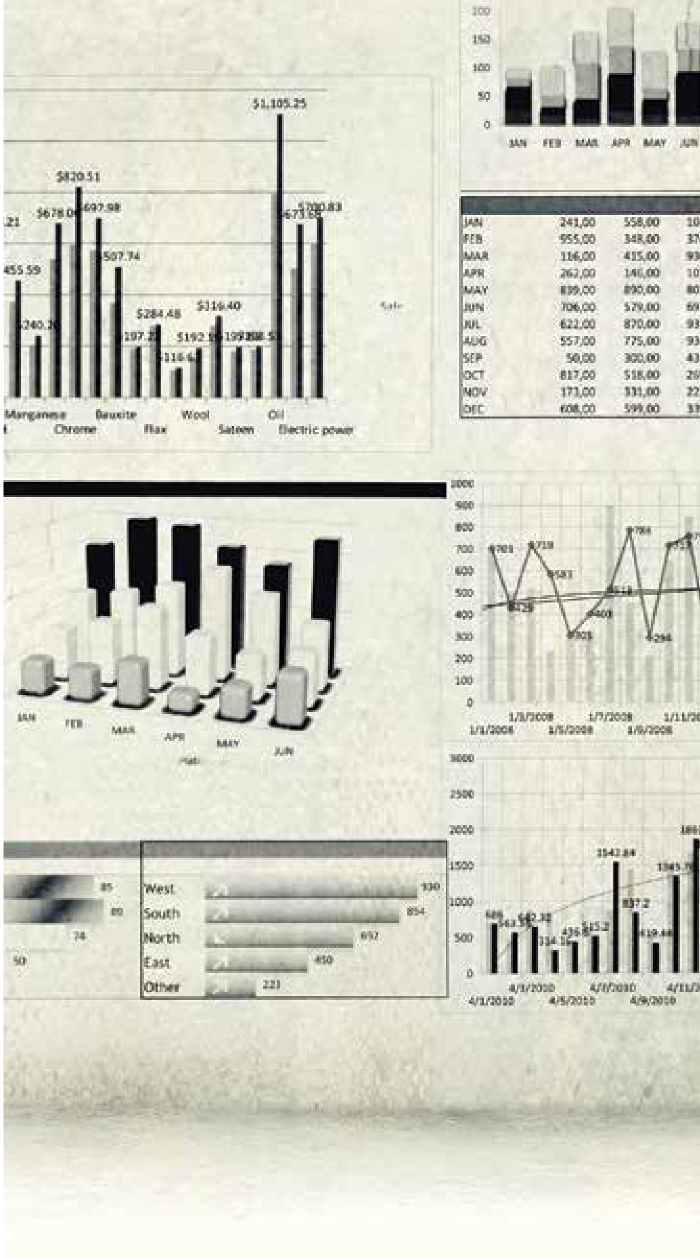
Preserving Reserves

Modernizing life insurance reserve formulas has been challenging for regulators and policymakers.



BY HEATHER MORTON

Life insurance is for those "what if" situations. What if something happens to me? What if something happens to my spouse? Maintaining adequate life insurance reserves ensures that those "what if" situations will be taken care of. Having enough reserves on hand ensures that life insurers will remain solvent so that policyholders will receive the benefits they need, when they need them most.

Why the Change?

Every state requires insurers to set aside enough money to pay a reasonable number of claims at any given time. But the traditional method used most often to calculate the required reserves has raised concerns among many life insurers, actuaries and insurance regulators. The formula takes a "one-size-fits-all" approach to regulation and hasn't changed much over the years.

Proponents of modernizing the system through principle-based reserving say the traditional way hasn't kept up with the times and can't easily adapt to today's innovative and increasingly complex life insurance products. To remain current, the traditional method forces frequent and time-consuming changes to state laws and regulations.

Advocates for a change also point out that the current formula too often produces results that inaccurately reflect the risks or the true cost of the insurers' liabilities and obligations. They fear that some reserve requirements may be too high, while others may be too low. If the reserve requirements are too high, consumers are at risk of paying more than they need to. If they're too low, insurance companies could become insolvent, leaving consumers high and dry.

In response to concerns, the National Association of Insurance Commissioners began the difficult task of modernizing the way reserve requirements are calculated nearly a decade ago. The process was arduous, with intense debate at numerous meetings, working groups and task forces, followed by revision after revision. The actuarial guidelines, for example, for just one specific kind of coverage (universal life insurance with secondary guarantees) have gone through several revisions since they were developed in 2003.

The insurance commissioners finally adopted a new method to calculate life insurance policy reserves in 2009 that is based on certain principles rather than on a pre-set formula. The association finished an updated Valuation Manual at the end of 2012 and, along with life insurers, began encouraging state legislators to revise their life insurance laws to incorporate the new principle-based method.

