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LIFE INSURANCE COMPANY FINANCIAL REPORTING SECTION

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MR. RICHARD K. KISCHUK: It is our intention here today for this open forum to serve a dual purpose. Our first purpose is to convene a meeting of the Financial Reporting Section and so record some business-related activities of the Section. We will assume that you have already read the annual report of the Section that was in the committee reports booklet, and while we will provide a brief update of Section activity since then, we will otherwise try to keep that as short as possible and only address topics that might come out in the question and discussion period.

Our second purpose is to present a forum for the outstanding panel we have assembled today. I think you will find an interesting meeting given the wide variety of topics the panel will be covering.

We are going to start out with an update from Gary Mooney on financial reporting developments in Canada. Bill Schreiner will follow with an update of financial reporting developments in the U.S. Following that Bob Stein will give a presentation which will be an update of recent developments in accounting for non-guaranteed premium products. Then I will give a brief update on developments relating to the U.S. statutory actuarial opinion.

We will try to take up only about half of our time this morning with formal presentations as I am looking forward to a variety of questions, opinions and discussion relating to financial reporting.

First I will give you a brief update on a few things that are not covered in the annual report of the Section. We have the results of the Section election,and the following three Section members were just elected to three year terms on the council: Tom Leary, Horace McCubbin, and myself. In looking at the candidates and nominees for the council, we felt that especially in the early going it was critical to maintain a balance of the various constituencies. For example, we want to make sure that we have both U.S. and Canadian representation, both stock company and mutual company representation, and consulting firm representation. We felt this was very important in defining the direction of the Section in the early going. We think we have a good cross section on the council right now and that seems to be working to our advantage in considering the various issues that are important in developing the Section.

Also, at yesterday's council meeting, we elected officers for next year. Those officers are the same as the officers for the last year. I will just mention who they are: Hank Ramsey, secretary; Norm Hill, treasurer; Bill Schreiner, vice chairman; and I will be serving as chairman for the coming year. Also continuing on the council will be Pete Chapman, Frank Klinzman, and Gary Mooney. I would like to invite anyone to talk to any of these people about anything that might be on your mind regarding development of the Section. We are in the stage of development where we are looking for all of the input or any ideas that anyone might have. We will reflect all of those in the development of the Section to the extent we can.

Also most of you probably noticed that, along with the ballot, you also received a questionnaire. We were really pleased with the number of those surveys that were turned in. Just before I left for this meeting I received a rather large box from the Society office which included about a two-inch stack of questionnaires. Obviously, between then and now we have not had a chance to compile those except that I did flip through them to see what I had. I was very pleased with the input. It looked like we had a fair number of people who took the time to write some comments in addition to just checking off the boxes.

Even better, I noticed that quite a number of people checked off several boxes in volunteering to help us develop the Section. We need that. We talked yesterday about the fact that we have nine council members, and we have 1,000 people in the Section. We need a group of about 50 or 100 between that level to help make the Section go. That is what we will be looking for in going through these questionnaires. One of the first things I intend to do is to sort the questionnaires into two stacks: those that include volunteers and those that do not. Then we are going to be seeking some of you out in the near future.

In addition to that, we spent a lot of time yesterday talking about activities that we would like to develop in the near future. I think at least half of the time yesterday was spent talking about developing various types of meetings for the Section. We are starting to see that as one of the critical activities for the Section, and an area that we think would be very beneficial to the membership. At yesterday's meeting we talked about at least three different types of meetings, and there may be more types of meetings we could talk about.

One type of meeting which we would like to continue is the panel discussion. We would like to develop at least one session at each Society meeting related to financial reporting. We do not think that is enough, and we have talked about the idea of having a one day Session meeting in conjunction with one of the spring meetings each year. This would be something on a more informal basis, more of a current topics meeting. In addition to that, we think there are a number of topics where a special meeting might be called, and we will try to develop meetings to address specific topics. One very important topic that was talked about yesterday, for example, was the changing financial role of the actuary.

We also talked about the desirability of developing a Session newsletter to try to keep members up-to-date on everything going on in the financial reporting world. There are so many things going on that obviously this could be a major undertaking. In assessing whether or not we can do that, the level of volunteer support we have is going to be a critical aspect of how fast we can move in that direction.

Having touched on some of these issues, I will leave any discussion to the question and answer session except to say that we are always glad to hear any ideas or suggestions that you might have. Feel free to contact any of us at any time.

With that we will launch into Gary Mooney's presentation giving an update of financial reporting developments in Canada.

MR. GARY C. MOONEY: Because many of you may not be familiar with the Canadian scene, I will start by giving you a brief background. The Cana-

dian Institute of Actuaries, Canada's own version of the CIA, represents all actuaries in Canada including those involved in life and health insurance. Its responsibilities include accreditation as well as education and research. Its activities parallel those of the Academy and to a certain extent overlap those of the life and casualty actuarial societies. However, there is good communication and considerable cooperation between the Institute and these associations.

Most Canadian companies and branches of foreign companies are federally registered and, therefore, subject to federal solvency regulations. The Federal insurance acts were last revised to take effect in 1978. One of the major changes was the creation of the position of valuation actuary in respect of each life company or branch. The valuation actuary is appointed by and reports to the board of directors of the company. He or she has personal responsibility for determination of the actuarial liabilities and for insuring that the charge to the income statement in respect of the change in these liabilities is proper.

Another significant change was the introduction of a requirement that the reserves reported in the published financial statement of a life company must be the same as those included in the government statement. This requirement in effect mandates a close relationship between reserves determined for solvency purposes and those used in reporting income.

There are very few limits imposed on the actuary in the legislation and the associated regulations. Rather, the federal superintendent invited the Institute to develop and maintain its own rules for life insurance company financial reporting. The Institute responded by introducing a set of recommendations and explanatory notes for use by valuation actuaries of life companies in 1978. These recommendations are now binding. They are broad in scope but general in nature. Therefore, the actuary retains considerable flexibility as to their application to his or her company.

It is worthwhile to note in passing that the Institute has now introduced recommendations for the valuation of pension plans and is working on recommendations for financial reporting of property and casualty insurance companies. In both cases the recommendations for life companies have been used as a model.

