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KEYNOTE ADDRESS

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The title of my remarks today is "New Products, New Approaches" and I think it bears remembering what some of the elements are that these products and these approaches have in common. It implies, I think, not only new approaches at the company level but also new approaches for state regulation, and I think that if there is a common element within the different solvency threats that are presented by this environment, it is the possibility of excess leverage; and leverage, of course, uses a fulcrum.

Pyramids are great fulcrums, and it bears remembering that the tomb is never far from the pyramid. There is no doubt that we have had a structural change in the financial services market place. Interest rate changes and the lack of viability in the general economy have forced an intense degree of competition among different financial service intermediaries. That has expressed itself as a blending of financial service structures as well as the blending or synthesis of products.

The function of insurance companies, and life insurance companies are included in this as well, is not as exclusive as it once was, and the nature and structure of their products is not as absolute or exclusive as it once was. Margins clearly are narrowing, spreads are thinner, new players are entering the field with different levels of experience and integrity. That occurs not only at the company level in terms of who is producing the product but also at the distribution level in terms of who is marketing the product. The flow of funds and the accumulation of funds has accelerated dramatically and the magnitudes involved have also grown. Access to capital and the maintenance of a positive cash flow have been severely stressed for different companies; I don't think that there is anybody who wouldn't say that they have been stressed.

There is a need to create a level playing field while at the same time preserving the integrity of the historic mission performed by insurance and insurance products. There is a need as we preserve that integrity to be mindful of the need for competitive viability between insurers and other financial service entities. We really do have a critical balancing act where we need to modernize our standards in terms of the present market place but be mindful also of the need to maintain equal competitive viability between insurance entities and banks and other financial intermediaries.

One of the difficulties we have in this process is that the terms are inclusive and not exclusive. Traditional insurers are affected by some of the proposals to remedy current problems in ways that they do not fully understand the necessity of, and while we always have the problem of punishing the innocent as well as the guilty in terms of regulatory standards, there is a great deal of, I think, resistance to the kind of radical re-thinking of our posture that

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needs to occur, chiefly based on a lack of familiarity with the nature of the problems. The issues that we are addressing within the ranks of regulation, and that your Society and the Academy is addressing as well, have some common elements, most of which relate to the interest sensitivity of not only products but also of the financial structure of companies. I look forward to the timely conclusion of your C-3 Risk Task Force report, and I hope that will provide a consensus foundation from which we can re-examine many of the regulatory controls that exist and modify them appropriately without creating excessive burdens that either preclude competition in the financial services market place or extend the capacity of state regulation beyond the resources it has to deliver.

I think we do have to address the speed and volatility issues most dramatically. Those are administrative issues at the state level as well as at the NAIC level in large measure. We have to have more timely reporting. We have to have more emphasis on solvency surveillance and interstate cooperation and a joint response. We have made substantial progress in those areas through the data base management task force and the examination oversight task force. Our effort has focused in the area of ten companies per year on a priority co-operative basis in the last several years. That obviously is a start but it is not an adequate response given the magnitude of the issues that are facing us.

What I think holds us back, in addition to the habits of the past and some of our traditional parochial concerns, is a lack of technological resources, mainly meaning data processing resources and qualified staff at the state level. The other factor is the learned behavior of not only the staffs in the insurance departments but also the commissioners, and I think some explicit focus on the need to manage differently and not assume that the rote and routine procedures of the past will allow a timely response to current problems would likewise be helpful. There is no doubt that the traditional staffs of the insurance departments have a great fund of knowledge about the vulnerability to the public interest that in fact can and does exist in the insurance mechanism and that it has to be protected against. What is less clear is that they are fully comfortable with the kinds of resources that exist today and which are employed by those who would exacerbate some of those vulnerabilities and are not yet fully employed by state regulators whose job it is to mitigate, if not prevent, them. I think seminars in computer management and deployment, screening procedures, and what some of the logical difficulties are that lessen the value of these approaches or create vulnerabilities within the reporting and screening mechanism would be useful. For example: we recently created what seems like a very obvious problem but under the rules nobody really picked it up until someone took a minute and thought about it and that was those who were filing with the data base but didn't include their fee had their statement returned. So if you didn't want to be picked up on the data base screen, the easiest thing to do, and you still wanted to appear cooperative and not single yourself out, was either send the wrong fee or not send the fee at all, which would put you out of at least the first cycle. So there are some simple procedural issues that are also very important as we modify our procedure and approach.

