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New York Implements PBR Plus

By Felix Schirripa

In February, the New York State Department of Financial Services (NYDFS) adopted its First Amendment to Regulation 213, Principle-Based Reserving (PBR). The amendment implements New York's version of PBR. In brief, the amendment sets the reserve at the "greater of" (a) a modified version of the pre-PBR formulaic reserve, and (b) the National Association of Insurance Commissioners (NAIC) Valuation Manual PBR amount, modified to add extra conservatism (i.e., PBR plus potential margins). New York's approach is a hybrid reserving regime because it is not fully PBR as contemplated by the Valuation Manual and it is not fully the pre-PBR formulaic set of rules.

The reserves under amended Regulation 213 can be expected to come in above or equal to the NAIC standards. The exact differential will vary by company, by product and even by the features contained in those products. Variable annuities with guaranteed living benefits are especially negatively impacted because of new constraints on actuarial assumptions.

Insurers have expressed concern that New York's hybrid approach will add costs to the implementation and administration of PBR. The cost of system changes—both the up-front changes and the ongoing maintenance—can be significant when considering the governance implications and the added testing and training needed.

Another noteworthy aspect is the use of prescribed policyholder behavior assumptions that can bear little relationship to observed and/or expected behavior patterns. The use of assumptions not aligned with experience can lead to large differences between statutory reserves and economic liabilities and may constrain a company's ability to hedge its contractual obligations. This raises the potential for unintended consequences (e.g., insurers not being able to properly hedge assets to liabilities, increases in fees charged to consumers, and products withdrawn from the market).

But there is some reason for New York domestics to be optimistic. The NYDFS has demonstrated a willingness to hear concerns and may entertain amendments to help address the big disconnects between PBR and the statutory reserves mandated by New York's amended regulation.

What follows is a brief description of New York's PBR amendment to insurance Regulation 213. The full text is available from the DFS. You can also review the public comments DFS received along with the responses the department provided.

EFFECTIVE DATE AND SMALL COMPANY EXEMPTION

The application of NY PBR Regulation 213 is mandatory effective Jan. 1, 2020 (optional for year-end 2019), and applies to all life companies and fraternal benefit societies doing business in New York. The regulation, Sections 103.4(d) and 103.7(d), has a mechanism for an insurer to request a delay of up to one year in implementing the new reserve standards. The department may approve these requests on demonstration of "undue hardship, impracticability, or good cause."

Small companies have the option to use the Life PBR exemption, as detailed in Section II of VM-20 of the Valuation Manual, which was adopted by DFS. The small company exemption is relevant for life insurance business only. It does not extend to other lines of business, which is also true under NAIC reserve requirements.

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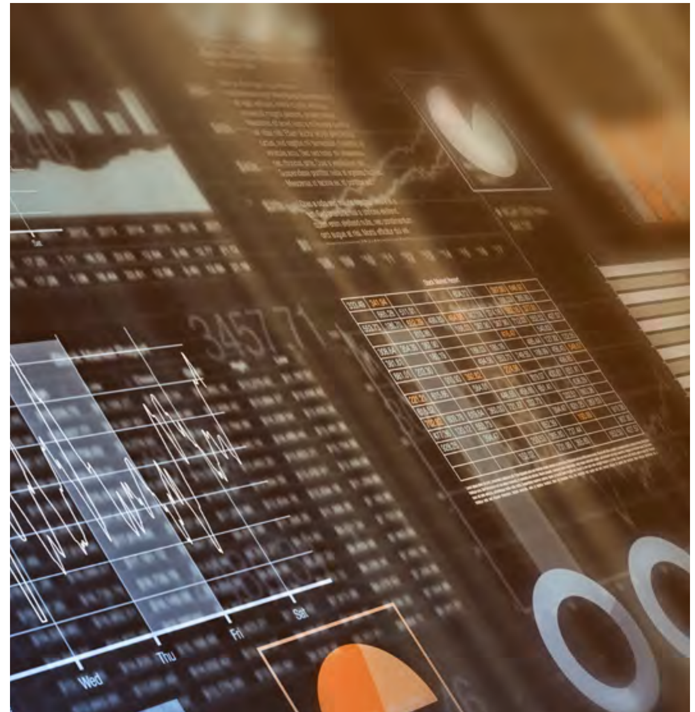
INDIVIDUAL TERM LIFE INSURANCE

Under Regulation 213, the reserve for *new* term life business is set at the greater of (1) and (2), where (1) is the aggregate reserve under VM-20 and (2) is the greater of (a) the sum of the cash surrender value and (b) 70 percent of the total current seriatim reserve under Regulation 147.