The Committee on Financial Reporting is charged with the responsibility of maintaining the life company recommendations, providing interpretations, conducting research and assisting in the continuing education of actuaries. During the past couple of years, much of the committee's activities have been directed toward continuing education. The committee conducted a comprehensive survey of valuation actuaries to determine what practices were being followed and what problems were being encountered. It was found that there was a definite need to provide some guidance to actuaries in the practical aspects of valuation, particularly with regard to the more recently introduced products.

The committee organized a full day seminar that was held the day before the start of the Institute's annual general meeting last June. The committee asked for volunteers to write essays on the application of the recommendations to various product types. Ten essays were contributed with some of the topics being:

1. Valuation of renewable term plans.

2. Impact of asset-liability maturity structure on actuarial liabilities.

3. Valuation of nonparticipating universal life plans.

4. Valuation of new money adjustable life insurance products.

More than 150 people attended, or about 10% of the total members and students of the Institute. The papers were presented and discussed in plenary session throughout the day. The audience participated enthusiastically and a good time was had by all.

During the past several years, the Institute has been heavily involved in discussions with the Canadian Institute of Chartered Accountants (the CICA), relating to the development of generally accepted accounting principles, GAAP for life companies. Life companies are exempted from the accounting rules contained in the CICA handbook which define GAAP because of some elements of nonconformity with accounting principles used for other commercial enterprises.

About four years ago the two Institutes appointed a joint task force. Its terms of reference were first to develop and recommend financial reporting and disclosure principles which could become generally accepted actuarial principles and then generally accepted accounting principles. The second goal was to develop procedures such that both solvency reporting and income reporting could be accomplished in a single set of financial statements; and thirdly to develop reporting to cover both life and accident insurance, both par and nonpar insurance, and both mutual and stock insurance companies.

Some of the issues addressed in the task force report are:

1. Accounting for portfolio investments supporting long term obligations.

2. The need for segmented information.

3. Accounting for reinsurance.

4. Accounting for taxes.

5. Determination of the actuarial liability with reference to deferral of acquisition expenses.

6. Provision for adverse deviations.

7. Definition of cost to include policy benefits, dividends, expenses, and taxes.

8. The reporting of changes in actuarial bases.

The report was presented to the two Institutes in December last year and is now under review. Because of the time required for due process and because some changes will be required in the insurance acts, it is expected that implementation of the task force recommendation will take several years.

The CICA handbook currently exempts life insurance companies and pension plans from its rules regarding auditing standards, in part, because of the role played by actuaries in the determination of liabilities. The CICA has been working towards the removal of this exemption for some time.

About a year ago the CIA convinced the CICA to establish yet another joint task force with terms of reference being to recommend for life insurance companies, property and casualty insurers, pension plans and other uninsured or welfare plans:

1. The definition of the separate responsibilities of the auditor and the reporting actuary.

2. How the auditor and reporting actuary should interact in carrying out their respective responsibilities.

3. The extent of use by each of the work of the other.

4. The method and extent of disclosure of their respective responsibilities.

This task force has identified the following issues:

1. Uniqueness of the reporting actuary's role.
2. Overlapping responsibilities.
3. The objectivity of the reporting actuary.
4. The right to question the competence of the specialist professional.
5. Assessment of the work of the specialist professional.
6. Basis of inquiry between the two professionals.
7. Expressions of opinion.
8. Disclosure in the auditor's standard report.
9. Basis of disagreement.
10. Recourse.

It is anticipated that the task force will present its report and recommendations to the two sponsoring organizations before the end of the year. It is interesting to note that this task force has dealt concurrently with life companies, property and casualty companies and pension plans. It is the opinion of the task force that the principles involved are common to all of these situations and that, therefore, rules can be defined to apply equally to all. That brings us pretty well up-to-date in Canada.

MR. KISCHUK: Thank you, Gary. The next speaker will be Bill Schreiner who will present an update of what is going on in U.S. financial reporting.

MR. WILLIAM J. SCHREINER: I would like to discuss two areas involving U.S. statutory reporting. First, I would like to give an update of those changes that will be required for 1983 statutory reporting, and second, I would like to give a preview of those areas which will be reporting issues in 1984. Starting with the 1983 changes, the first one of note involves reinsurance. For 1983 there will be a new Schedule S, Part 3C for reinsurance assumed. This schedule is reasonably extensive and has two parts, one for life and one for health insurance. With respect to life insurance, for example, it requires in force reserves and premiums for each contract. As originally proposed and sent on to the NAIC body that makes the final decision for annual statement changes, it would have included identification of commis-

sions and expense allowances; however, that requirement was deleted by the NAIC at their June meeting. Another item of interest regarding reinsurance schedules is that NAIC company code identifications will be required. These codes are available from the NAIC Office in Kansas City.

The next item is the State page. There is a new line for annuity and other fund deposits for individual products required in 1983. This has been added because of concerns that arose as a result of the Baldwin-United situation when the regulators found out that they did not know the distribution of these products by state. Another State page change is that the Credit section, which formerly could be filed by April 1, now has to be filed by March 1 with the rest of the page. With respect to the Accident and Health Policy Experience Exhibit, separate reporting of individual Medicare supplement policies will be required starting in 1983. Also, for mutual companies only, there will be a new Schedule M supplement which will require a description of the dividend practices of the company, and which will include a requirement for an actuarial opinion that the dividends paid follow the practices and principles of the American Academy of Actuaries. The subject of actuarial opinions is attracting growing interest as you will see from my subsequent comments, and from the material that Rick will discuss later.

The threshold levels for Schedules I and J have been changed for 1983. For Schedule I, which shows commissions and collection fees, the threshold has been raised from $5,000 to $10,000. In other words, each payment now has to be reported when it reaches $10,000 or more; it had been $5,000 or more. For Schedule J, legal expenses, the threshold has been raised from $500 to $5,000. Also, provision for optional "Other" columns has been added to page 5 for 1983. Each company may add one or more additional line of business columns on page 5. This change will provide the means to report corporate accounts or other lines of business that the current page 5 does not provide for.

In a related matter, not affecting life and health statement reporting, the NAIC will require actuarial opinions for the 1983 annual statements of HMO and Blue Cross/Blue Shield organizations. I would also mention that the IRIS report (Insurance Regulatory Information System) -- the so-called early warning system -- is unchanged for 1983.

