

CLIENT MEMORANDUM

Client Alert: Update on Implementation of Principle-Based Reserving for Life Insurers

October 2, 2015

AUTHORS

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I. Background

For over a decade, the National Association of Insurance Commissioners (“NAIC”) has been developing a principle-based approach to life insurers’ reserving methods, in which actuarial judgment and the risks faced by a life insurer would carry greater weight than under the current formulaic approach. Principle-based reserving (“PBR”) is the result of these efforts. The goal of PBR is to provide a more accurate valuation methodology for a life insurer’s reserves by incorporating the expected values of both asset and liability cash flows.

In order to implement PBR, the NAIC revised the NAIC Model Standard Valuation Law (the “SVL”) in 2009 to authorize the replacement of the formulaic approach for determining policy reserves with a principle-based approach. The NAIC has also developed a valuation manual (the “Valuation Manual”) that contains reserve-calculation and other requirements for implementing PBR.

For PBR to become effective, no fewer than 42 states representing at least 75% of total industry premium (the “Valuation Manual Operative Threshold”) must adopt laws with “substantially similar terms and provisions” to those set forth in the SVL. Under the revised SVL, if the Valuation Manual Operative Threshold is reached by July 1, 2016, PBR will become effective as of January 1, 2017.

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II. Current Status of PBR Implementation

On September 30, the NAIC's Principle-Based Reserving Implementation (EX) Task Force (the "Task Force") held a conference call during which it was reported that California and North Carolina have now enacted the 2009 amendments to the SVL.¹ It was also reported that, as a result, 38 states representing approximately 69.6% of total industry premium have now adopted PBR. As a result, only four more states representing approximately 5.4% of total premium volume would have to enact the 2009 SVL amendments before the Valuation Manual Operative Threshold is reached, paving the way for PBR to become effective as scheduled on January 1, 2017.

The numerical analysis set forth above presumes that all 38 states reported to have enacted the 2009 amendments to the SVL to date will be deemed to have adopted "substantially similar terms and provisions" to those set forth in the amended SVL. However, whether this presumption is, in fact, correct remains uncertain—because the NAIC is still in the process of finalizing the criteria for determining whether a state's enactment of PBR contains "substantially similar terms and provisions" to the amended SVL. A draft list of these criteria was exposed by the Task Force during the NAIC's 2015 Summer National Meeting, and the Task Force engaged in some discussions of this item during its September 30 conference call. In particular, it was noted during the conference call that the most significant distinction between the amended SVL and certain state adoptions thereof is the inclusion in the latter of the "small company" exemption—potentially with different provisions from the "small company" exemption incorporated into the Valuation Manual earlier this year. As a result, the Task Force will need to consider how rigid its review should be with respect to any state adoptions of the "small company" exemption.

The Task Force is expected to continue discussions of this item, and potentially adopt the list of "substantially similar terms and provisions," at the NAIC's 2015 Fall National Meeting in late November.

III. Other Developments

On the September 30 conference call, the Task Force also addressed its work with respect to the NAIC accreditation process. PBR is currently expected to become an accreditation standard, meaning that enactment of "significant elements" of the amendments to the SVL will become a requirement for a state insurance department to maintain accreditation by the NAIC. On the September 30 call, the Task Force confirmed that the NAIC Life Actuarial (A) Task Force ("LATF") will review and suggest any necessary revisions to the accreditation criteria for PBR that were developed by LATF several years ago. We note in particular that the list of "significant elements" of the amended SVL that will form the basis for the PBR accreditation standard will not necessarily be the same as the list of the "substantially similar terms and provisions" to the amended SVL that will be utilized in determining whether the Valuation Manual Operative Threshold has been reached.

¹ Contrary to the report made on the Task Force conference call, we understand that the relevant California and North Carolina bills have not yet been enacted, but have been passed by these states' respective legislatures, and, as of the date of this Alert, are awaiting the respective states' governors' signatures.

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In addition, the Task Force adopted during its September 30 conference call the Valuation Manual Process and Procedures Handbook, which contains the charges and operating procedures of the PBR Valuation Analysis (E) Working Group ("PBR VAWG"). This confidential document will assist PBR VAWG in its charge of supporting state insurance regulators in the review of PBR and uniformly addressing questions and other issues with respect to the amended SVL and the Valuation Manual.

The Task Force also discussed and exposed for comment through October 14, 2015 a draft public statutory financial statement disclosure of adjustments to a life insurer's risk-based capital as a result of the requirements imposed by the XXX/AXXX Reinsurance Framework.

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