NONVARIABLE PAYOUT ANNUITIES

The regulation deviates from VM-22 (fixed, payout annuities) in three major ways. First, it adds conservatism by relying on a high-quality reference portfolio composed of 5 percent Treasuries, 45 percent AA and 50 percent A, whereas the NAIC standard uses 5 percent Treasuries, 15 percent AA, 40 percent A and 40 percent BBB. Second, it adds further conservatism by placing a 200-basis-point cap on the gross spread before defaults for each bond quality segment. Third, it then removes some of the added conservatism by using a clever rounding rule that, in many interest rate and spread environments, produces no differences between the New York valuation rate and the VM-22 rate. But if credit spreads widen, the New York rate can be expected to fall below the rate in the Valuation Manual.



Mathematically:

NY Valuation Rate = VM-22 Rate –
[round down to the nearest 25 basis points (unrounded VM-22 Rate – unrounded NY Rate)]

In addition, for jumbo annuity cases (with contract premiums exceeding $250 million), the valuation interest rate is set monthly, not daily as in VM-22, and the regulation also adds a maximum spread constraint of 190 basis points.

The DFS has said that it plans to publish these valuation interest rates on its website, likely monthly.

VARIABLE ANNUITIES

The reserves for in-force variable annuity contracts (i.e., issued before 2020) are now set at the greater of (1) NAIC VM-21 and (2) AG43 Standard Scenario (as of Dec. 31, 2017) with added constraints on assumed mortality, interest, lapses and other factors. These new constraints increase reserves by an amount that varies by type of living benefit. The reserve increase could be significant. The regulation provides a modest level of relief by allowing the reserve increase to be amortized over a period of three years.

For contracts issued after 2019, the minimum reserve is set at the greater of (1) NAIC VM-21 reserve and (2) the New York–prescribed Objective Floor (OF) reserve. The OF is a modified, more conservative version of the Standard Scenario that must now also reflect an Option Value floor determined on a seriatim basis. Relative to the AG43 Standard Scenario, the OF is more interest-rate sensitive and will likely encourage more interest-rate hedging.

The OF must be determined using two prescribed equity scenarios: (1) –20 percent immediately and 4.5 percent annual gross returns after year one, and (2) +20 percent immediately, –30 percent return in year one, and 4.5 percent after year one. The returns for bond funds are set at –4 percent followed by the yield on the five-year Treasury plus a spread of 100 basis points. Other return assumptions are also specified.

Before the election of the contract's living benefit option, mortality is assumed to follow the 2012 Individual Annuity Mortality (IAM) Basic Table with projection of specified mortality improvements. Postelection, the mortality assumption is required to follow the 2012 Individual Annuity Reserving (IAR) Table. In both cases, selection factors consistent with the mortality assumption in the NAIC VM-21 standard are required.

Lapse rates are required to follow prescribed assumptions that vary by the type of guaranteed benefit, the in-the-moneyness and the presence of a surrender charge.

For guaranteed minimum income benefits, the benefit utilization rates will follow the old AG43 requirements. But for guaranteed minimum withdrawal benefits, the delay withdrawal cohort method is used with modified assumptions that add conservatism.

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CONCLUSIONS

New York has adopted the Valuation Manual (including, for example, the Life PBR exemption and its other sections), but its amendment to Regulation 213 is intended to add conservatism to what is in the Valuation Manual.

The NYDFS has also used the amendment to strengthen its existing reserve standards for variable annuities. Companies are given three years to phase in these increases in statutory reserves.

It remains to be seen how the amendment to Regulation 213 will impact insurers and consumers. ■

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