One area that the NAIC gave serious consideration to this year was the disclosure of the market value of bonds and preferred stocks. A proposal to provide such a disclosure was passed by the NAIC Blanks Task Force this spring, but was rejected by the NAIC Financial Condition Subcommittee at their June meeting, and thus it will not be an NAIC requirement for this year. The proponents of market value disclosure fundamentally believe that disclosure is good and that market value information would be of interest or use to the regulators. Those who oppose its introduction feel that it is not useful information and holds the potential for being misunderstood or misused whenever there is a difference between the market value and the statement value. Even though the NAIC rejected this particular disclosure, two states, Wyoming and California, have since sent out bulletins indicating that they would require such a disclosure for 1983. California has requested disclosure of the value of bonds and preferred stocks in the aggregate, along with the aggregate statement value of those bonds and stocks and the difference between those two figures in the Notes to Financial Statement. Wyoming wants similar information as a supplement to the annual statement.

I would now like to indicate those items that the NAIC is likely to consider in 1984. First is a draft of new instructions for the annual statement. There is one set for the life blank and one for the property and casualty blank. These are extensive instructions, although they do not consider every schedule and exhibit in the statement. The life version covers 134 pages. However, it is not intended that the proposal change any current accounting practices. Another item that the NAIC will consider in 1984 is the replacement of the current page 4A with a cash flow schedule. The major difference between the schedules is in the area of developing cash from operations. The current page starts with the operating gain and backs out the non-cash items to arrive at an aggregate operations cash figure. The proposed revision would start with each element and work down to the aggregate cash flow. In other words, the ins and outs for premiums, claims and expenses would be shown line-by-line, instead of in one aggregate figure.

Work is also in progress with respect to Schedule DA. Currently, Schedule DA for short-term investments only shows status as of December 31, unlike the schedules for long-term bonds. They are in the process of developing a verification between the years for short-term investments that will be an addition to the current Schedule DA. Work is also going on to produce a new schedule for interest rate futures and options, now that several states permit investment in these instruments. There is a feeling that there is a need to have a special reporting format designed to report the specifics of these investments. There is also an effort to give consideration to obtaining a clearer statement of approval by the NAIC regarding the equity method of accounting for subsidiaries. There also is a study being done of Administrative Services Only business, reflecting a desire to find a way to more effectively report such business.

The last topic I would like to mention is the Mandatory Securities Valuation Reserve. In the latter part of 1981 a study of the MSVR by three consultants was jointly sponsored by the NAIC and the American Council of Life Insurance in order to make recommendations for potential modifications. Early this year the consultants made their report which contained recommendations for 15 changes, with two of particular significance to companies and to the regulators. One proposal would have unified the two reserve components and, therefore, prevented any spillover into surplus until this unified reserve reached 100%. The other recommendation that gained particular attention was a proposal to exclude from MSVR consideration subsidiaries of the insurer. The reaction of the industry was that the proposal to unify the components would be likely to have an adverse effect on common stock investments, because it would take much longer before common stock capital gains would spill over into surplus and become available for distribution to policyholders. A study group of the ACLI has been reviewing the consultants' proposals, and it has made a recommendation that would keep the two components separate, but would provide for a faster buildup than is presently the case when the ratio of the amount of reserve to the maximum is low. I think everyone agrees that strengthening the MSVR is appropriate and now the question is: What is the best way to accomplish that? With respect to excluding subsidiaries from MSVR calculations, the ACLI study group has recommended that it be done only on a prospective basis, while the consultants' recommendation, in effect, would have made it retroactive.

It appears probable that the NAIC will agree with the recommendation to keep the two components separate. At this point it seems the regulators would not agree to any change in the handling of subsidiaries — they would not

agree to either a retroactive change or to a prospective change and would support retention of the present treatment of subsidiaries.

MR. ROBERT W. STEIN: I have been asked to make a few remarks concerning the status of accounting for non-guaranteed premium products. The term "non-guaranteed premium products" is meant to be general. On the one hand, it refers to the various new products which have been introduced in the last several years, primarily indeterminate premium and universal life plans. On the other hand, it refers to the activities of the AICPA Task Force of the same name, which has been very noticeable in recent months. To avoid confusion, I will briefly describe product features when necessary.

These comments are based on my participation in committees and task forces of the actuarial and accounting professions. At present, I am on the Academy's Financial Reporting Principles Committee and am chairman of its New Products Task Force. In addition, I serve as technical advisor to the AICPA's Insurance Companies Committee Task Force on accounting for new products.

My specific remarks will consider GAAP, as opposed to statutory, reporting developments related to the following products:

1. Indeterminate premium plans.

2. Single Premium Deferred Annuities (SPDA's).

3. Universal Life.

Indeterminate Premium Plans

For today's purposes, included in this category are plans which permit the company to periodically change the gross premium charged, subject to a maximum premium which cannot be exceeded. These plans may be either permanent or term and generally have a fixed death benefit schedule. Cash values, if any, are traditional fixed amounts.

The Academy Committee began studying the accounting alternatives for this product approximately three and one-half years ago. Extensive discussions were held, culminating in a proposed Financial Reporting Interpretation which was exposed for comment about eighteen months ago. Changes were made, although they were not considered significant and re-exposure was not necessary. A final Interpretation was presented to the Academy Board one year ago and was adopted at last year's annual meeting. Generally, the new Interpretation provides for the following:

- On the date of the premium change, the amount of the net reserves are to remain unaffected.

- The existing net reserve, in addition to future net premiums, are to be used to fund future benefits and expenses.

- New net premiums and estimates of future costs are to be based on new assumptions, appropriate as of the date of the premium change.

The AICPA Task Force has reviewed this guideline and has indicated their agreement with its conclusion. A paper promulgating similar accounting guidance has been prepared and is currently in the hands of the Insurance Companies Committee. The timing of any Committee action is unclear, particularly as the issue is not considered critical at the present time.

SPDA's

The AICPA Task Force has been very active in this area since its formation. However, their work has been based, in part, on earlier efforts of the Academy's Committee. About eighteen months ago, the Academy began to study universal life accounting alternatives. We began by considering the SPDA product because it represented an extreme case and was a situation in which we believed the fundamental and basic principles could be more readily studied. It was not our intention that a separate, stand-alone SPDA paper be issued. Based on our discussions, a working document was prepared which summarized our thoughts.

