RECORD OF SOCIETY OF ACTUARIES
1984 VOL. 10 NO. 1

NAIC UPDATE

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A briefing on current NAIC activities.

1. General description of how the NAIC operates

2. Integrated financial services

3. Investment aspects of actuarial opinions

4. Universal life and variable life regulations

5. Cost disclosure

6. New mortality tables - blended male/female, smoker/nonsmoker, individual and group annuities

7. Other current topics

MR. JAMES B. SMITH - The purpose of this meeting is not to go into the usual detail of a workshop or panel discussion, but to provide more of an overview of what is happening with the NAIC. When the program committee originally discussed this topic, it was felt this program would be most attractive to the actuaries from small life insurance companies who didn't have the opportunity or the time to keep current with the NAIC. However, as we proceeded, we realized that there was a large group of actuaries, including myself, that did not have a good feel for the NAIC. As I got into this subject, there were two topics that crossed my mind. One was that I had been an actuary for a number of years and yet did not fully understand how the NAIC operated. How does a model bill come about? I'm going to be very interested in finding out from one of our panelists, Steve Kellison, about how these bills actually emerge and how we can possibly affect the final outcome of a model bill. Secondly, I realized there was very little centralized information that I could get my hands on. One source is the NAIC Proceedings, a volume that is published after certain NAIC meetings. Because of the voluminous nature of this document, it is difficult to spend the time necessary to read it. Another source I have used is the National Underwriter and the ACLI's General Bulletin. Generally, those were current in the information they provided, but may not provide enough details. There has been a recent development that I have found particularly helpful. Starting in December of this past year, the NAIC is publishing the NAIC News. It is a monthly newsletter to which anyone can subscribe. If you would like to have a subscription, you can contact the NAIC headquarters in Kansas City. One of the attractive features about the newsletter, in addition to its current content, is its length of roughly eight pages. I think this is a reasonable length for sitting down and briefly going through many of the activities without getting so bogged down in the details as to take up a great deal of time.

MR. STEPHEN G. KELLISON - My presentation will be in two rather distinct sections. First, I would like to give a general description of how the NAIC operates. Secondly, I will give you some information about the raft of new mortality tables you have heard quite a bit about.

Let me start with a few structural observations about the NAIC concerning how it is structured and how it operates mechanically. Toward the end of this session, perhaps we will talk about it a bit more qualitatively in terms of specific operating characteristics and how to deal effectively with it.

First the structural observations. What is the NAIC? It is a loosely knit association of 54 insurance commissioners. Each one of them is independent in his or her home state. Its main function has been, traditionally, to try to strengthen state regulation by encouraging uniformity in state model laws and regulations, providing a national forum in which insurance issues can be debated and discussed, and similar efforts that involve multiple states. One of the difficulties in trying to follow the NAIC is working your way through its hierarchy. It has a rather complicated labyrinthian type of structure. Moreover, it is a structure that changes quite often. It is a challenge to stay on top of what is the current structure and how it fits together. Matters work their way through the hiearchy. Let me start at the top and work down.

The NAIC has a plenary session which is all 54 state insurance commissioners. Ultimately, to go into effect, matters will have to get passed by the plenary session. However, many items are rubber stamped by the time they get to the plenary session with all the real decisions having been made at a lower level. There is a series of six major committees underneath the general plenary session with the Executive Committee being more equal than the others. This consists of 16 members, 4 officers, and 12 others. Most matters, as is typical of many organizations, are channeled through the Executive Committee before they reach the plenary session. Then there is a series of five other standing committees that deal with major subdivisions of the insurance arena. There is an A committee on life insurance, a B committee on accident and health insurance, a C committee on personal lines property and liability insurance, a D committee on commercial property and liability insurance, and finally an E committee on special issues (a "catch all" for anything else that doesn't fit into this structure). However, many matters are focused at the Executive Committee level and, in fact, the Executive Committee has a number of important subcommittees that deal with issues outside the scope of what I just listed in the insurance areas. One example that's close to the actuarial profession would be the EX 4 Committee which deals with financial condition matters such as accounting practices and procedures, the Blanks Committee, the changes to the blanks, and several others that we have dealt with as the actuarial profession. That is directly under the Executive Committee rather than under some of the operating committees. In addition, underneath some of these committees or subcommittees are a variety of task forces. These address special types of issues of interest to the life insurance area such as life insurance cost disclosure and universal life. There is a Life Insurance Cost Disclosure Task Force, a Universal Life Task Force, and a number of others in the various areas. In addition, there are advisory committees. Most of these working groups within the NAIC have an advisory committee composed of interested parties from the industry, from consumer groups, and others whose job is to advise and counsel the task force or subcommittee or committee to which they are attached. So as you can see, it is a fairly complicated structure with multiple levels.

Different types of issues take different tracts through the maze of committees. It pays to get familiar with this structure if you are going to deal with the NAIC. You might get a copy of one of their programs that they distribute at each of their meetings. You can find in the back half of this booklet a relatively detailed description of the structure. If anyone wants to get involved, I would recommend taking a look at it sometime to get a better feel as to how this is put together.

One of the major functions of the NAIC is to develop a model regulation or a model law. Basically, these are typically developed by starting at one of the lower levels; either a task force or subcommittee level or often times an advisory committee. In fact, much of the work of the NAIC evolves out of work done by advisory committees. Ultimately adopted and ratified by its current level (task force or subcommittee level), it starts working its way through the chain up to adoption at a plenary session. In trying to influence or change that which goes into a model law or a model regulation, I think it is fairly clear that the quicker you get in (the lower levels) the more successful you will be. It's progressively more difficult to modify something that has worked its way up the chain. It can be done however. There have been decisions that have been changed even at the plenary session, not common, but it has happened.

