Principle-Based Reserving

- Life insurance policy reserves are the money an insurance company must set aside today to pay expected future life insurance claims.

- Life insurance policy reserves are currently calculated (or “valued”) using pre-set formulas. Principle-Based Reserving, or PBR, would use more advanced methodologies to better reflect and measure the risks of the new innovative insurance policies.


- PBR will be effective only after a supermajority of states, representing 75% of written premium, adopts the revised laws and will apply only to new life insurance business.

Background

Innovation in life insurance products provides consumers with products they want, but can also make it more difficult to capture the value of the life insurance promise with a simple formula. The result is a constant need for modification of formulas and the laws containing those formulas. In 2009, the NAIC adopted a revised model Standard Valuation Law (SVL) which introduced a new method for calculating life insurance policy reserves to more easily adapt requirements for changing products. This new method is referred to as Principle-Based Reserving, or PBR. Once adopted by legislatures, PBR would replace the current formulaic approach to determining policy reserves with an approach that more closely reflects the risks of the highly complex products. The improved calculation is expected to “right-size reserves,” reducing reserves that are too high for some products and increasing reserves that are too low for other products. While the impact on each company could vary widely, it is expected that the effect on total reserves would be a small decrease, especially in the initial years. However, the increase or decrease in reserves is much less important than the “right-sizing” of reserves. This new method will help reduce the incentive for company “workarounds” designed to reduce reserves. The revised SVL would authorize creation of a Valuation Manual that contains reserving requirements. The Valuation Manual was adopted by a supermajority of NAIC members in December 2012, paving the way for states to begin adopting revisions to the SVL in their legislative sessions. Once at least 42 states (a supermajority) representing 75% of total U.S. premium adopt the revisions to the SVL, PBR will be implemented.

Key Points

- States may adopt revisions to the Standard Valuation Law (SVL) beginning in the 2013 legislative sessions.

- PBR will be effective only after the law revisions are adopted by at least 42 states representing 75% of total U.S. premium and then, after a three-year transition period. (Companies can implement PBR anytime in the 3 years.)

- The Valuation Manual will continue to be updated annually as part of an ongoing maintenance process.

- The NAIC and state insurance departments must assess their needs for additional staffing, as PBR requires a greater degree of actuarial expertise. Already, the NAIC plans to hire additional actuarial staff to assist states.

- Change to the Standard Non-Forfeiture Law for Life Insurance is intended as a package with the SVL changes so that mortality and interest rate assumptions are coordinated.

- The Valuation Manual provides exclusion criteria which allow simpler products, with fewer guarantees and therefore less risk, to be subject to simpler reserving requirements.

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1 Additional discussion of the impact on reserves can be found in the NAIC PBR Educational Brief.