At that time, we began working jointly with the AICPA on this issue. To facilitate their review, we made the SPDA paper available. Since then, the AICPA Task Force has concentrated on the more narrow SPDA issue, using the earlier Academy paper as a starting point. Academy positions and conclusions have been modified, in some instances materially. At the present time, the AICPA paper on SPDA's would require the use of accounting practices which result in no gain or loss at issue, excluding the expensing of non-deferrable acquisition costs. This is commonly referred to as prohibiting the anticipation of, or the front-ending of, investment income margins. Several specific means of achieving this result are outlined, but no single method is mandated.

As of this date, the AICPA Task Force has completed their work and has sent the paper to the parent committee. However, the Task Force has requested that the Committee delay action on SPDA's until it has thoroughly studied the accounting alternatives for universal life. This request was made in an effort to avoid the possibility that decisions concerning SPDA's would be made which might ultimately conflict with later decisions in the universal life area. Nonetheless, the Committee appears sympathetic to the SPDA conclusions and could act more quickly.

If the Committee acted, the following sequence would be followed:

- The AICPA's Accounting Standards Executive Committee (AccSEC) would be given the paper and asked to review its conclusions.
- AccSEC could table the matter, send it back to the Committee for further work, expose the draft, or send it to FASB.
- When eventually sent to FASB, the issue could be tabled, dismissed as too narrow an issue, or, if not done previously, expose the paper.

The entire process is quite lengthy and the possibility exists that the conclusions could be changed at any point. In the circumstances, it appears that adoption of formal guidance is not likely in the near future.

Universal Life

Broadly defined, this product category includes all plans with account value or cash value funds which are based on current interest and mortality elements. The premium and face amount patterns may be either fixed or flexible.

As in the case of SPDA's, both the Academy and the AICPA are studying the accounting alternatives. The AICPA is moving very slowly and a quick agreement on basic issues is not likely. Generally, there seems to be much more difference in opinion than in the SPDA case. The Academy Committee hopes to make more progress and to provide members some guidance on a more timely basis. As a practical matter, however, no official guidance is expected this year. However, the Academy Task Force has tentatively concluded that existing literature (the Audit Guide and FASB 60) is adequate to account for universal life. It presently believes that further, and perhaps new, guidance is not necessary for this product. Thus, the Academy Task Force currently believes that earnings patterns for universal life-type products are consistent with the principles of existing literature. It should be noted, however, that Task Force positions can change and this conclusion is only tentative.

Other Matters

During the last several months the SEC has taken a more active role in these SPDA and universal life issues. As a result, there exists the possibility that SEC action may supercede the professions' leisurely development of guidance for these products. Based on discussions held at various Committee and Task Force meetings, the following events appear to have occurred in recent months. (It should be noted that this is based on unofficial, and perhaps incomplete, information.)

- Several months ago the SEC requested various companies active in the annuity business to provide specific information concerning accounting policies and procedures.

- Based on these responses, staff at the SEC identified a company which they believed was anticipating future interest margins and requested it to restate 1982 earnings. Discussions between the SEC, the Company, and their auditors are continuing.

- Additional inquiries have been made by the SEC concerning companies' accounting for SPDA's and universal life. These questions emphasize the handling of future interest spreads and the separate savings and protection elements of the universal life product.

Based on these actions, it appears that the SEC has taken a leading role in the determination of GAAP accounting principles for these products. At present, we are awaiting the next actions taken by the SEC.

MR. KISCHUK: Thanks very much, Bob. That certainly is a very interesting area. With both the actuaries and accountants involved, and now with the SEC dipping its oar in the water, it may be a little difficult to predict what is going to happen. For sure, something is going to happen.

Today, I would like to give a brief overview of the actuary's role with respect to the statutory statement in the United States. First, I will give a brief overview of events over the past eight years. Then, I will describe some recent activities in this area that I am aware of. Others in the audience may be aware of additional activities, and may be able to update us on those.

At the June, 1975 meeting of the NAIC blanks subcommittee, revised instructions were adopted, requiring a Statement of Actuarial Opinion by a qualified actuary. Among other things, the instructions require that the actuary express an opinion as to whether the reserves and other actuarial items "make a good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies".

The American Academy of Actuaries, through its Committee on Life Insurance Financial Reporting Principles, worked very closely with the NAIC as the revised instructions were drafted. As a result, in 1975, the Academy was able to issue Financial Reporting Recommendation 7, which delineates the responsibility of the actuary in signing the required Statement of Actuarial Opinion. At the same time, three Interpretations of Recommendation 7 were issued.

Interpretation 7A outlines the responsibility of the actuary and others. Among other things, it states that "an actuary stating an actuarial opinion in a statutory annual statement is expressing a personal opinion for which the actuary takes full responsibility, except to the extent which the opinion indicates reliance on other opinions".

Interpretation 7B gives some guidance on factors the actuary should consider in judging the adequacy of reserves. I will come back to Interpretation 7B in more detail later.

Finally, Interpretation 7C gives guidance to the actuary in the event it is necessary to give a qualified or adverse opinion.

The Statement of Actuarial Opinion, adopted by the NAIC in 1975, has served the industry well. And Recommendation 7 has provided the necessary guidance to the actuarial profession in signing statements of actuarial opinion over the past eight years.

However, more recently, questions have come up in a couple of areas. Economic conditions since 1979 began to prompt greater concern and discussions about matching assets and liabilities, and about the liquidity position of insurance companies. As a result, members of the Academy began to ask specifically whether the actuary had a responsibility to consider liquidity in signing the Statement of Actuarial Opinion.

In January, 1981, the Academy's Committee on Life Insurance Financial Reporting Principles wrote a letter to all members of the American Academy of Actuaries, specifically addressing these concerns. The Committee addressed two questions. The first question was: "Does the statutory opinion that reserves make a good and sufficient provision for all unmatured obligations of the company also mean that the actuary is expressing an opinion that assets will be sufficient to meet said reserve obligations?"

The Committee stated its belief that the present statutory opinon <u>does not</u>

impose this added burden on the actuary. The Committee called attention to paragraph one of Interpretation 7B, which states:

> "The statement requirement does not call upon the actuary to express an opinion with regard to the general assets of the company. The NAIC spells out the valuation bases for assets in some considerable detail, and it is expected that the actuary can rely on the company's valuation of assets in accordance with these procedures, and the resulting yield in determining valuation interest assumptions."

