Testing, NYID referred to comments about PBR's smoothing out reserve "volatility." He said this should be tested by the Life Actuarial Task Force (LATF). The same comment about LATF testing seemed to apply to p. 11, last bullet.

On p. 10, ACLI referred to LATF's charge to address implementation timing for additional products, such as annuities and long-term care (LTC). Similarly, on p. 11, fourth bullet, references to Actuarial Guidelines 33 and 43 really addressed products issued prior to PBR. They recommended deletion of these two references.

On Section 5, on Captives and Special Purpose Vehicles, no comments were received. In an earlier call, Torti had mentioned that several companies had told him they were sure that these types of organizations should still exist, even after PBR becomes effective.

On Sections 7 and 8, no comments were received.

McPeak said that a new draft of the Implementation Plan is needed. The TF adopted this draft, although NYID still abstained.

LATF Call, June 25, 2013

Three proposed amendments to the VM were discussed. Chairman Mike Boerner said that several more LATF calls before the NAIC summer meeting may be required before LATF can finally adopt. Some language changes and clarifications in the amendments are needed. It was understood that no amendments can be effective until current VM and PBR have been adopted by a supermajority of state legislatures.

The first amendment was to use an iterative process to determine the overall discount for gross premium or deterministic reserves. In March, a draft was exposed that required this new approach. Now, the ACLI and other parties have proposed that the iterative approach be optional.

One interesting question was posed by ACLI: Should this iterative process be applied to stochastic exclusion tests (SETs)? For the 16 scenarios in one sub-option of SET, interest rates are specified in some detail. I believe the likely intent of this question is to generate a brief discussion and preclude unwarranted interpretations of the process later on.

The second amendment was to simplify calculation of the pre-tax interest maintenance reserve (IMR), when used in PBR reserves. This was described as mathematically equivalent. This change would not change annual statement instructions for IMR.

The third and final amendment was intended to clarify modeling of policy loan cash flows in gross premium and stochastic reserves.

Aggregate Margin Subgroup

An LATF subgroup is working with AAA on this question. If aggregate margins to best estimate assumptions are permitted in PBR reserves, it is expected to reduce reserves further than current requirements for separate margins by assumption. Several insurers and some AAA members strongly support the aggregate approach, while, among regulators, NYID has been adamantly in favor of the current separate assumption approach.

As the subgroup announced in its last June 3, 2013 call (and also last March at the NAIC), several approaches to aggregate margins are being studied. These include a flat percentage adjustment to reserves and some kind of cost of capital approach (which might result in a similar percentage reserve adjustment).

So far, one possible complication from the aggregate approach hasn't been discussed. In an earlier TF call, the ACLI was asked to estimate the overall PBR impact on reserves for term and universal life with secondary guarantees. Paul Graham replied that, across all durations of blocks affected, reserves might be reduced about 20 percent. If the aggregate approach for assumptions is used, the reserve reduction could be significantly greater. If this possibility is conveyed to state legislatures during the ini-

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tial VM approval process, it might increase their concerns about PBR.

Document Sources

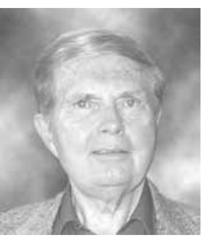
Draft documents prepared so far by the EXPBR TF (dated June 21, 2013) are available under their section of the NAIC website (*www.NAIC.org*). Later versions may be attached to notices of future TF calls. Minutes of these calls that include discussions will probably be available at NAIC meetings.

The three VM20 amendments proposed to LATF should be available under LATF's portion of the same NAIC website. Also, they should be available in monthly LATF mailings. Minutes of these calls that include discussions should also be included in the mailings.

As for aggregate margins, a document detailing their work to date was distributed at the March LATF meeting. Minutes and discussions from their calls should be included in monthly LATF mailings.

Summary

Both the Product Implementation TF and LATF plan to hold several calls before the next NAIC meeting. Even while the state legislative approval process is still in its infancy, PBR itself continues to be volatile and contentious.



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