I think we clearly have to establish some excess interest reserve standards across the entire country. Some states have been more effective in this than others, and I think as we do that, and this illustrates the nature of the new approach problem, we have got to be careful that we don't create other consumer jeopardy as we worry about the solvency standards. The notion that

an insurer cannot guarantee a product beyond 12 months may make sense in terms of limiting the insolvency risk arising from a product and the funds it generates, but it also creates a risk that the competition in the first year guarantee will cause an excessive amount of first year guarantees and then a reduction following that, with a lock-in provision and a penalty provision that would cause insurers or insurance purchasers not to be treated quite equitably. We are considering in this state creating some kind of surcharge on surplus based on the nature and amount of business done in certain lines that will be linked not only to the nature, but also the structural problems occurring in that line of insurance. That is a kind of reserve on reserves, and it is not a very elegant method; but in terms of its practical affect, it does produce a very positive outcome. The figures we are now discussing would allow 96% of the insurance industry on the life side to comply, with a grandfathered work-in period for the remaining 4%. That at least means in terms of amount of surplus that things could not get worse than they now are without having some kind of response, and basically what we did is look at the kinds of impairments and insolvencies we have had in the proportion of different lines of insurance to come up with those factors. Then we ran them on a practical basis and made trial and error adjustments until we came into rough balance. That means if you do write a substantial amount of health insurance you will require more surplus. If you write a substantial amount of SPDA's, or think you can continue to do so, you likewise will require more surplus than if you do not. More traditional insurers would have less impact in most cases from such standards, but they are also giving up some risk in the marketplace as well as some opportunity conceivably that would allow them to be so benefited.

I think we need some more effective uniform standards on surrender penalties for interest sensitive products and some standards limiting the degree to which you can negate the ostensible surrender penalty or fail to achieve a practical advantage from it based on the terms of the contract. We likewise have to rethink the approach to guaranty fund coverage including considering some kind of pre-funding, either through a private mechanism, as in a private company that would serve as a safety net across the industry, or the creation of additional pre-funded deposits that would be benefited from greater insulation from legislative action. The State of New York's recent raid caused people to conclude that their suspicion about pre-funding had been correct all along. As I have thought about the nature of the problem in guaranty fund capacity, I am not certain that that case is compellingly made by the New York action. The temptation is still there, it is still an issue and a problem, but I don't think pre-funding can be dismissed simply by virtue of either the investment interference or the borrowing or spending that has occurred with that fund. I think there are ways to get insulation that would reduce the risk of that kind of interference, and it is quite clear to me that the easiest solution to the capacity problem is to get either more assets certainly in the structure that becomes impaired or insolvent, or more assets in the hands of regulators to mitigate the claims against the guaranty fund. That has moral and equitable overtones as well as the practical issues of generating adequate capacity.

I think that we have to re-think the nature of the disclosure the consumers get to make it both more appropriate and compatible with security disclosure, since the security elements of products are clearly increasing and that would be important to maintaining the jurisdiction of state regulation as well as providing more informed consumer decision making. Perhaps more liable agent positions as well. We have been rightly concerned that the existence of a

guaranty fund should not be used to obviate the personal responsibility of the person underwriting the product and distributing it. I think we have perhaps been excessively concerned when we create a standard that says you can not discuss coverage under the guaranty fund without violating the fair trade practice laws, since that has not limited to my knowledge dumping on the fund where it has occurred with both guaranteed renewal products as well as other products that probably went beyond the legitimate bounds of insurance and moved into the area of investment and speculation. I think informed consumers are better defense than prohibitions that appear to secure the industry and guaranty fund capacity from danger but as a practical matter, do not; and do preclude the ability of having informed consumers.