Another group you have probably heard about that effects much of what actuaries do is the Technical Staff Actuarial Group (often refered to as TSAG). This is a group of state insurance department actuaries which has been meeting for several years. Two of its leaders over the years have been John Montgomery of the California Insurance Department and Ted Becker from the Texas Insurance Department. Just to show you how complicated the NAIC structure is, this group does not fit into any of the categories I just cited in terms of what type of group it is. It is yet another more or less autonomous, free floating advisory group of state insurance department actuaries through which many actuarial issues get channeled. In fact, when it comes to NAIC issues I've heard some actuaries say that all they have to do is watch TSAG. I think that's a mistake. Most issues that do effect life and health practice, at some time or another in their development, go through TSAG, but there are many other groups with which it is also important to deal. There are a certain number of issues that do not go through TSAG. It is not the "end all" or the "be all" although it is a very important group through which the life and health issues proceed. There really isn't a counterpart on the casualty side. There is a group of casualty actuaries within the NAIC called Actuaries in Regulation, but they really don't have quite the same type of operating procedures and structures as the TSAG group. For any of you who are interested in becoming involved in the TSAG group and its work, I caution you that it takes a commitment. They deal with a lot of issues, have very lengthy agendas, meet several times a year (always on Saturday and Sunday), and the amount of paper they distribute is contributing to the destruction of forests in North America. Monitoring the actions of TSAG should not be taken lightly. It does require a few hours of professional time to get a handle on it.

Further organizational complexity, I think, arises out of the zone concept. The NAIC has four zones which are geographic breakdowns of their membership. Each state falls into one of four zones: northeast, southeast, midwest and west. Some NAIC meetings are zone meetings. Also, each zone gets three delegates on the Executive Committee.

The NAIC formerly held two annual meetings (possibly a contradiction of terms). They then decided to expand to four meetings a year and to tie each one of their meetings into one of the four zone meetings so that there would be a nice symmetry. They had one zone meeting a year and a national meeting tied along with it. This has never developed into four co-equal meetings. The old June and December meetings, which previously were the two annual meetings, are still the major meetings. The March and September meetings have never developed the substantial type of program content as the other two. Virtually all final decisions of the NAIC have to be ratified at either the June or December meeting. In fact, because of pressure on travel budgets of the state insurance departments, I've heard that they are considering going back to two meetings.

It's an interesting experience to go to a NAIC meeting. There are a lot of industry representatives present. Everyone has a color-coded badge to distinguish who is fulfilling what role. The green badges are the industry representatives who comprise the majority. So, there is a considerable amount of industry attention at these meetings.

The NAIC has a staff. It has recently moved from Milwaukee to Kansas City. They've gone through much turmoil in the last year as a result of that move. It has been a rough year for the staff of the NAIC during 1983 since they lost approximately 60 to 70 percent of their previous staff. It's a good staff, but I would characterize its powers as limited. This reflects the fact that commissioners, in general, want to run the show. They run the show in their own state, and they want to run it at the NAIC level. The role of staff is supportive but not in the leadership role in a policy sense.

I'd like to turn now to the role of the American Academy of Actuaries for just a couple of moments. The American Academy of Actuaries, as most of you probably know, fulfills a public interface role for the actuarial profession. In concept, we try to deal with the NAIC very much as we would deal with federal agencies and the U.S. Congress on issues that affect the actuarial profession. I believe the actuarial profession has become much more involved in NAIC activities over the last few years. I can recall the first NAIC meeting that I went to in 1977. There were very few actuaries at this meeting. There was no real awareness on the part of anyone as to the nature of the American Academy of Actuaries. This situation, fortunately, has changed considerably. I think the Academy has been able to establish a higher visibility for the profession at these meetings and, in general, the actuarial profession does have a greater role to play with probably an even greater role yet that it should be playing.

I want to mention some examples of matters we have been involved with over the past few years. The statements of Actuarial Opinion would clearly be at the top of the list. These statements include the addition to the Life Insurance Annual Statement in 1975, the Casualty Statement in 1980, the two Health Service Corporation and Health Maintenance Organization blanks in 1983, and the Statement of Opinion on Universal Life that was also adopted in 1983. The latter will be a topic discussed later. Anything that involves a Statement of Actuarial Opinion is clearly very uppermost in our minds.

Dividend recommendations and interpretations, with which anyone in the mutual companies is familiar, have been developed with a considerable amount of input at NAIC forums. The unisex issue has been addressed, though not recently. However, when there was more effort at the state level for the NAIC to impose something, we became involved in this issue. A number of health

insurance issues have been addressed such as rate filings, valuation standards, minimum loss ratios for medicare supplement policies, and a growing number of casualty issues. You can see that there is a broad array of issues that we have been involved with over the years and in which we'll continue to be involved.

The Academy does hold a briefing session at each NAIC meeting. For any of you who were to attend, it's at 8:30 on the first day of the meeting. It's an opportunity to have a forum for actuaries to exchange information, and try to get a handle on what is going to be going on at the meeting.

What about some other observations on dealing with the NAIC? In order to put it in more conceptual terms, you have to remember that the glue that holds the NAIC together is essentially to fight off federal regulation in insurance. If that sounds like a negative mission, so be it. The organization does involve a lot of different individuals with a lot of different perspectives that could very easily go flying off in different directions were it not for this one unifying force. The thing that really binds them together is the fear that Uncle Sam is going to take over what they do. It is unlikely this will happen in the short run in any kind of comprehensive sense. What's much more likely, is for the federal government to continue to pick away around the edges. It may start out with the SEC becoming involved in investment related contracts, the FTC looking at life insurance cost disclosure, the unisex legislation in Washington, the Congress passing a bill on minimum loss ratios on medicare supplement policies, a number of bills in the casualty area risk retention acts, product liability, tort reform and so forth. What you see is not a comprehensive gutting of McCarran-Ferguson in terms of the federal government totally preempting the states, but a pattern over the years of more and more federal initiative in certain selected areas. I would expect to see that sort of thing continue.

Another thing to remember about the NAIC is it is not an organization that's necessarily characterized by strong consistency in its positions over time. You have to remember that each commissioner is king in his or her own state. They do not have to adopt what the NAIC would like them to adopt. They have an annual rotation of officers which leads to a considerable change in their hierarchy. As I indicated earlier, they have a limited role for the staff and they go through some fairly frequent reorganizations. So, a strong consistency in policy from the top level does not always emerge out of this kind of a structure.

Another issue, on which I would totally agree with our Moderator, is that it is very difficult to follow the NAIC. It is difficult to find a centralized data source for what is actually happening in the organization. For several reasons, as I indicated, the committee structure is complex and it changes frequently. Not all the committee meetings occur at the regularly scheduled meetings of the NAIC. Sometimes they are scheduled between meetings. Unless you are on the mailing list of the chairman, you may not even find out about this meeting. They do have an official "sunshine" policy of open meetings. However you get the impression, if you sit through very many of their meetings, that most real decisions don't seem to get made in the sunshine. It appears to be largely a proforma ratification of something that has already been decided. They don't have a good centralized data source of current initiatives except for their Proceedings which comes out many months after the meeting. They don't have something like a Congressional Monitor or Federal Register where you could find out almost instantaneously the status of issues. It is difficult to get plugged into this organization. You need

to spend time with people who know the ropes and know the right people to contact. The NAIC is trying to improve on this. As Jim has mentioned, they've come out with a newsletter just within the last three months which is an attempt to be a swifter notification service.

