NEW YORK STATE
DEPARTMENT of
FINANCIAL SERVICES

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Dear Commissioners:

The National Association of Insurance Commissioners (NAIC) has been moving steadily to adopt a principles-based reserving (PBR) regime for life insurers, which would be a significant departure from the rules-based approach that has enabled the insurance industry to weather the economic storm that buffeted the banking sector in the aftermath of the 2008 financial crisis.

For the NAIC to complete its initial work, it must finalize a Valuation Manual that implements the Standard Valuation Law, the model law that governs life insurance reserving. Once the NAIC signs off on the Valuation Manual – an action that requires the approval of a supermajority of 42 commissioners – it will take passage in a like number of states for PBR to become effective on a national basis.

Proponents of PBR contend that pivoting away from the rules-based reserving system will reduce "redundant" reserves, and thereby benefit consumers by bringing down the cost of products offered by life insurers. There is no question that to avoid tying up capital needlessly and to safeguard consumer protections are laudable goals. But before scrapping the rules-based regime in favor of an untested PBR model, regulators have the responsibility – indeed, the obligation – to understand the risks associated with such a paradigm shift. There are numerous factors that should give regulators pause:

(1) **Principles-based reserving in the banking sector proved disastrous.**

The crux of PBR is less reliance on formulae prescribed in statutes and regulations, and more flexibility based on company-driven models and credible experience regarding key assumptions like mortality, consumer behavior, and investment returns.

That may sound like a sensible approach, but when the banking industry transitioned under the Basel II regime in the early 2000s to a framework coincidentally called "principles based reserving," failure ensued. Indeed, banks like Lehman Brothers that reduced their reserves under the Basel II regime were hit hardest by the financial crisis.

Of course, the business of insurance is distinct in a variety of ways from the business of banking. But the appeal of PBR to industry in both instances is similar, if not the same: because companies that are publicly traded are under constant scrutiny from stockholders and analysts to report favorable quarterly earnings and capital ratios, there is intense pressure for those companies to jump at the potential reserve relief afforded by PBR at the expense of long-term solvency and, in the case of insurers, claims paying ability. Since the effects of under-reserving may not materialize for years – long after a company's current management may have departed from the scene – there is little institutional check on pursuing short-term gains.

(2) Under PBR, reserves will decrease, and the risk of insurer insolvency will increase.

Since one of the stated aims of proponents of PBR is to "right size" and reduce "redundant" reserves, it is reasonable to assume that PBR will, in fact, have the effect of lowering reserves. However, at a time when interest rates are at historic lows, and when the low-interest rate environment is expected to continue indefinitely, many insurers already are operating under the stress of having to produce sufficient investment returns to cover the guaranties made in existing products.

Given these challenges, a reduction in reserves could weaken existing consumer protections, and raise the risk of insurer insolvency, at precisely the wrong time. Any insolvency could create a vicious cycle by eroding consumer confidence in the industry, which could lead to reduced sales, which in turn could give rise to an even greater risk of insurer insolvency.

Needless to say, if an insurer's insolvency is – rightly or wrongly – laid at the doorstep of PBR, we as insurance regulators will be blamed for having loosened the screws on a rules-based regulatory regime that no one accuses of having weak reserve standards. The reputational risk to insurance regulators is not hypothetical, either: members of the National Conference of Insurance Legislators already have begun to assail PBR as an unwise, deregulatory approach. If PBR becomes operative, and then is considered even partially responsible for an insolvency, critics will rightly criticize state insurance regulators as failing to do their jobs — and failing to protect the public.

Proponents of PBR claim that it is not a foregone conclusion that reserves will decrease under PBR. Depending on the product, they say, reserves either may rise or fall. But even under industry-run estimates, the projected instances in which reserves will fall are far more plentiful than those when they will rise. And across the board, the size of any reserve reductions will vastly overshadow the size of any reserve increases.

Advocates for PBR also stress that PBR will not apply to in-force business, and will have prospective application only. Therefore, they assert that the initial impact of any transition to PBR will be limited, and allow sufficient time down the road for regulators to assess PBR's effectiveness. However, even applying PBR only to new business will lead to substantial reductions in reserves. Because industry estimates show that reserves in the aggregate will likely decrease anywhere from 20% to 50%, that translates into a potential shortfall – to the detriment of consumers – of tens of billions of dollars within a few short years.

