PBR Implementation and Review Process

Review, Assessment and Improvement

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Why Do We Need PBR?

- Addresses shortcomings in current formula-based reserve methodology
  - Reserve methodology fundamentally unchanged for 150 years
  - Increased complexity in product design not easily addressed through new regulations or actuarial guidelines
  - “One size fits all companies and products” does not work
  - Reserve may be too conservative or not adequate for some products and benefits

PBR

- PBR Represents a major paradigm shift:
  - From a strictly formulaic basis (static)
  - To requirements that include elements of stochastic modeling (i.e., using a range of economic scenarios) and an insurer's own experience (dynamic)
- There are benefits to consumers, regulators, and the industry, but the transition has its challenges
- And both the transition elements and the dynamic methodology itself require continuous review, assessment and improvement

Introduction of Prescriptive and Limiting Elements

- Regulators have expressed some concern about the model-based approach and the degree of discretion provided to companies in establishing reserves
- Prescriptive and limiting elements were introduced to address those concerns
- The Academy’s Life Practice Council (LPC) understands that there are regulatory concerns about transitioning to a PBR framework

Risk of Prescriptive and Limiting Elements

- Many of these prescriptive and limiting elements:
  - May add significant, unnecessary complexity
  - May add excessive conservatism not needed in a fully mature PBR system
  - May cause regulatory valuation to diverge from the processes used by insurers to manage their risks at an enterprise level

Need for a Process to Review Prescriptive and Limiting Elements

- It is critical to the success of PBR to develop a process by which the impact of these added elements can be evaluated and either adjusted or removed once actuarial practice is demonstrated to be established and regulators become comfortable with company filings
- The result will be a more purely stochastic-based, experience-based PBR framework that appropriately reflects individual company risk and experience

Need for a Process to Review Stochastic Modeling

- In order for a stochastic model to be an effective analytical tool:
  - The model's calculation routines, such as its interest rate generator, must be calibrated to be consistent with updated data and must be evaluated for reasonableness
  - The assumptions used in the model must reflect recent experience. A process to review the assumption-setting and modeling process is needed to ensure that it is up-to-date and is a necessary complement to a valuation method that incorporates stochastic modeling.

Additional Resources

- At State Insurance Departments
  - Need to develop the expertise necessary to analyze complex stochastic models
  - Need new tools to evaluate complex models, and a cohesive and objective framework for evaluating the adequacy of reserves if/when changes are needed.
  - May need additional personnel with expertise in risk management to make improvements to the PBR framework once sufficient experience exists
- At the NAIC
  - The many competing priorities (e.g., SMI, PBR for other lines of business, RBC), will create a demanding environment for finding and retaining dedicated working group and staff resources to undertake review processes

Additional Resources, cont.

- From the Academy, SOA, Industry and other interested parties:
  - Additional contributions toward training and design of audit procedures are necessary to the success of PBR
  - Maintenance of robust experience studies and documentation will be essential
- This paradigm shift in valuation requires actuarial input from all involved (companies, regulators, etc.) to evaluate the effectiveness of the overall valuation approach

Possible Ways to Address Resource Challenges

- Centralized Review Facility
  - Could be staffed by actuaries employed by the NAIC or contracted through consulting firms
  - Would provide knowledgeable and dedicated resources to support state insurance departments as they review companies' reserves using principle-based approaches
  - Could be used as a resource to the NAIC in its role in evaluating the overall effectiveness of PBR for the industry at large
- Additional actuarial resources at individual state insurance departments
- The NAIC and individual states should act now to determine the most effective means for ensuring the necessary tools and resources are in place to review, assess and improve this new dynamic approach to valuation

Summary

- The Academy's LPC supports the adoption of the PBR methodology in the Standard Valuation Law and the Valuation Manual (VM)
- However, it would not be prudent or responsible to establish a stochastic valuation requirement without also establishing a process that facilitates the ongoing review, assessment, and improvement of such dynamic methodology
- The LPC stands ready to assist the NAIC and NCOIL in this effort

Additional Resources

- Comments on NAIC PBR Draft Implementation Plan

  Comment letter to the National Association of Insurance Commissioners' Principles-Based Reserving (E) Working Group with suggested changes to its November 2012 draft implementation plan for principle-based reserving of life insurance. (January 11, 2013)
  http://www.actuary.org/files/Comments_on_NAIC_PBR_Plan_1-11-13.pdf

- LPC Comment Letters to NAIC on Valuation Manual

  Comment letters to both the NAIC Life Actuarial Task Force and the Life and Annuities (A) Committee from the Academy's Life Practice Council and Life Financial Reporting/Risk Management Committee regarding the need for changes to the valuation manual as well as a formal updating and review process. (July 16, 2012)

  http://www.actuary.org/files/VM_Comment_Letter_7-16-12.pdf

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