I'd like to close this section of my presentation by discussing a little about some problems in the state insurance departments and perhaps why this gives the actuarial profession a real opportunity. Insurance departments are facing very difficult resource problems. They are woefully understaffed in many of the states, particularly smaller population states. There have been tremendous budgetary pressures in many of the states in recent years which makes it very difficult for insurance commissioners to attract and retain good personnel. In fact, even the turnover among insurance commissioners is very high. The typical duration in office is probably not longer than two years. How does this give an opportunity to the actuarial profession? Well, I will give you a scenario I think would give us an opportunity to enhance our image as a profession and also do something to benefit the commissioners. Historically, the insurance business in this country has been highly regulated in a very detailed sense as it affects actuaries in terms of statutory standards for reserves. This structure has become increasingly unresponsive in the 1970's and 1980's as life has become more complex and as the business has become more complex. In sharp contrast to this kind of a system, I would cite what happens in Great Britain or Canada. Great Britain is the pre-eminent example where there is not this kind of regulatory structure but where actuarial opinions are much more heavily relied on by the regulators. To some extent, the same type of concept exists in Canada with its "valuation actuary" concept. I would submit that there may be an opportunity along this same path in the United States. We would certainly not be able to go as far as Canada or the U.K. in the short run, but I think with the pressures that are facing state insurance departments, this could be a "win/win" situation for both the commissioners and the actuarial profession. If there were a way to place greater reliance on actuarial opinions, it would help state insurance commissioners spread their resources more efficiently. It would also help us enhance our image as a profession and our sense of professionalism. This will not happen overnight. In fact, it may not happen at all. I think there is a good deal of skepticism within many state insurance departments that they could rely on actuarial opinions as opposed to a highly regulated type of structure. Perhaps the opportunity is there if we are up to the challenge. I consider this our major challenge, conceptually, in dealing with the NAIC in the next decade. The resource problems the states are going to face will continue to get more severe. This is our opportunity to provide a service to the public and to the state insurance commissioners and to help enhance our stature as professionals at the same time.

I would like to turn now to the new mortality tables. The past year has witnessed a rather amazing amount of development of new mortality tables. There are four listed in your program: the blended unisex tables, the smoker/nonsmoker tables, a new individual annuity table, and a new group annuity table. All of these passed through the TSAG group during some stage of their development. All were adopted in December of 1983 with the exception of the individual annuity table which was adopted in 1982. The blended unisex tables were adopted in the immediate aftermath of the Norris Decision from the Supreme Court in July, 1983. Basically, these tables were designed for policies which were affected by the Norris Decision and any other unisex needs that might face a company (such as doing business in Montana assuming their unisex law remains on the books, or doing business in

any other state that might pass a unisex law). The blended mortality table applies to 1980 CSO and CET tables. There is not a corresponding table for the 1958 CSO and CET tables since those were already blended using age setbacks. There are seven tables with blended ratios ranging from 100% male/0% female down through 80/20, 60/40, 50/50, 40/60, 20/80, and 0/100. Those are labeled 1980-a, b, c, d, e, f, and g. There is a provision that the 1980-a and g tables, which are 100% male or 100% female, are not to be used for policies issued after 1/1/85 unless the composition of the group is expected to be 90% or more of one sex. The construction of these tables is rather interesting. Because of the different mortality tables, you obviously can't weight the qx's at each age by these percentages or otherwise there would be an inconsistency. The way this is actually done is to pick age 45 as pivotal age, then the lx's at age 45 are weighted by these porportions. The rest of the table is computed from that.

This new regulation on blended tables is defined strictly for nonforfeiture values since they affect what the policyholder actually has in hand. It does not affect valuation standards. You can continue to use sex based tables for valuation standards because that doesn't affect any premium or benefits that go to the policyholder. There is a specific provision that protects companies from unfair discrimination statutes when it sells otherwise equivalent policies, i.e., one on a sex based rate and the other on a unisex rate.

The smoker/nonsmoker tables were an outgrowth of several years of work involving the Society of Actuaries and the TSAG group. Many of you may recall that there was a report of the Society of Actuaries task force on smoker/nonsmoker mortality which came out in March of 1983. It developed the smoker/nonsmoker 1980 table which has ultimately been adopted unchanged by the NAIC. Also, there was a 1958 table that was developed for 1958 CSO and CET tables by splitting smokers and nonsmokers. This was constructed by the California insurance department trying to reproduce, to the extent possible, the methodology that was used on the 1980 tables. The model regulation drafted permits the use of either or both for reserves and nonforfeiture values. However, as nearly as I can tell, the primary motivation for the smoker/nonsmoker tables really goes to the question of deficiency reserves. From what I can tell, most companies don't want to have different nonforfeiture values on smoker and nonsmoker policies. I think what they want to do is to have the same cash values, but be able to charge a different premium and avoid some deficiency reserve problems. So, that would appear to be the main motivation for the smoker/nonsmoker breakdown. There is some interesting methodology in this table, which I would commend to your attention.

The individual annuity table is called the 1983 Table-a and it replaces the 1971 Individual Annuity Mortality Table. Some of the groundwork was done by the Society of Actuaries' committee to recommend the new mortality basis for individual annuity valuations. They even released an exposure draft. The table which was proposed in that exposure draft has been adopted essentially without change. There are seperate male and female tables, i.e., no age setback.

Similarly, the 1983 Group Annuity Mortality Table replaces the 1971 Group Annuity Mortality Table. A lot of the developmental work was again done by the Society of Actuaries' committee on annuities. The final table was adopted relatively without change. Again there are seperate male and female tables.

Now what about the adoption of all of these tables? Each of these has a supporting model regulation that goes along with it. To date there has been very little action. Since most of them were adopted in December of 1983, there has been scant time to see them adopted in very many states. At this point they are on the drawing boards. They are in force as far as the NAIC is concerned, but very few states have put them into place.