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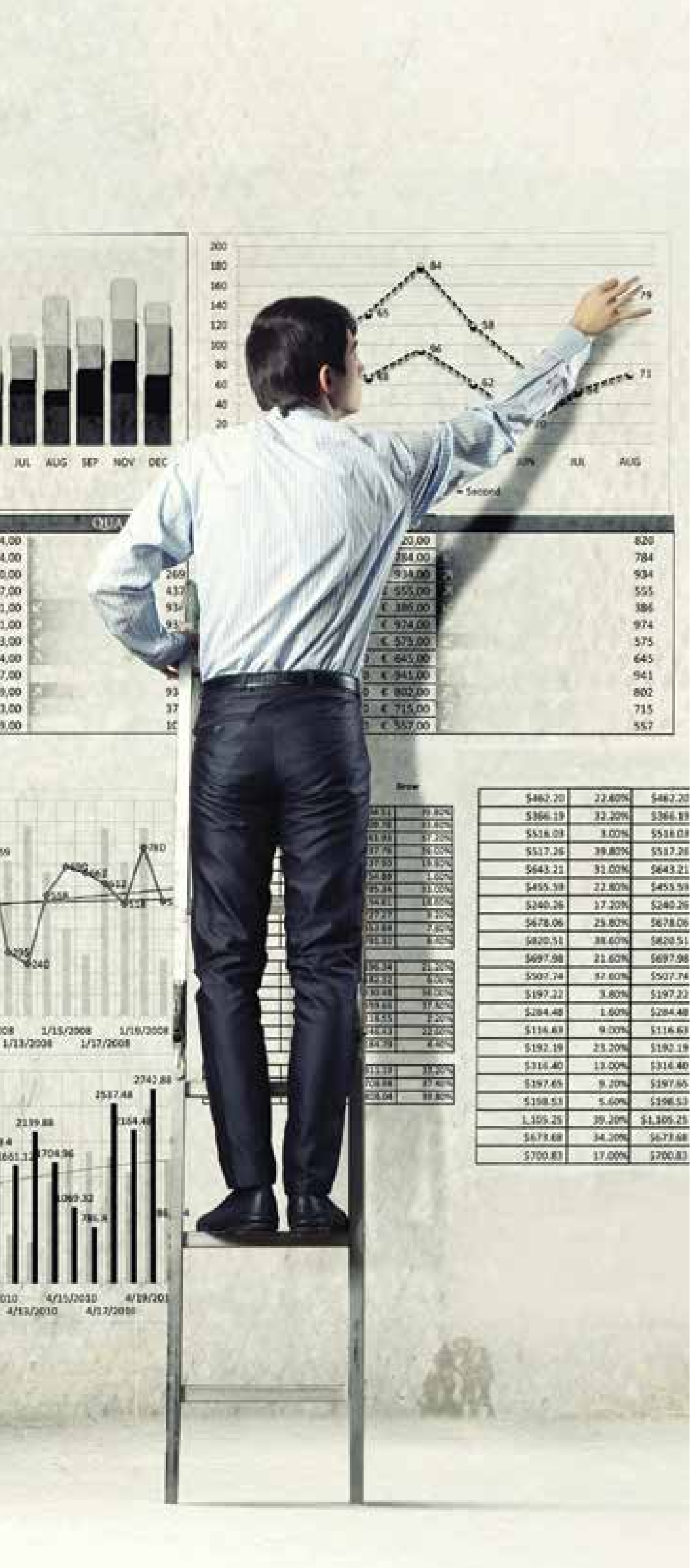


What Are the Different Life Insurance Products?

Term life insurance: Offers death benefits for a specified length of time, from one year to 30 years.

Whole or permanent life insurance: Offers death benefits and an investment component known as cash value. The cash value operates similar to a saving account against which a policyholder can withdraw or borrow.

Universal life insurance: Combines features of term life insurance and whole life insurance policies by offering death benefits at lower, flexible premiums with a cash value. Under a universal life insurance policy, the death benefit, cash value and premiums can be altered if a policyholder's circumstances change, and the policyholder can use the interest from the cash value to help pay the premiums.

Universal life insurance with secondary guarantees: Offers additional security that a universal life insurance policy will remain in force during a specified guarantee period, even if the cash value drops to zero, as long as certain minimum premium payments are made.

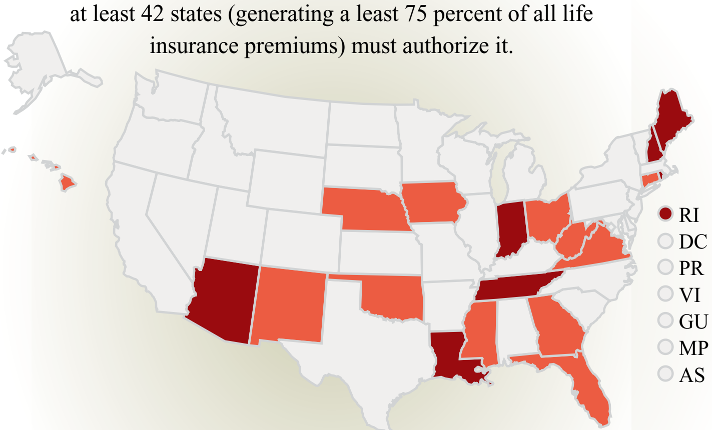
Adopting the new method requires amendments to state standard valuation and standard nonforfeiture laws for life insurance policies. To become effective nationwide, the revisions must be enacted by at least 42 states whose residents generate a least 75 percent of the total life insurance premiums paid in the country.