Nonetheless, some actuaries were not comfortable with this interpretation. In that event, the Committee suggested that a clarifying statement might be added to the opinion, stating that the actuary is relying on the NAIC valuation of assets. However, the Committee believed that such clarification was unnecessary.

The second question addressed by the Committee was: "What is the actuary's responsibility to consider the degree of matching of assets and liabilities?"

In addressing this question, the Committee referred to paragraph two of Interpretation 7B, which states that "the actuary should evaluate the actuarial assumptions used by comparison with plausible sets of adverse circumstances and in relation to the time periods over which such circumstances can plausibly be expected to prevail".

While the actuary is not required to address such considerations in the Statement of Actuarial Opinion, the Committee expressed its belief that the actuary should consider the market value of assets. The Committee stated that:

> "If in the actuary's opinion there is concern over liquidity which would pose some material degree of threat to the solvency of the company, then the actuary, acting professionally and prudently, should, at a minimum, inform management, and depending on the degree, consider qualifying the statutory opinion."

Since this letter was written in 1981, there have been a number of events which have caused the Committee to give further attention to this subject.

First, economic conditions have continued to prompt a great deal of concern and discussion about matching assets and liabilities, and about cash flow. Insurers have been taking a number of steps to reduce the risk of financial loss due to changes in interest rates. These include segmentation of invested assets, changes in investment strategies, the use of financial futures and options, and consideration of liquidity in pricing new products. Actuaries have been actively involved in developing and implementing these changes.

In addition, there has been a great deal of discussion among regulators about assigning greater responsibility to the actuary in this area. Beyond that, the New York version of the NAIC model standard valuation law permits the use of the more liberal valuation interest formula, for most annuities and guaranteed interest contracts, only if certain conditions are met. Specifically, to take the advantage of the higher valuation interest rates, the New York law requires that the company submit an opinion of a qualified actuary that the reserves, <u>and the assets</u> held by the company in support of such reserves, make good and sufficient provision for the liabilities.

Finally, over the past two years, there have been several important additions to the actuarial literature related to the risk of loss due to changes in interest rates. The Society of Actuaries' task force to study risk of loss from changes in the interest rate environment was formed in March, 1981. The task force has issued several reports and papers which are published in the Record of the Society of Actuaries. In addition, this topic has been covered in several panel discussions, documented in the Record, and in several papers published in the Transactions of the Society of Actuaries.

In light of these recent events, the Academy's Committee on Life Insurance Financial Reporting Principles issued a Discussion Memorandum to all members in January, 1983. The Committee asked for input on two important questions:

- Should Recommendation 7 be updated to recognize an increased professional responsibility in this area?

- If so, how should Recommendation 7 be changed?

Response to the Discussion Memorandum was disappointing. The Committee received only four responses. While the Committee did not receive any specific guidance on how Recommendation 7 might be changed, the responses were generally favorable toward the idea of reviewing Recommendation 7.

Accordingly, the Committee has appointed a task force to review Recommendation 7 and determine what changes, if any, are needed in light of recent events. Currently, the Academy task force is working with the NAIC to develop an acceptable statement of actuarial opinion which addresses the issue of matching assets and liabilities for index-linked universal life insurance.

I think that is about all I have to say on this particular topic, although I suspect that we may have some people who would have some comments and discussion on this as well as other topics that have been talked about by the various panelists. Our role here this morning has not been to pose as experts in these areas but to set the stage for some discussion from the floor. As I look around the room this morning, I see quite a number of people who know more about these issues than I do and probably more than some of the other panelists do, so I am hoping some of those people will contribute.

MR. DONALD D. CODY: First of all Rick, I think that explanation of history that you gave is a remarkably good one, and I am delighted that you gave it. Second, I have some personal opinions that I think are shared by most members of the Committee on Valuation and its numerous task forces, one of which is the C-3 Risk Task Force.

The status of the valuation actuary must increase, he must take on the responsibility of examining liability and related asset cash flow. There is no way of escaping it. Although this is a new subject, as you mentioned, a great deal of work has already been done: there are some 300 pages in the Record on all aspects of this. My personal feeling is that any company that gets into investment type contracts (GIC's, single premium deferred annuities and large amount universal life policies) must necessarily face some cost for certain benefits. I give, as an example, the thought that no company today would think of issuing a large ordinary life policy without getting a medical exam and an inspection report. Any company that gets into these investment contracts had better coordinate their product and asset policy, and their

valuation and pricing actuaries had better be informed about the relationship of the asset and liability cash flow.

As you probably all are aware, when the NAIC Technical Advisory Committee approved what is now the 1980 standard valuation law, we did it only on the grounds that the valuation actuary would eventually include in his opinion the effects of the liability and asset cash flows under various possible scenarios. The C3 Task Force has been working at this, and we are under serious pressure from the NAIC actuaries to make this a requirement of the actuarial opinion.

The Academy is standing by waiting for enough sensitivity to this issue and enough realization of the importance of it to arise so that Recommendation 7 can be changed.

I think that this Section has a great opportunity to sponsor changes in education and in examinations so as to make valuation actuaries competent to handle this issue, because eventually the NAIC is going to tell us to do it. I know this is necessary in the statute, otherwise many companies could not get their investment organization to give them the information. It must be required, and one of the things that could develop is that an actuary would have to render a qualified opinion on the good and sufficiency of reserves if he did not have this information. This is a very important step that the Board and officers of the Society must take; the natural location for this development is in this Section. We have to do the sort of things that Canadians have done, but we have a different environment and different problems here. So I say let us proceed on this in the various committees of actuaries in the Society and in committees working with the NAIC, and although we will provide all the help that we can in these groups, we need broader work on this than we can provide ourselves and, therefore, need the help of this Section.

MR. WILLIAM T. TOZER: I would like to bring some of your comments a little bit more up to date. The Academy committee met on Thursday, and you and Bob were tied up and could not attend. And as Rick mentioned, very often minds change from one meeting to the next.