As an interesting wrinkle, I would indicate that something like the new tax law (Stark-Moore Income Tax Law) may give an impetus for the industry to get the annuity tables adopted quickly. As I understand the tax bill, if it passes as it is written, it would not allow tables with projections. It would also not allow tables until they are adopted in 26 or more states. This means companies that want to have higher reserves for tax purposes, say using the 1983 annuity table instead of the 1971 annuity table, won't be able to do that until 26 states adopt the table. This may lead to more than the normal amount of pressure on the states to get these tables adopted.

The development of these tables is a very healthy sign in that it does show there is a real opportunity for cooperation among NAIC groups such as TSAG, the technical committees at the Society of Actuaries that conduct a lot of the mortality/morbidity studies, and groups like the American Academy of Actuaries. In this sense, a lot of this work was done through the combined efforts of those groups.

MR. EDWARD R. SHUGART - In recent years there has been a steady, unrelenting progression towards integrated financial services. However, until about twelve months ago, this progression did not appear (at least outwardly) to affect our industry. In fact, the Depository Institutions Act of 1982 (commonly known as the Garn - St. Germain Act) expressly prohibited bank holding companies from partaking in insurance activities. (According to the Independent Insurers Association of America, this Act constituted a major victory for the insurance industry.) We were once again outsiders in this struggle between the bankers and the brokerage firms. Once again, we could claim that our industry was unique with its insurance risk-taking capabilities.

A brief look at a few of the pertinent headlines of the last year shows us how smug and uninformed such claims were.

March, 1983 - South Dakota allows state chartered banks to engage in all facets of the insurance business.

April - Citicorp announces it will purchase a South Dakota bank.

- Treasury Secretary Regan calls for a moratorium on the entry of non-banking institutions into the banking business.

- Prudential announces it will purchase a Georgia bank.

May - K-Mart announces plans to open on-premises insurance centers in 500-600 of its stores during the next ten years.

- Sears announces expansion of its financial service centers to 30% of its stores during the next two years.

June - Supreme court approves interlocking directorates between banks and insurers.

- Insurance industry opposes the incursion of banks into the insurance business.

July - St. Germain introduces a bill establishing a moratorium on the mixing of banking and non-banking activities.

- At the same time, however, the Treasury Department sends Congress a bill which would substantially broaden the scope of bank holding companies while restraining other organizations from acquiring deposit-taking institutions.

August - Insurers ask the Federal Reserve Board to bar Citicorp's purchase of a South Dakota branch.

September - The Conference of Insurance regulators (commonly known as COIL) releases a study entitled "Risk, Reality, Reason in Financial Services Deregulation."

- South Dakota banking law challenged in court.

- Allstate announces its opposition to any moratoriums. Prudential favors one.

- Two mutually exclusive bills are introduced in Michigan. One would permit banks to sell all lines of insurance; the other prohibits such sales.

October - The MAP (Monitoring Attitudes of the Public) survey of ACLI indicates that banks outscore both insurers and brokerage firms on every point surveyed.

November - The New York Insurance Superintendent calls for reregulation, not deregulation.

- At the same time, Senator Garn introduces a major banking deregulation bill.

- Treasury Secretary Regan seeks industry support of the Administration's bill.

December - Congress to re-examine the insurance industry's anti-trust exemption under the McCarran-Ferguson Act.

January, 1984 - Merrill Lynch receives approval to form a New Jersey commercial bank that is not subject to the Bank Holding Company Act of 1956.

- Citicorp is given go-ahead by the Federal Reserve Board to acquire two thrifts in Illinois and Florida.

- K-Mart announces a network program with a Michigan S&L in order to sell CD's and Money Market Accounts.

February - A California thrift announces plans to acquire the life insurance subsidiaries of Beneficial Standard Corporation.

- Bank of America announces a networking program with Capital Holding for the purpose of offering auto, home and life insurance through its branches.

- An Arkansas bank holding company announces formation of its own insurance subsidiary.

March - Merrill Lynch announces a scaled down version of its Cash Management Account. Instead of $20,000 minimum it is now a $5,000 minimum.

- The Federal Reserve Board proposes revisions to Regulation Y.

- Pru-Bache announces that it will enter into a brokerage alliance program with six banks across the country to provide a full range of brokerage services in the banks on a pilot basis.

What happened? How did things get so confused so fast? From where has all the confusion stemmed? I think, in part, it stems from the myriad of laws developed during the days of the Great Depression and current attempts by financial institutions to circumvent them. In part, it results from the various regulatory bodies controlling the differing financial institutions.

However, in spite of the legal and regulatory confusion (or because of this turmoil), many banks are currently selling (and underwriting) various types of insurance. For example, banks have been selling credit life and accident and health insurance for years. Their consumer finance subsidiaries are marketing property and casualty credit insurance. Because of the major victory for the insurance industry (Garn-St. Germain Act), over 2,000 bank holding companies (those in areas with populations of 5,000 or less or banks with $50,000,000 or less in assets) are now empowered to sell insurance. Currently, about 250 banks own captive credit insurers. Also some 16 bank holding companies that were granted permission to engage in insurance activities before 1971 may continue to do so.

In addition to banks, we now have seen the introduction of a new type of financial institution, the so called non-bank bank or consumer bank. These organizations have sought to avoid federal banking regulations by not offering one of the two functions generally considered necessary to commercial banking, i.e., demand deposits or commercial loans. However, the Federal Reserve Board took steps last December that attempt to close this loophole by requiring these non-banks to register as bank holding companies and divesting themselves of any subsidiaries not engaged in banking.

However, toward the end of March, the comptroller of the currency decided not to extend the moratorium banning the mixing of banking and non-banking activities with respect to national banks. At the same time, the Federal Reserve Board, in a precedent-setting decision, approved plans by U.S. Trust Corporation of New York to charter its Florida subsidiary as a national bank. According to bankers, that ruling has opened the door to interstate banking. Since then, Mellon Corporation, Bank of New York and Chase Manhattan have applied for similar rulings.

It is readily apparent that both bankers and insurers are upset over the inequities of the "unlevel playing field". Until two weeks ago, it was likely that full integration of financial services would be resisted by both state and federal legislators and regulators and crippled by tremendous lobbying efforts from financial institutions on both sides of the question.

In a recent edition of The National Underwriter, Mr. Joseph P. Decaminada, President-elect of the Society of CPCU, provided a very concise list of both *insurers' arguments why banks should not be allowed into the insurance* business and bankers' arguments why they should.