We clearly need to make some modifications given the nature of the interest sensitive products which are at one and the same time partly banking, partly securities, and partly insurance. While I think we do preserve the guarantee represented by the guaranty fund, which I personally think is crucial for competitive viability, it will become increasingly so in the future but where we reduce the amount of the guarantee to a manageable level that is secured by the standards of regulation. I think it is not reasonable to say that there should be no guaranty fund obligation at all. I think competition in the market place with institutions that do have guarantees that are secured by American taxpayers through the FDIC and FSLIC would show that over time. I would rather assume that as an operating assumption going in than have to discover it in the market place. I do believe that it is possible to restrict the amount of the guarantee without eliminating it or without saying that whatever an insurance company guarantees is the obligation and liability of the guaranty fund. We clearly need substantial amendments. Actually they are not substantial amendments numerically, but they are substantial amendments in capacity to the Holding Company Act where I believe we should and can hold holding companies responsible for the negative consequences of their ownership of insurance companies and their affiliated transactions with them.

The State of New York has filed a bill that would cause the holding company to be at risk for any adverse development to its insurance subsidiary for a period of five years. That will not be as simple as that to create, since holding companies conceivably will be investing in other high priority creditors including bank depositors and others. I am not sure that you can automatically protect, at the exclusion of all other interests, insurance policyholders within a holding company structure, but we can certainly protect them far better than we are doing now. I think we also have to look at the nature of the debts incurred by holding company structures and what kind of collateral secures those obligations, and I believe we should be discussing with bankers and bank regulators the possibility of discounting that collateral value to the extent that the same assets already secure policyholder obligations within insurance companies. I think with the reorganization or redeployment of the Charter Group that we have a fairly well established pattern that it is not the insurance subsidiary that becomes insolvent necessarily where the difficulties of the insurance subsidiary are not nearly as acute as the difficulties of its parent. I think the Baldwin United case plus the Charter Group case plus 4 or 5 others that the Wall Street Journal has not yet discovered establishes this. The fact that the policyholders of the insurance subsidiary do better than the creditors of the parent does not suggest that we don't have to re-tune and more finely tune the standards for affiliated transactions within holding companies and the valuation of investments in affiliates within such structures.

Likewise for those companies that have grown through the acquisition model and whose debts are now secured by floating interest rates as opposed to fixed, I think that we need an adjustment in discounting to recognize the increased risk of two such structures of those interest rate changes. Within the area of the market value of assets where the two ends of the spectrum enjoy fighting more than they enjoy solving the problem, I think we can also make some practical recommendations that, though they would not get to debate at every meeting of the NAIC, as they have been, would prove useful to state regulation. Basically I think that using a reasonably comprehensive set of criteria, we could come up with some standards that most of us would agree indicate that a company has reached a hazardous condition. Any company that is in a hazardous condition clearly should have filed a market value valuation of assets with the domiciliary state and conceivably with the NAIC to then investigate what kind of market compared to book leverage also exists within such a structure and to begin the contingency planning process and redeployment within the portfolio process that is necessary to reduce excessive risk under such circumstances. The standards that insurance regulators are now using served us extremely well in a stabler deflationary economy. I suppose they might even serve us reasonably well in a stably inflationary economy. Where they do not serve us at all well is in a volatile economy which has different rates of inflation and deflation or disinflation, depending on your political party in that year, at different times.

The assumptions that are made that suggest that what exists now will exist in the future can not be very permanent and tend also, on occasion, to be forgotten. I think we do have to increase the assured liquidity of insurers, particularly those who have undertaken financial risk that exposes them to the impact of rapid financial structure changes. I think we will continue to emphasize within the regulatory field increasing solvency surveillance as opposed to the rote examination schedules. We will use more sampling techniques within exams and more pre-exam protocol development of priority problems that we wish to review. I suspect we will be experimenting with systems to assure the validity of the statement information, which is the main reason that triannuals or quintennials or whatever your own state standard is, are still required. We need to develop a mechanism that will have the same positive effect on voluntary compliance that a full exam does without requiring the deployment of resources in a complete full exam process. Sampling is clearly part of that. Random audits is clearly part of that as is priority scheduling with the interstate examination or zone examination process.