The final decision that was made on Thursday in reference to the actuarial opinion that Rick was referring to on the universal life issue was a redrafting of that opinion. The new draft refers to the actuary securing reliance from the investment officer, if he desires, and based upon the investment officer's suggestion on future cash flows from the investments as well as the future cash flows coming out of the insurance side of the product, that the cash flow does provide sufficient cash to meet the future obligations of this universal life policy.

That actuarial opinion has been redrafted, it was given to Don Cody's NAIC Standing Technical Advisory Group on Sunday, and they have looked at it. It will probably be exposed to the department actuaries on Thursday of this week. As Don was mentioning, actuarial opinions are becoming a necessity in order for these products (such as interest indexed universal life) to be acceptable to our regulators.

That is the latest development Rick.

MR. OWEN A. REED: My company is a multinational company operating in Canada,

the United States, and Great Britain. We are familiar with the financial reporting requirements on the actuarial side in all three territories. Those Americans that are not familiar with the British scene will be interested to know that the closest thing I have ever seen to solvency valuation was introduced this year. The assets are on the market basis, and liabilities are valued on a consistent market basis with constraints on the yields that are assumed for things like common stocks. You can only use the existing stock rate of the existing rental income and divide by the market value of the stocks and real estate to get the yield that you are going to use in the future. In any event the requirement is that you do the valuation on the minimum basis, and these are parts that I am talking about.

One explicit constraint is that you must consider the matching of the assets and liabilities, and if you do not think they are reasonably matched, you have to set up an explicit reserve to cover the mismatching. I can assure you from my own experience that it is a very challenging and interesting exercise. In fact, I think if you have not done a valuation that does in fact explicitly consider the assets versus the liabilties, then you have never really done a valuation (or more jocularly that you have not lived yet). I cannot see how in the U.S. area you can escape going this route, and it has been a requirement in Britain under the actuarial guidelines for many years, and now it is written in the regulations.

In any event, the requirement, as Don Cody said, is that certainly every time you do the valuation you have to have information on the assets, you have to rely on the audited information, but you have to be plugged into what the investment strategy is during the year. In our own case I lost count as to how many blocks of assets we had notionally allocated by the time we finished the valuation, but it must have been up near 15, and we found we had deficiencies in some cases and excesses in others. One big problem in the multinational level is swings caused by currency exchange rates.

If I could swing now to a question to Bob Stein. I was not quite clear what you were saying about what was not permitted with respect to deferring acquisition expenses on single premium deferred annuities.

MR. STEIN: The AICPA draft does not specifically require any one or any two procedures to be followed, so some methods would include an explicit deferral of acquisition expenses. Other methods that were considered acceptable would have an implicit deferral built into them. The simplest method would be to establish the account value to be equal to the premium. Then the account value is the reserve. This defers what FASB 60 defines as deferrable acquisition expenses. That would accomplish, in the minds of the task force, no gain or loss at issue, excluding non-deferrable acquisition expenses which are incurred at issue, but which, under FASB 60, must be expensed immediately. The objective is to exclude the immediate expensing of non-deferrable expenses and establish reserves so that you break even at issue. This can be accomplished with the gross reserve and a deferred acquisition cost asset. Or the paper also allows a present value of future benefits to be established using an interest rate, which would be the rate such that the present value equals the premium received less the deferred expenses incurred (in essense, that rate which is break-even).

MR. REED: I see, so what is prohibited is the excess over the deferrable acquisition expenses.

MR. STEIN: That is right, I guess you could say that the AICPA would allow recognizing future interest profits at issue to the extent that is required to establish deferred acquisition costs.

MR. SCHREINER: On this issue of actuarial opinions and the NAIC, my observation is that apart from the department actuaries, there is not a great ground swell of support for actuarial opinions within the NAIC. But at the same time, one cannot underestimate the impact that the Baldwin-United situation is having on the regulators. They are actively seeking any number of ways to identify troubled companies, ways to deal with troubled companies and ways to pick up the pieces after those companies fall in the tank. I think that is a major impetus towards actuarial opinions, the practical issue of how do we get a handle on these things quite apart from what actuaries might think is appropriate actuarial practice.

MR. CODY: May I respond briefly to that because you put your finger right on the problem. I would not have stood up at all if there had been a ground swell. I would say that I stood up because there is complete apathy. And the apathy is on the part of the actuaries. There is a problem here, and we sure had better get to work to develop a solution.

MR. KISCHUK: I would like to underline that by pointing to the disappointing response that the Academy got in issuing the discussion memorandum on this. When we issued that memorandum, we thought for sure that we were going to get a lot of responses and would probably hit a lot of people's hot buttons on this. And we were very disappointed to get only four responses. We had hoped to get quite a lot of responses and stir up a fair amount of controversy. What I think we found was a lot of what you are describing: a fair amount of apathy on this issue.

MR. TOZER: I will have to disagree with Bill a little bit, because I think that the interest is beyond the actuaries in the departments now. It may not be completely at the commissioners' level, but I have been in other discussions with policy approval people in the insurance departments, and these people are now becoming very concerned about whether or not we should permit this type of policy or that type of policy with this type of language. They are concerned about bail-out provisions and other provisions actually being in contracts that might possibly cause another Baldwin-United. I think it is going beyond the actuaries and is developing in other staff people. This concern may not be working up to the commissioners yet, but it is spreading among other staff people in the insurance department. So I agree with Don. This is becoming a very important issue, and I share his concern. I am afraid we are dragging the actuaries kicking and screaming into this issue rather than the actuaries standing up and accepting the responsibility.

MR. KISCHUK: Bill, you can correct me if I am wrong, but my recollection is that the proposal on index-linked universal life actually requires that a statement of investment policy be filed with the policy at the time it is filed with the insurance department.

MR. TOZER: Yes, you are correct on that.

MR. GARY CORBETT: I would like to address this subject of support for the valuation actuary. It is something that the Society is certainly conscious of. We definitely need to do more here, and the planning committee of the

Society has been addressing this as one of its major problems. At one time it was thought that we perhaps should start an ad hoc committee to investigate practical support, not so much the theoretical basis which is being done by Don and his groups, but more to determine the sort of practical support the valuation actuary needs.

I think the way this is going to come out now and, of course, by the time the Record gets published it will either be so or not so, is that this problem will probably be referred to the Section very soon. I think the planning committee is going to have a short meeting. They have a very large list of items to address. We certainly cannot address them all ourselves. So they are going to have to be assigned out to committees or sections. I think that has got to be addressed very early.