Insurers opposed to the entry of banks use the following five arguments:

1) The potential for abuse in the area of credit leverage or tie-in sales is too great.

2) Bank entry could result in concentrating the insurance market.

3) The Bank Act of 1933 (Glass-Steagall Act) separated banking and commerce and nothing has occurred that has indicated this principle should be overthrown.

4) Banks perform several unique functions in the economy and this economic role should not be used by banks to give them an unfair advantage over insurers.

5) Recently, bank insolvencies have increased. Thus, it would be inadvisable to authorize banks to enter additional risk-taking arenas.

Bankers, on the other hand, argue:

1) By broadening their range of financial services, banks can better satisfy their customers' needs.

2) If banks are in insurance, there will be reduced costs to the consumer.

3) *Banks should be allowed to play on a "level playing field."*

Currently, there is one dominant piece of legislation and one regulation that is open for debate. Senate Bill No. 2181 was introduced by Senator Garn on November 18, 1983. This Act, known as the Financial Services Competitive Equity Act, would "authorize depository institution holding companies to engage in activities of a financial nature, insurance underwriting and brokerage, real estate development and brokerage, and certain securities activities." Additionally, it provides "for the safe and sound operation of depository institutions" and it amends the Federal Reserve Act, the Home Owners' Loan Act of 1933, and the Bank Service Corporation Act. Further, it attempts to deal with the issue of tie-in or leveraged credit sales by banks. It would pre-empt certain state banking laws (such as that enacted by South Dakota last year), and prohibit mergers by giant banking organizations with other financial services entities if the total investment would exceed 25% of the bank holding company's capital.

On March 2, 1984, the Federal Reserve Board proposed a list of nine non-banking activities which, if adopted, would be permissible activities for bank holding companies. Comments should be submitted to the Board by May 2, 1984.

Some of the activities proposed for inclusion in Regulation Y are:

1) Commodity trading advisory services;

2) Consumer financial counseling;

3) Tax planning and tax preparation;

4) Property appraisals;

5) Future commission merchant advice, e.g., portfolio advice;

6) Definition of permissible insurance activities under the 1982 Garn-St. Germain Act (in areas of less than 5,000 population or with banks of less than $50,000,000 in assets, in connection with credit and mortgage insurance and other similar items).

At the NAIC level, the Integrated Financial Services Task Force, chaired by Commissioner Foudree of Iowa, met in Portland on March 6. Mr. Robert Seiler of Allstate presented an interim report of the Industry Advisory Committee. (The final report is expected by June.) Basically, we can expect recommendations in the following areas:

1) Modifications to the NAIC Model Holding Company Act with regard to maintaining the integrity of insurance company assets;

2) Modifications to the NAIC Model Unfair Trade Practices Act with regard to leveraged credit sales or debtor coercion.

The task force also decided to study the recommendations of the New York Temporary Committee. These proposals would allow the banks to act as agents and brokers of insurance, banks to open both on and off premises insurance offices and gradually to own, manage and control insurance companies.

Where all of this will end up is beyond my predictive capabilities. The only prediction I have is that the person who does know when and how financial services will be integrated will become a very rich person.

Before I discuss the current status of universal life and variable life legislation and regulations, it might be beneficial to define the products involved. First, variable life is essentially a fixed premium whole life policy which has improved internal interest accumulations and automatically varying death benefits. Premiums go into separate accounts with the policyholder having anywhere from two to five investment account options: a money reserve account, an intermediate government bond account, a long term corporate bond account, a capital stock account, and a growth stock account. At the end of every year, the excess interest accumulations go to buy additional units of paid-up life insurance. The product pays traditional, whole life type commissions.

Universal life is either a fixed or a flexible premium, flexible benefit policy that has improved internal interest accumulations and, at the policyholder's option, varying death benefits. Premiums go into the company's general account, with the only quasi-investment choice for the policyholder being which product to purchase. At the end of each month, the premium less the cost of insurance and expense charges plus interest accumulations go directly into the cash value fund. The product pays anywhere from traditional whole life type commissions to annuity type commissions.

Flexible premium variable life is obviously an attempt to combine all the current advantages of universal life with all the current advantages of variable life. This means a universal life policy which provides the policyholder with the variable life type of investment options. In addition to its premium flexibility, universal life's benefit flexibility is preserved in flexible premium variable life.

Thus, this new product is a flexible premium, flexible benefit policy that has improved internal interest accumulations and, at the policyholder's option, varying death benefits. Premiums go into separate accounts with the policyholder having several investment options. At the end of each month, the premium less the cost of insurance and expense charges plus interest accumulations go directly into the cash value fund. The product will probably pay commissions similar to Universal Life.

Now that we have a few product definitions out of the way, let's take a look at the status of legislation and/or regulations with respect to these products.

In connection with universal life, the NAIC, at its December meeting in San Diego, adopted the Model Universal Life Insurance Regulation. This model regulation represents two years work on the part of the Universal and New Life Products (A) Task Force chaired by Commissioner J. Richard Barnes of Colorado. Additionally, the Industry Advisory Committee on Universal Life chaired by Mr. James Jackson, Counsel of Transamerica Occidental Life, met many times in various locations since June, 1982 in order to provide much of the needed "grunt" work for this model regulation. Also, Mr. John Montgomery's NAIC Technical Staff Actuarial Group provided valuable input to the final product. The final regulation was recommended for approval by the ACLI and the Academy.

The major purpose of the model regulation is to supplement (not replace) existing regulations on life insurance policies in order to accommodate the development and issuance of universal life. The model regulation first defines universal life. It then further refines this by defining flexible premium universal life, fixed premium universal life, and interest-indexed universal life.

It explicitly encompasses all individual universal life policies except those policies which provide for either the amount of life insurance or its duration to vary according to the investment experience of any separate accounts. These exceptions are covered under Article II, Section 19 of the NAIC Model Variable Life Insurance Regulation.

Article V defines the minimum valuation standards; Article VI establishes the minimum non-forfeiture standards; and Article VII defines the mandatory policy provisions. Article VIII sets the disclosure requirements, and Article IX provides for periodic disclosure to the policyholder. The last article (Article X) establishes some additional requirements for interest-indexed universal life policies including an annual Statement of Actuarial Opinion with respect to such policies.

There has not been enough time to allow any states to adopt the Model Universal Life Insurance Regulation, but it is hoped that a lot of action in this regard will occur during the next few months.