I think we need to be assured that all states have adopted modern liquidation and rehabilitation acts that provide an orderly process from supervision through liquidation if that becomes essential. We need likewise more objective triggers to define impairment and to define not only the prerogatives of regulators but the responsibilities of regulators. We need a clearer statement of the liability and responsibility of those who breach or fail to discharge their fiduciary duty in the management of such structures. An excessive disregard of the nature and vulnerability of the company's policyholders should be punished, and certainly no gain should be allowed on a personal basis to those who allow such circumstances to occur. We need to emphasize the utilization of state resources on a more cost effective basis. We probably have enough money going into state regulation; the distribution of those funds does leave something to be desired. We do need to retain our concern or increase our concern with the prevention of problems and not just with the remedial action after the problem has occurred. No amount of funding put into liquidation divisions or bureaus will adequately protect the problem because, even if you

have a rehabilitation, you have had a substantial amount of public injury during that process.

I think we can maintain our historic standard of protecting the public interest effectively in insurance regulation. I think we can not do that in an environment where people are concerned about whether we will actually have the information we need in order to regulate and, perhaps more threatening, still have the staff to be able to interpret what that means and limit public jeopardy exposure arising from it. There is a great deal of ambivalence in my experience within the insurance industry as it approaches such topics. I don't think that among those who are closest to the nature of the risk to the public interest that are affected that there is near the ambivalence that there is within those who have liked state regulation because it didn't regulate. But we have got to overcome that ambivalence and we have got to recognize our mutual interest in retaining the credibility of the insurance mechanism and securing the public interest adequately. We have a strong mutual interest. The financial exposure that we mutually share through the premium tax offset in most states of guaranty fund exposure causes that to be extraordinarily compelling.

I do believe if within the insurance industry, and certainly within professional organizations such as this, we objectively think through these issues, that we will come to satisfactory and mutually supportable conclusions for guarding them. Failure to do so will leave us continually attempting to react after the fact with an inadequate solution that will neither protect the public interest nor allow the maintenance of state regulation nor I suspect allow the public to have the confidence in the insurance mechanism that it now does. It is my hope that you will take those challenges extraordinarily seriously as a Society and as individual professionals. You are in my mind the first line of regulatory defense or common sense or professional standards within the company environment, and I think we are all well served by the professionalism that has in fact been engendered in the actuarial profession and the standards that have been developed. I am particularly mindful of the pressures that you encounter in your operating environment to perhaps be a little less rigorous on occasion or a little more generous or a little more optimistic than your own judgement would suggest is warranted under the circumstances. Your discharging that obligation fully and effectively saves state regulators a whole lot of difficulty later on, and I think it is important that you realize how appreciated that role is and how much we in fact rely on it. That doesn't mean that certification by itself is an adequate standard and we certainly do have to increase the credibility that certification can be allowed. It is possible if one shops hard enough to find someone who will certify almost anything and we have to do something about improving the consequences of that as well. But I do clearly see the Society of Actuaries as an ally of the public, of the insurance industry, and of regulators as we go through a very challenging period characterized by new products and new approaches.

MR. WALT MILLER: I would first like to thank you for what I will remember as one of the more thought provoking talks that I have heard from a non-actuary at a Society meeting. There is an awful lot of meat and food for thought in what you said. One thing concerns me. I very much appreciated your recognition of the role of actuaries and the role of the actuarial profession in meeting many of these challenges and I think that most people in the room here were pleased at hearing how you view actuaries and their particular expertise and the role they play.

MR. DAY: There is an easy explanation for that, and that is that actuaries are the only people that understand my speeches.