Let me ask one question before I sit down. What is happening on GAAP for mutual life insurance companies now? Where does that stand in the whole big picture?

MR. STEIN: The formal status, as I understand it, is that the AICPA task force has been deactivated but not disbanded. On a formal basis, it is not likely that anything is going to happen. On an informal basis, I have seen a resurgence of interest in something other than statutory for mutual companies, not necessarily GAAP as we understand the term GAAP. A lot of mutual companies and fraternal companies are looking at something other than statutory accounting, but no action is expected from the Institute in that regard.

MR. DANIEL J. McCARTHY: I have two comments and one question. I think we are either going to have better solvency regulation, or tighter product regulation. If we have tighter product regulation, I think what is going to happen is the products that would be good consumer oriented products will not be allowed. The alternative to that is better solvency regulations, including expanded actuarial opinions.

Second, I have a thought on the reserves do not matter notion. To me the related question is, "How good and sufficient is good and sufficient?" The answer to the second question is probably, "Well it is pretty good and sufficient, but it is not 100% good and sufficient." As long as you come down on that point on the second one, which I think you almost have to unless you are willing to sign off 100%, then I think reserves do matter, because that corridor articulates the margin for error in everything else that has happened. That is why I would not like to see the concept go away.

Finally a question to Bob Stein. In connection with the SEC activity on financial reporting for annuities and universal life, there has been other SEC activity in that area too. That activity is to question whether those products or some subset of those products should be treated as registered products, and the SEC has had an inquiry going on there and has subpoenaed a lot of people and gathered a lot of files. Are these totally separate activities, or are they related in some way?

MR. STEIN: I guess I have become aware of them and have had discussions about them as separate issues. The "are these products securities?" question was raised in the mid 1970's by the SEC when some companies began writing SPDA's pretty actively. So I think that question is just a resurgence of one that has always been there, and maybe now they are less comfortable with the notion that they are not securities.

I think this has caused some of the more recent questions on the SPDA. The other thing that generated part of the SEC's interest in the annuity question is that the AICPA meets periodically with the SEC to discuss current issues and what they are doing. In that process there is a fairly free flow of information between the AICPA and the SEC and that led to the SEC obtaining a copy of the discussion draft that the AICPA task force was working on. They had, fairly early on, some working drafts of the insurance company's task force on the annuity issue as to what their thinking was. I think that prompted them, along with the public outcry and problems with the other companies, to move more quickly than they might otherwise have done on the annuity issue.

MR. McCARTHY: The reason I asked that question was that along with other activities you mentioned going on for a long time, there is this whole question of where all of these products should be registered. We had some files subpoenaed on that as recently as six months ago which seemed to indicate a resurgence there the same time you described the other activity.

MR. STEIN: I have not seen any close correlation between the two. The letters I have seen recently requesting data have been addressed to accounting policies. They have not raised the issue, but were asked for support as to why this is not a registered product.

MR. KISCHUK: Getting back to some of these other issues, such as matching assets and liabilities, the one thing I have learned is apparently there is a little different wording in the Canadian statutory opinion. I think it says something in terms of assumptions being appropriate or something along those lines. I was wondering if Gary Mooney might comment on that and comment on the significance of that difference in his view.

MR. MOONEY: This is the report of the Valuation Actuary in Published Statements. The wording would be that "the amount of the policy benefit liabilities makes proper provision for the future payments under the company's policies; the proper charge on account of those liabilities has been made in the income statement; and the amount of surplus appropriation for policies with cash value exceeding the policy benefit liability is proper". That latter relates to a solvency override on the standard method for determining liabilities, with the emphasis being on the word "proper" and that opens up a real can of worms. "Good and sufficient" is a lot easier to deal with than "proper".

MR. WILLIAM R. WELLNITZ: Some time ago I had a chance to have a conversation with a chief financial officer of a major insurance company having to do with this subject of actuarial opinions. He expressed some degree of surprise and indignation that actuaries felt it within our purview to render an opinion on the asset structure of any insurance operation. I would like to get Bob's comment on what the AICPA is doing as far as opinions about asset structures. Have not actuaries always had the responsibility to choose valuation assumptions which properly reflect the conditions in their own companies? Has not that responsibility always applied to the situation of what kind of monies I have?

MR. STEIN: With respect to the AICPA's interest in the matter, remember the opinion that we are talking about here is statutory. The AICPA is not too concerned with the statutory opinion. They become concerned with statutory financials if there is an impairment problem, or on another basis, at least

for stock companies, there is some difficulty maintaining solvency. There perhaps is a different issue on mutuals and fraternals where statutory is GAAP or vice versa. They have not thought through that at this point. All the discussions we have had at the AICPA level in terms of accounting and validity of assets and so on have only come up with respect to the SPDA issue and whether or not somewhere in that proposed accounting guidance we ought to require segregation of assets for that product. That was talked about on occasion at the task force level, and it was decided that it would be improper to force more stringent asset segregation on this particular product when some other products are having just as tough a time in terms of operating results. In summary, the AICPA is not doing a whole lot in that regard. Their opinions, of course, relate to the company taken as a whole, as opposed to any individual element of it and, again, primarily are stock company oriented.

MR. KISCHUK: That is a difficult question to deal with. I think all I can really note is that there is a wide variety of opinion among the actuarial profession ranging all the way from actuaries who feel that the actuary should stay totally away from the asset side of the balance sheet to the actuaries who say that the statement of opinion that has been required for the statutory statement has always required that actuaries look at the asset side of the balance sheet, and surprise among those actuaries that anyone would think any different. I would be interested in any other reactions that anyone on the panel might have or anyone in the audience.

MR. GAYLEN N. LARSON: I am controller of Household International, and I am not an actuary; I am an accountant. I have been listening to this and am surprised at the discussion. I thought I would give you my comments. First of all, I think the fact that you are kicking and screaming and really not wanting to be dragged into this is the proper observation. The days of dealing with the kinds of products where you could avoid looking at both sides of the balance sheet are gone. There is no way that this industry, or any other financial services industry, is going to survive if you are not looking at matching of the assets: both the maturity and the risk rate. It seems to me that there is no way that you should be dragging yourself into it by trying to determine what your requirement is to sign off. You should be determining what you can do for your companies for your managements to develop the kinds of systems to assure that they understand the rate and maturity risk and to assure that the controls are there to keep them from geting into a trap. Really, the sign-off on the reserves is not going to do with new kinds of products. Obviously, I am naive, but I am looking as a controller, not as an actuary, and I really think your perspective perhaps needs to be broadened to deal with this issue.