What Is Principle-Based Reserving?

Principle-based reserving considers several factors when determining the amount needed to be held in the reserve. The method replaces the pre-set formulas with a new tiered, comparison approach that requires life insurers to make two computations and use the one that yields the higher amount. The first calculation, based on the traditional formula, uses standard mortality tables and interest rates set in statutes and regulations. The

Where the Action Is

For principle-based reserving to become effective nationwide, at least 42 states (generating a least 75 percent of all life insurance premiums) must authorize it.



States that have passed laws to authorize principle-based reserving
States currently debating laws to adopt principle-based reserving

Source: NCSL, March 1, 2014

The Indiana Department of Insurance has adopted the new principle-based reserving to measure the solvency of insurance companies. "One reason I supported the legislation last year," says Indiana Representative Martin Carbaugh (R), "is that this new method offers consumers a higher measure of security because it requires that providers maintain true adequate reserves. And that's important because it protects both the insurance industry and its consumers."

Representative Martin Carbaugh (R) Indiana

Life Insurance
By the Numbers

30%
American households with no life insurance

44%
Households with individual life insurance coverage

67%
Families who depend on the life-insurance industry for financial and retirement security

20%
Portion of Americans' long-term savings in life insurance and annuities

50%
Portion of households that say they need more life insurance

86%
Portion of consumers who believe they need more life insurance but haven't bought it because they think it's too expensive

Sources: The Life and Health Insurance Foundation for Education, LIMRA, the American Council of Life Insurers

second figure considers future economic conditions and uses individualized figures based on the insurance company's experience with factors such as policyholder behavior and previous expenses.

Life insurers tend to support principle-based reserving as a necessary step to allow them to introduce new multi-benefit products, such as life insurance policies that automatically convert to annuities upon retirement.

"Principle-based reserving represents a change that is important and proper to measure the increasingly complex products that companies develop to meet the needs of consumers, and to compete in the global economy," says former Governor Dirk Kempthorne, president and CEO of the American Council of Life Insurers.

Supporters of the new method point out that it really isn't all that new or untested. It's currently used by property and casualty insurance companies as well as health insurance companies in the states and in international insurance markets.

Does Everyone Support Change?

Despite supermajority votes during the National Association of Insurance Commissioners' adoption process, not all state insurance regulators support the transition to the new method. Two of the more vocal opponents have been Benjamin Lawsky, superintendent of the New York Department of Financial Services, and Dave Jones, commissioner of the California Department of Insurance. When compared to the other states and territories, residents of New York and California generate the two highest percentages of life insurance premiums.

In September 2013, Superintendent Lawsky announced that New York would no longer allow principle-based reserving for universal life insurance with secondary guarantees. He expressed concern that the new method could weaken reserve and capital standards for insurance companies, similar to what occurred in the banking sector before the recent financial crisis.

"In its current form, principle-based reserving represents an unwise move away from reserve requirements that are established by formulas and diligently policed by insurance regulators," Lawsky says. He questions the validity of the new method that uses "internal models developed by insurance companies themselves. Although proponents assert that the leeway granted to companies is limited, those restraints are so loose as to be practically illusory."

California's Jones has voiced concern over a lack of expertise among regulators to accurately verify the adequacy of the new reserve amounts required. He's also concerned that states will not be able to participate in the review and analysis of the new system.

"I am disappointed that the National Association of Insurance Commissioners decided to move ahead with a dramatic change to the system ... without any fiscal analysis or adopting a complete plan to address capacity and oversight issues," says Jones.

What Have States Done?

Since the National Association of Insurance Commissioners voted to adopt the Valuation Manual in 2012, seven states have enacted laws to authorize principle-based reserving.

"In New Hampshire, our goal in amending the standard valuation law was to achieve a more complex actuarial modeling that provides better data to capture various risks inherent in establishing adequate reserves for life-insurance products, including annuities," says Representative Donna Schlachman (D).

Representative Donna Schlachman (D) New Hampshire

"By using a principle-based approach, which considers the type of products sold, we are able to adjust our reserves to the right size based on the specific product, and thus maintain the high solvency standards the people of New Hampshire expect."

There's still a long way to go before the new method becomes the law of the land. Combined, the seven states that have voted to adopt it represent only 8 percent of the life insurance premiums necessary to meet the threshold. At least a dozen more state legislatures are debating the issue in legislative sessions this year.