MR. WALT MILLER: In that sense, viewing actuaries as people who do have special expertise in the measurement of risk and in the development of reserving and other techniques that are necessary as we move ahead into what will be a much more tangled and turbulent product scene before it smooths out, recognizing that there is definitely a need in the interest of our employers and the interest of our professionalism and the interest of the public to develop these techniques, to develop better reserving methods, to develop better methods of measuring risks. We actuaries like to hear you say that, but how can we be comfortable with hearing you espouse the guaranty fund concept which broadly stated says that we will tolerate sloppy work, it doesn't matter if you do a lousy job of reserving because the fund is going to be around to bail you out.

MR. DAY: I think that part of what is not allowing you to think clearly about that topic is our own historic success, or mutual success, which I will say is chiefly the success of companies. I don't think you perceive currently the kind of consumer lack of confidence that may exist if we were to remove the guaranty fund obligation entirely, as some have suggested should be done, and you were competing with institutions that were insured and had the American taxpayer behind them. I don't doubt at all that a radical restructuring is not only necessary but desirable and conscionable. I would personally like to link guaranty fund obligations to standard nonforfeiture values, since I think that creates the heart of the regulatory process and the valuation standards that ought to be used. I don't think it is reasonable, and over time I don't think it would be competitively viable, to say there is no obligation at all. I would also be very happy to look at any process, be it public or private, that would allow more prefunding of those obligations whether that's a percentage per product or varying percentages based on the recent experience we have had with different products that could be pooled in an insulated fashion whether that's a reinsurance company that takes such deposits and has a myriad of accounts to secure them, all a kind of FDIC model, or whether it is a combination of a number of things, all of which mitigates the exposure and allows adequate capacity. I am more interested in figuring out what is an equitable and adequate remedy to the current problem we have. It may be hard for you to believe, but I am driven more insane by guaranty fund assessments than you are. That was not true until Iowa State Travelers, but Iowa State Travelers really frustrated me because I had done everything that I knew how to do to mitigate the exposure of Utah to that company. It included the whole process. They had a reasonable book here, a profitable book here, and that was entirely irrelevant as it went down the sink. Utah being a small part of any problem both because of our vigilant standards and administration of them as well as our population size doesn't get the ability to have an independent response to problems. I also concluded at that time that the deranged commissioner argument was not only a lobbyist argument designed not to offend the person that was actually the source of concern which is, "we are not worried about you, we are worried about the next guy because he might be deranged," but it was also a necessary posture if you are to be taken seriously and effectively perform your job because I did not act deranged with Iowa State Travelers, and I now regret very much that I didn't. I acted like I was fairly aware and fairly informed, but I also acted civil, and I regret that. I acted civil both with Iowa and with the company and I regret both of those. So it is not the case that I think we needed just to have it or because we wanted somebody to serve as a reinsurer without bene-

fit of premium. That is not the case. I do think that the public under the present system can't make an informed decision adequately. The people who want to exploit the fund in terms of the operating realities of the market at the company level, the agent level or the general agent level, still can do so and have done so. Until we start pursuing them more aggressively than we have pursued them to-date, we'll have some serious incentives to continue to do so. That, I think, is the real key to getting dumping not to occur, but I don't think we can say to consumers, "what you had didn't have anything behind it from a security or protection standpoint." It is the same as hot dogs or the same as used cars. If we attempt to do that, I think the very attempt will ultimately be exploited, and then you will really feel unfairly picked on because you will have savings and loans or banks or as yet undefined financial institutions who do have the FDIC or who do have the FSLIC behind their products up to a point using the failure to have an equivalent protection as a reason not to buy your products. Even if that were true of some insurers and not true of you or not necessary for you, I frankly don't think that anybody can be allowed to not have some kind of security mechanism. There are situations where if we got a run on the insurer, it would be as catastrophic as if we acknowledged the value of the Latin American loans. Those situations are not likely to occur, but they still theoretically could occur, and I think we have got to have a uniform effective mechanism that puts as much obligation on policyholders and the management of companies to produce their own assets to secure those obligations and guarantees timely access to them in the event of impairment or insolvency or liquidation. We can do a lot of good in improving the system in those kinds of senses. I think we could also increase the personal liability of the people who create problems far beyond where it has been pursued today. What I don't think we can do is say there isn't going to be any coverage at all. It's not good social policy, it's not good business policy, and over time it just wouldn't be competitively viable. It would also lead, and all roads may lead to this eventually anyway, to a reintroduction of the Federal FDIC equivalent for insurance, and whoever has that liability is going to have the commensurate regulatory responsibility to go along with it. Then we are going to have the mixed system with overlapping jurisdiction. People are going to drop the ball more frequently, be challenged as to jurisdictional efficacy more frequently, and we'll have an even worse situation. So I think we have got to fix what we have, but I think we have to take a very responsible and long term view while we are about it.