Variable Life and flexible premium variable life, unlike universal life have required action at both the federal and the state level. Since its inception, variable life has been regulated by the SEC under the power of four acts:

1) The Securities Act of 1933;

2) The Securities Exchange Act of 1934;

3) The Investment Adviser's Act of 1940; and

4) The Investment Company Act of 1940.

In 1976, the SEC provided exemptive relief from various provisions of the Investment Company Act of 1940 by adopting Rule 6e-2. This relief was mainly in the area of sales load restrictions.

Currently, with respect to flexible premium variable life, the ACLI has filed a proposed Rule 6e-3 with the SEC requesting updated exemptive relief. The proposed rule follows Rule 6e-2 as much as possible after allowing for flexible premiums, back end loaded products, and flexible death benefits.

In November, the SEC took the unusual step of publishing the ACLI request for certain exemptive relief without comment. The SEC release solicited comments through February 14. Washington pundits think action should take place at the federal level during the next tewlve months. However, there is a possibility that the SEC would prefer to grant relief on a product-by-product basis until they are more familiar with the product.

On the NAIC front, the original Model Variable Life Insurance Regulation was adopted by the NAIC nearly a decade ago. This model was adopted in whole or in part by about 50% of the states. It essentially covered the qualifications of an insurer to issue variable life, policy requirements and design features, reserve requirements, separate account requirements, disclosure requirements to applicants and policyholders, and agent qualifications. With respect to fixed premium variable life, this model regulation worked quite satisfactorily. Then along came universal life and its premium flexibility and, thus, the idea of a flexible premium variable life product.

One major provision of the original model had to be modified in order that this new version of variable life could be sold in those states that had adopted the original bill. The modification had to allow for the flexibility in premium payment. Thus, in December, 1982, the NAIC adopted an amended Model Variable Life Insurance Regulation. In addition to allowing premium flexibility, the new model brings variable life into conformity with the 1980 Model Standard Valuation and Nonforfeiture laws. It removes some redundancy with federal regulation and allows for additional separate account flexibliity. Thus far, only Delaware and Maine have approved the new model. (But it is currently pending in several other states.)

I believe two of the reasons for the deliberateness of the states with regard to this model regulation are:

1) The NAIC Technical Staff Actuarial Group, at the time of recommending approval of the model regulation, also recommended that they and the Industry Advisory Committee be assigned the task of drafting three

guidelines with respect to the new model, i.e., the application of the standard nonforfeiture law to flexible premium variable life, the determination of sufficient net investment income and readily marketable assets to meet anticipated withdrawals under policies funded by the account, and the preparation of illustrations specified by the regulation addressing issues regarding guaranteed and non-guaranteed aspects of variable life insurance policies.

2) The previous lack of a model universal life insurance regulation since the two products are similar in nature.

Now that the second item has been eliminated, at least at the NAIC level, I fully believe that progress on the three guidelines will be forthcoming within the next year.

Recently, four companies (Travelers, IDS, Acacia, and Lutheran Mutual) have registered and filed prospectuses for a flexible premium variable life product. One of them has applied for individual exemption as opposed to tying their product to the new proposed exemptive Rule 6e-3. Additionally, I believe two other companies have filed in the last two weeks.

In closing, I would like to commend to you a very good article on variable life written by Mike Tuohy in the February, 1984 issue of Emphasis, a newsletter published by Tillinghast, Nelson & Warren.

MR. STEVEN W. FICKES - My talk today will concentrate on NAIC developments in three areas. Two of them are listed on the program. The third topic which is not on the program is NAIC developments in the area of annuities. I will begin with cost disclosure.

Recently the NAIC adopted a new model life disclosure regulation. This regulation is supposed to be a revision of the old life insurance solicitation regulation. It's quite important that we make distinctions in names between disclosure and solicitation. The new regulation applies to inforce as well as new policies. The old solicitation regulation, adopted in 1976, basically requires that insurance companies provide the prospective purchaser with a Buyer's Guide and a Policy Summary. The Buyer's Guide describes the different types of insurance and the cost indices associated with them. The Policy Summary simply includes the cost indices. The old solicitation regulation was adopted in about 40 states. The revised disclosure regulation is aimed primarily at our new products, i.e., those with adjustable premiums and benefits. Other differences between the solicitation and disclosure regulations are:

1) The disclosure regulation is about twice as long as the solicitation regulation. This is partially due to all of the new products we have.

2) We now have to give cost indices on two bases : Guaranteed basis and the current cost of insurance basis. Both new and existing policyholders are now allowed to request information (referred to as policy data in the bill) pertaining to their premium and benefits.

The disclosure regulation also tries to disclose unusual patterns in premiums and benefits. This is done via the Discontinuity Index. The Discontinuity Index is defined as "the sum of the backwards second differences squared in

the yearly price of death benefits for policy years 8 to 23". In other words, they are trying to measure the slope of the cost indices . Early durations are excluded because there will be some discontinuity introduced when cash values first become positive. The later durations, beyond 20, are included in the Discontinuity Index in order to prevent any actuaries from manipulating 20th year cash values. If your Discontinuity Index exceeds state limits, the insurance company must explain why this occurs to the department and include a statement with the cost indices that an unusual pattern of premiums or benefits makes a comparison of the cost indices to other policies unreliable. It's interesting to note that New Jersey currently requires companies to meet their Discontinuity Index requirements on universal life policies with surrender charges.

The new disclosure regulation also affects mutual companies. For new business, the sales material must state whether the investment generation or the portfolio average method is used in determining dividends. They also must state whether or not the contribution principle is applied in calculating dividends. For inforce business, policyholders must be notified if dividends are not determined in accordance with the contribution method. Also, the company must notify policyholders if it ever switches to or from the investment generation method.

The main crux of this regulation is Special Plans. One of these is enhanced ordinary whole life. To calculate the cost index for this one, you assume that dividends are used to purchase paid-up additions until the death benefit exceeds the initial amount. Thereafter, you can assume that the dividends are paid in cash. For universal life, you make an assumption as to future premiums and future benefits. You must also tell the policyholder when his policy will expire on both a guaranteed and current basis. Finally, for re-entry products, you must calculate a cost disclosure on both the assumption that the policyholder re-enters and that he does not. Policyholders must be provided with the conditions for re-entry.