(3) **It is not clear that a PBR regime will benefit consumers.**

Supporters of PBR assert that by freeing up capital that currently is "redundant," PBR will enable insurers to price products more favorably, which will redound to the benefit of consumers. Many regulatory actuaries, however, believe that prices are unlikely to come down, since products in the term life and universal life with secondary guarantee markets already are extremely competitive, with pricing based on aggressive assumptions about investment rate returns and consumer behavior.

In order to ensure that consumers derive the asserted benefits from favorable pricing under a PBR regime, regulators should consider establishing a threshold that requires insurers, upon realizing a particular reserve reduction benchmark, to refund to consumers some portion of the premiums paid on existing business.

(4) **Regulators are ill-equipped at present to implement and oversee PBR.**

There is universal agreement – among state regulators, the insurance industry, and even the American Academy of Actuaries – that the administration of a PBR reserving regime will create significant challenges for state insurance regulators. Indeed, because PBR is intended to establish a framework that takes account of each company's individualized experience, PBR will require state insurance departments to police the marketplace, evaluate insurer models, and ensure that the experience on which companies may rely is, in fact, credible. To do so will demand a far greater commitment of resources than is needed under the current rules-based approach, which has the benefit of clarity and simplicity.

Many state insurance departments lack actuaries or other technical personnel with the skill sets necessary to administer a PBR framework. If states move to a new regulatory paradigm and then have to farm out the responsibility of regulating the insurance industry to outside consultants, it leaves the state-based system of insurance regulation exposed to criticism – which might be a particular unwelcome development given the fact that the Federal Insurance Office has drafted a report that assays the efficacy of that very system.

Many states, on both ends of the political spectrum, have expressed apprehension about moving forward with PBR unless and until state insurance regulators across the board have a concrete understanding of the resource drain and cost that administration of PBR will inevitably require. While the NAIC only recently has initiated preliminary discussions to begin tackling the issue, it nonetheless seems ill-advised to charge headlong into a vote regarding the substance of the Valuation Manual without having first developed a well thought out, comprehensive game plan regarding the resources that state insurance regulators will need to apply the PBR framework properly.

(5) Even if the rules-based approach has its shortcomings, it does not necessarily follow that PBR is the answer.

Many commissioners believe that even if PBR has its flaws, it is needed because the current rules-based approach has created "redundant" reserves. This inefficiency in the marketplace is exacerbated by the fact that some state insurance regulators, but not others, have allowed companies to create captives, special purpose vehicles, and other complex structures that are intended to "work around" the inefficiencies of "redundant" reserves. The resulting unlevel playing field thus puts some companies at a competitive disadvantage, depending on whether or not they are domiciled in a jurisdiction with an accommodating regulator.

Of course, there is a mechanism within the current framework for providing reserve relief. In the past, for instance, the NAIC and state regulators worked together to update mortality tables to reflect underwriting improvements and overall favorable trends. But at bottom, if the reserves for term products, for example, are widely considered too high under the rules-based regime, then perhaps we as regulators ought to consider developing a more targeted response, instead of throwing out the baby with the bath water and scrapping the rules-based approach altogether.

Given the importance of the solvency and soundness of the life insurance industry to ordinary Americans, state insurance regulators need to be careful about removing the current regulatory scaffolding and replacing it with a structure whose ramifications are not clearly and fully understood. Indeed, before moving away from a proven regulatory regime that withstood the financial crisis, insurance regulators nationally ought to ensure that they understand exactly: (1) how PBR works; (2) how to administer it; (3) what PBR means for the companies they regulate and the industry at large; and (4) be able to say with a straight face that it is at least as good, if not better, than the rules-based system that currently is in place.

If, despite the reasons set forth in this letter for taking a more sober approach to PBR, a supermajority of state regulators are at this time resolved to plow forward with PBR, then at least we as commissioners ought to do the following: run the PBR and rules-based approaches in parallel for at least a three-year period, while still booking the numbers from the current system, before making a final, irrevocable commitment to PBR. In that manner, state insurance regulators will be able to familiarize themselves with the intricacies of PBR, hire new personnel, develop the expertise and oversight necessary to analyze company models, understand and appreciate the differences between the two frameworks, and assure themselves that consumers are not disadvantaged by a reserving structure that requires insurers to hold less capital behind the long-term obligations that they have made.

Sincerely,

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