MR. ROBERT WINTERS: I agree that there is a great deal of meat in what you have said. I am neither persuaded nor unpersuaded. I think part of what you are saying implicitly is that, just as a matter of national policy in 1933 we decided that banks could not fail at the expense of their customers, while we are still willing to see farm equipment manufacturers fail at the possible expense of farmers and the sure expense of shareholders, you implicitly assert a policy that we should not permit life insurance company failures at the expense of policyholders.

MR. DAY: But at everybody else's expense guaranteed. The shareholder expense has got to be more assured, the promoter or entrepreneurial penalty has got to be more assured than it now is, all those things. The policyholder penalty is an issue of reasonableness where the caps that we have have not produced a problem. I am not sure you can income test or means test that as some states have tried to do a little more overtly. I think we can, through the use of deductibles and contract reformation, a variety of techniques,make a more reasonable situation than exists now, but you can't just leave them

high and dry.

MR. WINTERS: I don't think you will find very many people in this audience to quarrel with that. You have got a receptive group.

MR. DAY: It's the government affairs lawyers that make me nervous. It's not the actuaries.

MR. WINTERS: Speaking as one who has some responsibility for government affairs lawyers also, and recognizing the very considerable thought you gave to the state regulatory mechanism when you were in charge of the NAIC, you are talking about a very substantial restructuring of supervision and regulation. I think it would be interesting to hear your thoughts on how that can be brought about within the state structure without the kind of dual regulation you referred to a moment ago.

MR. DAY: The theoretical models are probably more numerous than I am going to be able to elaborate immediately, but if the challenge were severe enough, and the Rodino hearings are probably not a severe enough challenge as yet but they may yet become so, it would be possible to preserve the local responsiveness and partially preserve the diversity and other advantages of state regulation and still have a more uniform mechanism by defining through an interstate compact passed by the Congress what the structure would be and how it would operate. That idea has been around for sometime and it has been espoused at various times by various people, and I think that ultimately we will get to something akin to that at least on the financial aspects of insurance regulation. The de facto system where the State of New York served as the federal equivalent in assuring uniformity and effectiveness has not worked for a long time adequately. You can now do business outside of New York, California, etc., and still survive and exist and when that wasn't true, then the de facto informal mechanism worked more effectively. I do think that we should consider either through an interstate compact or through reciprocal agreements that if linked to the annual statement or linked to the zone examination system, or even taken seriously by the insurance industry are likely to get passed. When we amended the standard nonforfeiture law, thirty-six states had enacted the amendment within the first year. That wasn't simply because regulators thought it was a good idea to amend. It was in fact that the insurance industry recognized that their competitive viability depended on getting those amendments and getting them quickly. I do think, as I chaired the relevant committee at the time, that insurance regulators were equally concerned about getting new products to market and allowing an appropriate amount of financial deregulation through those amendments. But I think, as I recall, the record was thirty-six the first year, an additional twelve the second, and then I am not sure about the other two states or even who they were. So if we ever were serious about getting an effective uniform reciprocal system enacted, even using state reciprocity to do it, I think we would have a means to do it. The other part of that is if we are willing to say we are responsible in each and every state for regulating not only domestics, but also foreign companies, and if we are willing to live through the friction that would accompany that, which I personally am. I call it peer accountability. A lot of people think that is "pure" accountability and they are emphasizing their accountability a little more than the fact that we are peers and could do it. But I do think that I have seen a maturation among regulators of their interdependence and mutual obligation and that they can not tolerate their parochial and competitive interest to the extent that perhaps we could before. People are willing to be held accountable and more people are

