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CLIENT ALERT

New York State Legislature Adopts Principle-Based Reserving

July 13, 2018

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On June 18 and 19, 2018, the New York State Legislature passed the substantively identical Assembly Bill No. A.11116A and Senate Bill No. S.8978A to implement principle-based reserving ("PBR") for life insurers in New York. However, even though PBR legislation has been enacted by the New York State Legislature, the legislation still needs to be delivered to and signed by Governor Andrew M. Cuomo, who will have 30 days to sign the legislation into law after its delivery for his signature. The purpose of PBR is to implement 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 formulaic approach for calculating reserves that is currently in effect in New York.

PBR was developed by the National Association of Insurance Commissioners ("NAIC") for over a decade in response to concerns that formulaic reserves did not accurately reflect the features and risk profiles of certain life insurance products and that life insurers were taking certain steps to reduce the formulaic reserves recorded on their financial statements (for example, by ceding business to captive insurers). The New York State Department of Financial Services ("NYDFS"), led by its former Superintendent Benjamin M. Lawsky, vigorously opposed the adoption of PBR by the NAIC, criticizing PBR as an "unwise move" away from reserving requirements established by formulas and diligently policed by insurance regulators. However, in practice, there was little that the NYDFS could do to stop the adoption of PBR on a nationwide basis. Following its adoption by 42 U.S. states representing over 75% of total U.S. life insurance industry premiums, PBR was implemented by the NAIC effective as of January 1, 2017. Subsequently, the NAIC made PBR an "accreditation standard" effective as of January 1, 2020 — effectively requiring each U.S. state (including New York) to adopt PBR by that date.

If New York adopts PBR, the state will become one of the last U.S. jurisdictions to enact PBR (as of the date of this report, PBR has been adopted in 47 other U.S. jurisdictions and is pending adoption in Alaska, Massachusetts and the District of Columbia). If finally enacted, PBR will still not become effective in New York until the following two conditions are satisfied:

- First, the NYDFS must approve the Valuation Manual developed by the NAIC, which sets forth the PBR framework and minimum reserve requirements for insurance products that are subject to PBR. The NYDFS's approval of the Valuation Manual must be based upon a finding that the Valuation Manual is for the best interests of the holders of life insurance policies and annuity contracts in New York. If approved by the NYDFS, it is not clear whether the NYDFS will issue an order approving the Valuation Manual or whether this approval will be set forth in a regulation.

- Second, the NYDFS must implement all necessary regulations required for adoption of PBR in New York (see below for a discussion of the potential contents of these regulations).

Even if the above steps are completed within the next few months, the legislation provides that the earliest date on which PBR may become effective in New York is January 1, 2019.

As a result of the above, significant work must be completed by the NYDFS before PBR will become effective in New York — and prior to the NAIC accreditation deadline of January 1, 2020. The good news is that the new leadership at the NYDFS appears to recognize that PBR is the right approach to reserving for life insurers, and is committed to its adoption in New York. Indeed, the NYDFS, led by its current Superintendent Maria T. Vullo, led an effort both this year and last year to push the PBR bill through the New York State Legislature. In February of this year, Superintendent Vullo noted during her remarks at a life insurance industry conference that she believed that it would be feasible for the NYDFS to complete all of its work related to the then-pending PBR legislation by the end of 2018, so that PBR would become effective in New York as of January 1, 2019. It remains to be seen whether this timeline remains a realistic target for the NYDFS.

Substantively, the enacted New York legislation is largely identical to the NAIC model law amendments implementing PBR (*i.e.*, the amendments to the NAIC Standard Valuation Law) (the "SVL Amendments"), but features three key differences from the corresponding provisions of the SVL Amendments:

- First, as noted above, in order for PBR to go into effect in New York, the NYDFS will need to adopt the requisite regulations relating to the implementation of PBR. In this regard, it is important to note that the New York PBR legislation authorizes the NYDFS to issue regulations that would result in deviations from the reserve standards and methods set forth in the Valuation Manual, including deviations based on a percentage of reserves required to be held under New York law prior to the operative date of the Valuation Manual. No such deviation may result in reserve valuations that are lower than minimum standards prescribed in the Valuation Manual. It remains to be seen to what extent the NYDFS will exercise this regulatory authority in order to deviate from the requirements of the Valuation Manual.

- Second, the SVL Amendments provide that a principle-based valuation of reserves “may” include a prescribed formulaic reserve component. However, the NYDFS’s view since the start of its effort to have PBR adopted in New York has been that a principle-based approach to reserving must incorporate a formulaic floor. Indeed, one of the first steps undertaken by the NYDFS as part of this project was establishing a working group for the purpose of developing a minimum reserve floor for all life insurance and annuity products sold to New York consumers, regardless of company experience. Consequently, it is not surprising that the enacted New York legislation provides that a principle-based valuation of reserves “shall” include a prescribed formulaic reserve component. It appears likely that this prescribed formulaic reserve component will be promulgated by the NYDFS via its new regulatory authority to deviate from the reserve standards and methods set forth in the Valuation Manual, as described in the immediately preceding paragraph. As to the substantive impact of this formulaic floor, we understand that it is currently expected that its impact on life insurance companies licensed in New York will not be significant, so as to avoid placing these companies at a competitive disadvantage.

- Third, the enacted PBR legislation provides that no amendment to the Valuation Manual shall take effect in New York unless and until the NYDFS finds that such amendment is for the best interests of the holders of life insurance policies and annuity contracts in New York. This approach is different from that adopted in other states, where any changes to the Valuation Manual will become effective immediately upon their adoption by the NAIC.

Finally, one feature of the SVL Amendments that has also been enacted in New York and that may be particularly important to the New York life insurance industry is the company-specific written exemption from PBR requirements, which may be obtained from the NYDFS by a life insurance company that is licensed and doing business only in New York. Upon being granted this exemption, the company would be able to continue computing its reserves using assumptions and methods that were in effect prior to the implementation of PBR in New York. Life insurance groups that have established separate insurance companies domiciled and licensed only in New York should consider whether to seek these written exemptions from the NYDFS.

The enacted PBR legislation also requires the NYDFS to conduct studies of the impact of PBR on the New York life insurance industry and consumers. Reports on these studies must be delivered by the NYDFS to the New York State Governor and the New York Senate and Assembly in the second, fifth and seventh years after the PBR operative date in New York. The enacted PBR legislation is set to expire ten years after its enactment, unless subsequent legislation extends it.

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