What's the future for cost disclosure? It should be noted, this bill took over four years in the making. It was conceived and supported by the ACLI. Can we assume that it's dead for a while? Probably not. In adopting this regulation, the NAIC agreed to set up an industry advisory committee, probably aimed at universal life products, to develop a uniform basis for determining effective rates of yield.

The second area of this discussion concerns the actuarial opinion on interest indexed universal life products. The ACLI's new model regulation on universal life now requires the actuary to sign an opinion if the product is indexed. This is unusual for actuaries to actually have to sign an opinion of this nature. The actuarial opinion primarily states that the actuary has considered the characteristics of the assets, considered his company's investment policy, made various tests and calculations pertaining to cash flows, relied upon projected cash flows, and considered all the provisions and characteristics which might cause the cash flows to vary with changes of interest rates. One important note is that this is an opinion and not a certification. The opinion is primarily aimed at cash flows. Many of us are quite accustomed to dealing with GAAP accounting, statutory accounting and tax accounting; with an opinion like this, we may actually have to consider real cash for a change.

Since most of us are not familar with investments, we need to look elsewhere for guidance. The American Academy of Actuaries is close to issuing an

exposure draft of a recommendation and interpretation pertaining to this opinion. The recommendation, Recommendation 11, basically is very nice but doesn't give us an abundance of specific guidance in this area. The interpretation does, however, go into a few more specifics. Basically, the opinion is whether or not cash flows are adequate. We must not only look at cash flows from the product but also cash flows from investments, both with assumptions as to future investments. In considering the characteristics of the product, we must look at death benefits, policy loans, surrenders, premiums, compensation and expenses. The characteristics of assets to be considered are: the types of assets, incidence of earnings, call provisions, marketability, and expenses such as income tax.

One important aspect on which we aren't required to make an opinion is the quality of the assets. Additionally, the interpretation seems to imply that we need to make more than one test under various interest rate scenarios. The interpretation implies a minimum of three: assuming interest rates remain level, assuming an increase in interest rates, and finally assuming a decrease in interest rates. From an actuarial viewpoint, crossing into investments, we should also consider shifts in the yield curve.

What is the importance of this opinion? For companies with long term indices, it could be devastating since very few actuaries could sign such a statement. Dual indices are probably also gone if we are required to sign them. From an actuarial point of view, we have to consider whether or not we could sign such an opinion if our company invests in treasurys or in corporates when the index is in fact hooked to treasurys. There are many other problems with this opinion. The most important, of course, is the possibility that a similar opinion could be required on other products. TSAG has indicated that they want to extend this opinion to indexed annuities.

While we're on the subject of nontraditional actuarial topics, let us talk briefly on the developments of the minimum surplus levels. TSAG has a separate project on its agenda to determine an appropriate method of determining minimum surplus in order for companies to meet their future contract liabilities. A lot of people fear that in the wake of Baldwin United, some states could go off by themselves and adopt minimum surplus requirements without having a reasonable basis for doing so. In a TSAG report to the NAIC last December, they reported that the latter stage of this project will be to recommend changes in the standard valuation law. If this happens, products such as A&H and similar ones that have traditionally not been included in the standard valuation law, may be brought into the law for purposes of the minimum surplus of a company. TSAG is being assisted by the Greely Committee and is following the Society's work on various C risks.

In December, the NAIC indicated the Greely Committee expected to have recommendations for practical applications by 1984. This project has a 1985 completion date, however, this is probably optimistic. It is a very complex subject and requires much additional study before any guidelines can be developed. Rules of thumb to be developed for all companies are probably impossible. It's also an interestingly timed subject in that just last month, all life insurance companies domiciled in the European Economic Community (EEC) became subject to so called solvency requirements (minimum levels of surplus). Percentages are generally .3% of all inforce plus 4% of all reserves. It is going to be interesting to see whether we follow the EEC practice or proceed more along the lines of the C risk. Additionally, minimum surplus could be given more light with the passage of Stark-Moore (assuming it does pass). If mutual companies try to shed surplus, then someone may need to adopt minimum levels for it.

Now, I would like to address the area of annuities. There is much talk about the proper methods to reserve annuities with bail-out provisions. Currently, there are three methods. The first is to set reserves assuming the fund value is paid. That is, your bail-out rate or your current rate of interest could drop below the bail-out rate without the assessment of surrender charges. The second would be to assume surrender charges could be deducted, but treat the bail-out rate as a guaranteed rate. Finally, the method of one company is to ignore the bail-out provision all together. Their logic is that if current credited rates of interest drop, they are going to realize so much money on their assets that they don't need to worry about the surrender charges they just lost. TSAG has been asked to develop guidelines in this area.

Another area of annuities, substandard or structured, is getting some attention regarding reserve practices. The Standing Technical Advisory Committee has issued a report to TSAG as of October of last year recommending a reserving basis for substandard annuities. Part of the reason for the attention is the phenomenal growth of this market. These reserves for some companies represent significant portions of their liablities. The major problem with reserving substandard annuities concerns the mortality basis as opposed to the interest rates. The reason a proper mortality basis cannot be established lies in the fact that there are no mortality studies in existence on substandard deaths for annuities. Additionally, even if any did exist, the amount of data that could be contributed would be very small. To properly conduct a mortality study would require subdivisions by impairment creating even smaller data. It should also be noted, the characteristics of structured annuities vary significantly from company to company. Some companies sell almost all standard structured annuities while others are heavily into the substandard market.

The committee recommended, basically, there be more in the area of disclosure while continuing reliance upon the actuarial opinion as to adaquecy of reserves. In December, TSAG made a proposal to the Blanks Committee to add additional interrogatories to the annual statement. In March, the Blanks Committee adopted this recommendation.

The final topic I would like to discuss is nonlegitimate surplus relief reinsurance. This is one of the new topics on TSAG's agenda. The problem in this area concerns differentiating between legitimate surplus relief reinsurance and nonlegitimate surplus relief reinsurance. Theoretically, the dividing line is whether it is a loan because there is no risk transfer or is the company actually advancing future profits. State regulators are having a problem in this area, first of all, because there are practical questions of how much risk transfer has to take place before it is legitimate. Secondly, these contracts are normally quite complex. You can spend days working through all of these formulas and then realize they all cancel out, i.e., there is no risk transfer. Additionally, most of these contracts tend to be rather customized. A state regulator cannot say "This is a contract you can use and this is one you can't." This is under the heading of annuities because it's quite common, especially if you do any business in the Caribbean, to see nonlegitimate surplus relief involving SPDAs.

