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PBR Overview and Implementation Update

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American Academy of Actuaries

The American Academy of Actuaries is a 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Agenda

- Overview of PBR
  - History
  - Methodology
  - Benefits
- Implementation Challenges
- PBR Guardrails: Prescriptive and Limiting Elements
- Questions

PBR: 15+ Years in the Making

- Different variations of model-based (i.e., principle-based) valuation approaches have been considered over the past 15+ years. A PBR framework was first implemented for variable annuities in the mid-2000s.
- The PBR approach contained in the Valuation Manual (VM) is a hybrid between a rule-based and a pure PBR approach
- PBR will be implemented gradually: limited scope and constraints on the methodology
- PBR is more than valuation: regulators will have more tools and information than ever
- PBR will be subject to continuous review and improvement to assure that it works as intended

PBR Addresses Shortcomings in Current Reserve Methodology

- Current reserve methodology has been 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
- Reserves may be too conservative or not adequate for some products and benefits

Comparison of Valuation Systems

Formula-based

- Formula for broad categories of products may not address all risks or contract benefits
- Same assumptions and margins for all companies
- Calculated using formula for each policy
- Assumptions locked in at issue date
- Uses industry average assumptions

Principle-based

- Model-based calculations for groups of policies
- Reflects all risks in products
- Reflects company experience in assumptions
- Reflects current economic conditions, and possible changes to future economic conditions
- Reflects risk management business practices
- Assumptions can be unlocked to reflect changes in experience

Benefits of a Principle-based Valuation System

- Addresses all of the identifiable, quantifiable and material risks, benefits and guarantees within an insurance contract
- "Right Sizes" reserves based on risk profile of the insurance company and product features and guarantees
- Consumers are not over charged because of redundant reserves or under charged because of insufficient reserves
- Reserves reflect actual product and company risks and risk management processes
- Eliminates constant regulatory or legislative action to make adjustments to formulas or rules
- Retains the ability to establish a minimum floor if needed

Principle-based Valuation System Challenges

- Developing modeling expertise within the regulatory community
- Collecting and analyzing a vast array of company experience data
- Development of industry-wide benchmarks for experience data
- Implementing enhanced controls and governance around the actuarial function
- Explaining changes in reserves/volatility
- Verifying/Validating model reserves for complex and risky products

PBR: Prescriptive and Limiting Elements

- Concern among regulators exists due to discomfort with a model-based approach and the discretion granted to companies in establishing reserves
- Prescriptive and limiting elements were introduced to address those concerns – transitional guardrails. These guardrails may be temporary or may become permanent.
- PBR only applies to policies issued after the effective date of the manual (1/1/2017) – not to all inforce policies
- PBR includes a minimum reserve based on assumptions set by the NAIC

PBR: Prescriptive and Limiting Elements

- Reserves will remain subject to an asset adequacy analysis (a form of stress testing) and an Actuarial Opinion
- Impact of PBR is difficult to predict
  - NAIC commissioned an impact study in 2011 conducted by Towers Watson.
  - Greatest impact expected for competitive term and universal life with secondary guarantees (ULSG) where reserves are expected to increase the most
- PBR implementation is phased in over three years
- An NAIC resource group will work with the states to refine and implement PBR requirements

PBR: A Major Paradigm Shift

- PBR modernizes the valuation techniques for life insurance:
  - from a strictly formulaic basis (static) to requirements that include an insurer's own experience and adjusts with time (dynamic)
  - for products with features customized for the consumer that are difficult to value using the current, inflexible rules
- Insurers are issuing these complex products today

Additional Academy Resources

- *Legislation-in-Brief, The Standard Valuation Law and Principle-based Reserves*
  http://www.actuary.org/files/PBR_Legislative_Brief_1152015.pdf

- *PBA Perspectives*, a quarterly update on the principle-based approach
  http://www.actuary.org/files/publications/EE.PBR_.06.16.pdf

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