Principles-Based Reserving: What to Expect

With the adoption of the compromise proposed by the American Council of Life Insurers, the transition from formulas-based reserving to principles-based reserving (PBR) appears almost assured. Details remain vague, but many life insurers expect the change to result in lower reserves for level-premium products.

Towers Perrin’s Duncan Briggs voices his optimism to Pat Kelleher, Executive Vice President and CFO, pointing out that PBR should make reserves more representative of a company’s risk profile. Still, issues around timing of the transition, tax treatment and PBR’s effect on required capital levels, Briggs argues, need careful observation to both ensure successful execution and avoid unintended consequences.

In addition to being a Managing Principal of Towers Perrin, Duncan is the Americas Region Manager for the firm’s Tillinghast business. He consults on a variety of topics, including mergers and acquisitions, financial reporting, securitizations and other capital management strategies. Duncan is a graduate of the University of Edinburgh and a Fellow of the Institute of Actuaries.

Pat Kelleher: The industry and regulators are moving towards adopting principles-based reserving (PBR). What benefits in your opinion may PBR offer?

Duncan Briggs: The biggest positive for me is that it should result in reserves that more appropriately reflect the full spectrum of risks that a particular company takes. The current system is intended to be conservative – and by and large it is – but at the same time doesn’t accurately reflect a company’s own products, its own features and the resulting inherent risks.

Even though the current reserving system is generally conservative, certain products and features are not treated conservatively under current reserving requirements. I think PBR will reduce those types of anomalies where companies have introduced features in part to reduce statutory reserves.

PBR should handle new products and product features much better as they’re introduced because it looks more holistically at the products and risks. In contrast, the current reserving regime is essentially reactive in that it tries to develop a formula for setting prudent reserves only after companies have introduced new products, provisions or features.

For a company using PBR, any reader of its financial statements should have a better picture of its true financial position. Hopefully at the end of the process the company should know that the reserve level that it’s publishing is appropriate for its risk profile, and so will the public. This should result in companies doing a much

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better job of understanding and measuring the risks that they’re assuming, ultimately leading to better risk management.

PK: What concerns you about moving to PBR?
DB: I’m concerned that the regulators will introduce excessive conservatism. When you consider life insurance and look at PBR, a number of different parameters and assumptions go into the equation. We could see requirements that cause undue conservatism in each of these assumptions. That could result in a situation where, when added up, reserves are not really much different than what we currently have and may even be higher for many products.

Another challenge is that it will still be hard to compare companies on a like-for-like basis because of the judgment involved in setting assumptions. We will need significant disclosure so that someone can really perform a valid comparison between two companies and the relative conservatism in their reserves.

And obviously moving to PBR will be highly complex and time consuming, particularly for smaller companies.

PK: Looking at the implementation risks, it seems that things will need to be done on many levels to ensure successful implementation. What do you think needs to happen at the industry level?
DB: We need more comprehensive and up-to-date industry experience studies. We have some industry experience – most notably on mortality and morbidity – but it does not include enough companies. It also has a time lag between the actual experience emerging and being incorporated in a Society of Actuaries report.

We also need to extend these studies to cover other elements that maybe aren’t captured currently at the industry level but will be important to setting the assumptions to perform the calculations - premium persistency on UL policies and shock-lapse rates on term products, for example. Those types of information, to the extent that the industry can start more systematically gathering and sharing it, will help companies have more benchmarks against which to set their own assumptions.

PK: How about at the company level?
DB: Companies will need to commit significant resources to implement the modeling processes. They need to ensure that all affected lines of business are modeled appropriately, use models that can incorporate all of the assumptions, and run all of the scenarios that are necessary to do the calculations. That’s a big investment that basically all companies will need to make.

Companies also must improve their experience monitoring and gathering processes. Many companies today have reasonably good experience studies, but that’s certainly not consistent throughout the industry – there are companies with little or no good experience study data. Companies will need to invest time and resources to get processes in place to monitor and measure emerging experience and feed that into the assumption-setting process.

They should also establish policies to ensure valid, defined procedures for setting assumptions. As I mentioned, a lot of judgment will be involved in developing the assumptions that ultimately drive the reserves, and emerging experience must be taken into account and be reflected in the assumptions.

PK: How will the role of actuaries change in a post-PBR world?
DB: Actuaries will be required to exercise a much higher degree of judgment, and I’m not sure that we currently have all of the skills that we need to appropriately exercise that judgment. We will experience a bit of a learning curve.

There’s talk about having a Canadian-style independent peer review of the reserving assumptions and calculations. If we go that route then the review will add an additional layer of cost, which ultimately will need to be reflected in pricing.

PK: Looking forward, how might PBR change the competitive landscape for life insurers?
DB: The risk-appropriate nature of reserve calculations should help level the playing field. There will be far less scope to introduce product designs and features developed to minimize statutory reserves and give a company a
competitive advantage.

It might also drive more consolidation. Some smaller companies will have difficulty in committing the required resources to an expensive and time-consuming process.

Alternatively, some companies might decide to coinsure more of their business, passing the risks to reinsurers and sidestepping necessarily having to do all of the calculations.