Due to the complexity of this subject, possibly the only adequate way to regulate it would be through self regulation. However, because of the potential for a major disaster in this area, it's highly unlikely we'll get an opportunity to self-regulate. Additionally, with Stark-Moore, the surplus in mutual companies is going to disappear. We are going to see a much greater variety of treaties.

MR. A. G. HASSELMEIER - I want to ask about the new blended unisex tables. Will those tables be extended for smokers and nonsmokers as well?

MR. KELLISON - That is an interesting question. The two developments were moving on seperate tracks and never became linked. The smoker/nonsmoker table has been under development for several years whereas the blended tables were a quick and dirty response to the Norris case. They were not anticipated during the time most of the smoker/nonsmoker work had been done. That's a distinct possibility. A company may want to use smoker/nonsmoker rates since it is operating in an environment where it has to use unisex for some reason. Neither regulation is written in such a fashion that they are cognizant of the other. I think the methodology is fairly clear in that you could use the same methodology as was used for the blended unisex tables. There would be a lot of permutations or combinations if you put all of these things together, but I guess it could be done. Now whether the state would grant it would be up to the discretion of the insurance commissioner. At the moment, of course, neither model regulation has been adopted anywhere. I think a couple of states are pretty close to adopting the blended table.

MR. FRANKLIN C. CLAPPER, JR. - I have a related question which muddies the waters even further. Has anybody given any thought as to what is the minimum table, now that we have unisex tables and smoker/nonsmoker tables? If the new tax law is passed, I don't think it is going to be clear what minimum standard means.

MR. KELLISON - I think you're right.

MR. PAUL E. SARNOFF - I would like to answer Frank's question. I've given it some thought because I'm interested in federal income tax matters. I think the law says you use the most recent mortality tables that have been adopted by the NAIC and are appropriate to the risk. If a company is classifying its risk by smoker and nonsmoker then, presumably, it would use the smoker/nonsmoker mortality tables. If it doesn't distinguish by smoking habits, then you could use the combined smoker/nonsmoker tables.

MR. SMITH - Just recently, I have been looking at a product that I would characterize as a flexible premium universal life product to see how this model bill would apply to it. In our special case, which may not be unique, the CRVM reserves that are generated just don't make sense. Either the reserves are 0 or a multiple of what I think are correct. When I say a multiple, I mean 2,3, or 4 times what they would be if it were a traditional whole life product. What is a practical way a company may get some relief when they see some technical problem with the model bill?

MR. KELLISON - First of all, I think you have to realize what a model regulation is. It is not necessarily a cookbook that anticipates every single event that might happen. It basically attempts to cover an issue in some degree of detail in order to give guidance on the majority of situations that are likely to come up. I don't know that it purports to be able to handle every conceivable question of a unique nature that might come up. The next problem you run into is, of course, whether the state adopts the model regulation or does it put its own regulation into place, being either some modification of the model regulation or something entirely new. The third question is what will the insurance commissioner live with in practice, all these written rules and regulations notwithstanding? There are multiple levels to consider. Certainly if you want to deal with it in terms of a clarification or interpretation of the model regulation itself, the only

opportunity to do that is to go back into the NAIC and hopefully get a hearing; not a formal hearing, but a listening. You could raise the issue with them and see if you can get them to take it up in an issue of clarification, an amendment or something that would do what you want. Failing that, your only recourse is to go to the state insurance commissioners in question and hope that they will agree with how you've tried to comply with what they might impose. The best method depends on the circumstances.

MR. SHUGART - I have a couple more thoughts. A small company, could raise the question with their home state department. They could raise the question with their reinsurers and let their reinsurers gather these questions and try to raise it. I suspect reinsurers don't want that function. One last possibility would be to contact either Mr. Montgomery or Mr. Becker at the TSAG level or with the industry advisory committee on valuations, the Greely Committee. They will at least listen and respond to you. I don't know if you'll get any action, but you do get some response.

MR. KELLISON - I might just mention one other thing that was triggered by a comment that was made earlier about Recommendation 11. It was mentioned that the Academy is putting out a recommendation on universal life. I might just indicate what the background is and where it might go from here. Basically, as you heard, the NAIC did adopt the Model Universal Life Regulation in December. As part of the discussion leading up to that, the Academy's Committee on Life Insurance Financial Reporting Principles did commit itself to provide guidance to actuaries who would be signing the statements of actuarial opinion. It is contained in the universal life model regulation. This is the statement of opinion that, for the first time, puts the actuary in the position of saying something about asset/liability matching. It's recognized that even though this is applicable to only one special policy, this really is a foot in the door, nose of the camel under the tent, or whatever metaphor you want to use in terms of it being a precedent which gets the actuary into the asset/liability matching issue. The TSAG group does have an interest in the more general topic of asset/liability matching. The Committee on Life Insurance Financial Reporting Principles is looking at the issue beyond the scope of universal life. The recommendations and interpretations that we're releasing will be an exposure draft in the April issue of our newsletter. They will be in the mail in the next two to three weeks. I encourage all of you to give them a careful look and respond to them as you can to any exposure draft recognizing that this is the first step of what may be a much broader question concerning asset/liability matching. Whether or not the Academy does address the subject more generally is open at this point. It would obviously be controversial within the profession. There are very serious technical questions that have to be dealt with. It would be a very difficult project. There are a lot of people looking over our shoulders, such as TSAG and others, but there is considerable sentiment on that committee that there does need to be a broader type of actuarial opinion on the financial statement concerning the asset/liability match. This is a project that could run for several years. The universal life, in that context, may turn out to be a stop-gap measure in response to the Model Universal Life Regulation that was adopted by the NAIC and may not be the ending point for this effort. I would commend this exposure draft to your attention. It's probably more significant than the typical one because of where it may lead into the future.

MR. SMITH - I agree with you. This is something you don't know how far it will go. There are a lot of implications. How will the investment people in

insurance companies react as actuaries start looking over their shoulders, as they're looking over ours now?

MR. FICKES - I do want to make a comment about the U.K. While we are moving in the direction of giving actuaries a little more freedom in what to sign, the U.K. has decided to move in our direction. They are now requiring maximum interest rates for determining reserves in many other areas. I believe the U.K. and the U.S. are on a collision course meeting somewhere between our conservative basis and their formerly more realistic basis of reserving and matching assets with liabilities.