MR. KISCHUK: Thank you very much. Any other reactions?

MR. ALLAN G. RICHMOND: I guess my question is from the standpoint of the practicing actuary and practical assistance for him. We are in a situation where we are near the audit season, and our company, like many others, has come out with an interest-sensitive life product. We are in a situation where there is no formal procedures for how to set up GAAP reserves on these products, and our company is taking the basic approach that, although there are different procedures, the procedure to use is, after being able to agree with the external auditor, to come up with an approach that tends to produce GAAP profits that look reasonable on a duration-by-duration basis. Hopefully, that combination of demonstration with a reasonable method produces valid GAAP reserves.

But from a practicing actuary's standpoint, I do not understand how we can operate in the situation where things are not finalized. And then, until you have final statements, which could be one, two, or three years down the road, the business has multiplied on the books and then you are quite susceptible to some type of wholesale recalculation once a body like the AICPA or FASB finally comes out with pronouncements of what you are supposed to come up with. Any comments on that?

MR. KISCHUK: I will let Bob address that one, since he understands the way that the accounting profession works in these matters.

MR. STEIN: There is not too much I can say. That is obviously a real problem. We have been that way for a long time on the annuities, and I do not mean to make light of it. For a lot of companies, it is obviously a material matter and, with universal life, will impact virtually all the companies in any event. I think the approach that you outlined, in terms of reasonable earnings, would have been my answer. It is simplistic to say, "do what is reasonable and makes sense". But, none the less, that is all that you can do at this time. The existing framework for GAAP will encompass any alternative, any extreme, that the AICPA may choose to adopt if in fact they pick an extreme position.

For example, on annuities the total front-ending of excess interest, or the total prohibition against front-ending can be accommodated in the existing literature and the existing typical actuarial procedures via the selection of assumptions. Any extreme on universal life in terms of deferral of all excess interest spreads and mortality margins can be accomplished with the same traditional mechanics, again, by this selection of assumptions. So I think what each company needs to do, and from my perspective as somebody who looks at a lot of what companies are doing, is to just try to examine the possibilities, examine how the product is designed, and perform tests to determine reasonableness. There are lots of practices in the industry on annuities and universal life. You see all the extremes from full traditional GAAP for universal life to a full deferral of the interest and mortality margins. You have to do what is right for your company based on the characteristics of your marketplace, your product and your financial statement.

One other quick comment: an item noticeably absent from the AICPA's draft paper on SPDA's is implementation. Typically when papers come out of any accounting body and up to the AccSEC level, and to a committee level, and often when they are exposed, there is guidance provided on how to implement the conclusions that were reached. There are no good answers on how to implement retroactive or prospective changes in annuity accounting or universal life accounting. Because there are no good answers, that issue was not included in those that were addressed in the SPDA paper. We were waiting to see just what kind of reaction we would get from the industry on the proposal in the first place and then worry about how to implement it. Implementation is a problem and is likely to be a problem. But on the other hand, with respect to universal life, I would be a little surprised if the AICPA was able to come out with a conclusion that was diametrically opposed to what companies are doing. I think you are going to find, rather, the situation where they scour the industry and see the ranges that are being used, try to provide guidance, and pretty much adopt what the range of practices already is. After all, they are trying to set generally accepted standards. One of the first places they are going to look to is what is being done in the industry. I think they are well aware of the fact that all these deci-

sions have been made and are being made. They may well find themselves in a position of being unable to adopt truly revolutionary accounting guides for these kinds of products.

Rick, I guess hopefully the accounting profession can avoid finding itself in the position it did on SPDA's where you had companies that were front ending as much profit as possible and other companies trying to defer as much profit as possible. It is nearly impossible to come up with guidelines that really encompass that full range of practices.

MR. KISCHUK: Hank, I have seen you try to get to the microphone a couple of times, do you have comments you would like to make?

MR. HENRY B. RAMSEY, JR.: Just one thought about the discussions on adequacy of the assets and cash flow from those assets versus the liabilities. It sounds to me that we are saying something like this: I am the valuation actuary and I have made a reasonable estimate of my liabilities. Now, however, I am being pushed and I have got to say those amounts are really adequate. I have some trouble with that. I mean they are reasonably adequate, but what I am willing to say is the total assets I have got here are adequate, not that the liabilities that I have established are adequate. That is a different thing. It is a very basic point, and I am troubled by our problem with this.

MR. CODY: Hank brings up a point that we have been wrestling with in our committees and task forces. We are wary of suggesting, at this point at least, that the valuation actuary express an opinion about the adequacy of contingency surplus beyond the reserve. We feel that that is a management problem. The surplus is composed of a contingency reserve that is held against very low probability yet plausible scenarios of not only interest rates but all the other risk factors, and the balance of it is what you grow on. If you begin to put too much of your surplus aside formally in contingency surplus, you have nothing to grow on. You have no capital for expansion at all. I think the form that this is going to take is that the actuary, in determining the good and sufficiency of reserves, and more particularly in connection with the extent of the matching of the asset cash flows and the liability cash flows, will say that my reserves are good up to this kind of scenario. I think that that covers some reasonable level of probability. I used to think in terms of 1 in 10,000, although I hear people breathing rather freely at 1 in 10 now.

Then, to his management, he ought to express an opinion as to what further kinds of low probability scenarios that they have adequate surplus for. Of course, if his reserves are not adequate for high probability scenarios, they are not adequate; he must increase them or render a contrary opinion. We are going to be addressing that question in the specialty meeting in New York in June. There will be a great deal of attention paid to that. We really are not wild-eyed in our concern about these things. We are trying to get proper balance.

MR. KISCHUK: Well with that I wish we could continue and address some of the points you have raised Don, but I see that we have come to the end of our allotted time, and at this point I would like to thank our panel and all the people in the audience who participated in this meeting. This has been very enjoyable and interesting.