PK: How might PBR change the regulatory landscape for life insurers and regulators?

DB: It will likely fundamentally change the regulatory landscape. Today, regulators spend a substantial amount of time and energy developing formulas and guidance that are reactive – just trying to react to new products and new features being introduced.

That time and energy, in theory, won’t be required under PBR, allowing them to focus on reviewing what companies are doing – looking at the real underlying experience that companies are generating versus what they are receiving to determine reserves. As a result, regulators may gain a better understanding of the true experience of each company as opposed to just looking at statutory financials, which currently provide only limited information on emerging experience.

PK: Insolvencies are unanticipated events and some amount of reserve redundancy generally helps to protect policyholders in such a situation. As a move toward PBR assumes that some of the current reserve redundancies will be removed, what more should regulators be considering to safeguard against future insolvencies?

DB: I would argue that the overarching goal of PBR is policyholder protection. It’s just trying to do it in a way that more appropriately reflects the risks that each company assumes. So today you can look at Triple X reserves and AXXX reserves and say, “Yes, there’s redundancy there,” but it’s well above what any reasonable stochastic model might determine as prudent.

Because the goal of PBR is policyholder protection, I think the resulting reserve levels are going to be conservative – perhaps more conservative than many expect.

I think changes to capital models will accompany PBR so that the totality of reserves and capital will provide a very high safeguard against insolvency. So they will likely require principles-based capital in addition to PBR.

PK: In Canada, reforms to harmonize tax and regulatory reserves followed a move to PBR. What should we expect to occur here?

DB: There is quite a range of potential outcomes. From the government or IRS perspective, one of their primary motivations is looking at the revenue stream. And I find it a challenge to believe that they would agree to wholesale changes in tax reserving if that had a significant detrimental effect on their projected revenue stream. So we may not end up with wholesale changes that reduce the tax that companies will be paying.

For products where we currently have significant tax and statutory reserve redundancies like Triple X, if tax reserves move along with PBR, that would lower tax reserves, which would lower deductions and accelerate the tax revenue. The IRS might be quite happy with such a change.

The IRS and others are going to have to get comfortable with the judgment that goes into PBR calculations and hence the ability that companies have to manage their tax payments from year to year, and that will pose another big challenge. I’d like to believe that over time tax treatment can move in line with what is happening on the regulatory reserves. It won’t likely happen overnight because there are just too many issues that need to be addressed.

PK: It will take a monumental effort to build models to calculate PBR. How long do you think the industry will need to develop compliance capabilities?

DB: Despite proponents’ desires to have PBR almost in place by the end of next year, I think it’s going to take several years before it’s a reality. Too many issues have to be resolved – including tax-related issues, the definition of life insurance and legwork required just to do the implementation from a regulatory perspective.

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think it's going to take two to four years before that is going to happen. Even if 2009 is realistic, a few years of transition may be needed to allow full compliance.

PK: Current reserve requirements for life insurers have made both reinsurance and capital markets solutions very attractive to direct companies. How might PBR affect these solutions?

DB: I do a lot of work in the securitization area and a number of people say to me, “Well, clearly this is just a temporary market because PBR is going to remove arbitrage opportunities and there will be no capital markets involvement.” I really don’t think that is the case.

The regulators are driving this process, so expect significant conservatism in the combination of reserves and capital. Companies will still need funding for reserves or capital to support this business. Thus, there should be substantial scope for both reinsurers and the capital markets to offer solutions similar to what they offer today.

In addition, there will be companies whose assumptions and calculations are more conservative because they really don’t have significant or credible mortality experience. For such companies there may be an opportunity to use more reinsurance because the reinsurer can pool that experience with other experience. The reinsurer has credible mortality experience and can set PBR at levels that are appropriate to its overall experience. Lack of experience that may drive conservatism at the company level may increase reinsurance use because the reinsurer can arbitrage away that conservatism.

There is little argument that current reserve levels for level-premium products are well in excess of economic requirements. But in the rush to seek relief through a principles-based methodology, the industry could be overlooking other considerable side effects. The regulators’ primary role as consumer advocate all but assures that reserves will remain conservative. While redundancy levels may decrease, we don’t know the magnitude – or even the certainty – of that decrease.

On top of this, it is very likely that capital requirements will also follow a principles-based model and in the process become more conservative for many companies. The move to a PBR approach may accelerate a company’s tax obligation payments, at least until tax reserve regulations are harmonized with a principles-based approach. In fact, because of the conflicting interests between regulators and tax authorities, there’s no guarantee that complete harmonization will even happen, at least in the short term.

Will the relief from redundant reserves more than compensate for these capital and tax changes? The jury here is still out, but careful consideration should always be exercised when considering changes of the magnitude of a complete rework of reserve reporting.

Like others in the industry, Transamerica Reinsurance awaits greater detail from the National Association of Insurance Commissioners. But we agree with Duncan that implementation by the end of 2006 is overly optimistic. Whatever the results of PBR may be, Transamerica Reinsurance is ready to help our clients address any unanticipated challenges that a transition to PBR might involve.