willing to hold them accountable than existed historically. Basically, if you get the industry and the regulators to focus on the fact that these are interstate markets, that insurance is interstate commerce, has been and will be, and that the thing that is wrong with federal regulation is not the Interstate Commerce Clause but the Civil Service Act, I think we could make some substantial progress pretty quickly. We cannot have our allies support us for the wrong reasons and Prudential decided that we had to be improved and be worth supporting and, along with other companies, has assisted in causing that to be the case. But unfortunately a number of our allies support us because we are not as effective as we need to be and we are not able to respond with objectivity in some circumstances as we would like to be. I think that has got to become less tolerable and less desired as an outcome by everybody that has an effected interest. We need a better mix in our business, we need more informed consumers and the phrase that Dwight cited out of the statement I gave him was meant to suggest that we do need informed consumers. We don't need the kind of self-styled consumer advocates who really are not representative of consumers or the best interests of consumers in the future. We do need a better balance than what we have now. The ambivalence about state regulation that exists in most forums is just fatal and corrosive. I think we need to be non-defensive about the issues that are priorities to us and willing to explore any reasonable alternative. I think approaching the table in an open-minded and informed fashion is what our obligation is. But there will be risk in this. There is no way we can deregulate as we need to without increasing commissioner discretion. There is no way we can create standards for interest sensitive products that are inclusive enough to get everything we need without also getting things that we don't care about. People will have to assume some confidence in regulatory discretion and reason as we go through it. That also means we are going to have to spend a lot of time with established staff members saying "Start focusing on forests and not on trees", to some extent. We also need to experiment with language in some areas. The surplus aid treaties that are now occurring, which on occasion I seriously believe have as their primary purpose to frustrate regulatory oversight, need to be redefined in some way. Some need to be allowed, some need to be allowed with notice, some need to be allowed with notice and approval, and others probably need to be discounted to some extent under some set of circumstances. Proportional credit seems like a very good idea to me initially, but we ruled too much in if we just went to a proportional credit standard absolutely. I don't mind if people go down and get a loan, but I do want to know about it. I am not sure I ought to approve it necessarily. If it is a domestic, I want to approve it. No matter who it is, if it is material, I want to know about it. At the margin we are in each others business to an extent that probably reasonably makes us sensitive and concerned, but this is a marriage, and we do have to get along, and we do have to approach each other with dignity and respect and all those other things. We are just going to have to go through it. We can either do it long and hard, or we can do it short and easy, and largely that will be determined by the frame of mind that each side brings to that table and their willingness to make commitments in their mutual interest. I don't mean to disparage either lawyers or government affairs lawyers as a sub-set of people, but we do need more actuaries and fewer lawyers in that process, literally. We need more quantitatively oriented people generally, but particularly actuaries. You are now managing future profits and you clearly have better eyesight than I have to be able to see them in some of the products. If there is present value in those future profits, we might need to get new technology like electron microscopes to be able to determine it. We do need to have that explained. Looking at the two balancing items, one competitive viability with

other intermediaries, the other, the preservation of the integrity of the process and the mechanism. In recognizing also the prior approval administrative detailed oversight proscription in all forms and cases is not going to work practically. We can't afford it, we don't have the staff to do it, and the staff response to that kind of environment is interesting because if you can't manage disease in the forest, it's a lot easier to start worrying about the status of individual trees so you don't ever have to deal with the forest as a whole. We have got to be supportive of that defense in a way that helps staff members to cope with it. It's a lot easier to argue about a policy form than it is to figure out how much exposure through depository products exist in your market.

MR. GARY CORBETT: I would like to pick up on the last comment you made about the products becoming so complicated in some ways, the actuaries certainly knowing more than the regulators and the need to put the products under an electron microscope.

MR. DAY: That is to find the profit - the future profit.

MR. CORBETT: Reflect back to an earlier statement you made about the need for more objective standards in the area of solvency which is certainly an area that we have to do a lot more in. I think we are doing it. But one thing that concerns a number of us is with the new products as they come along. There is a real inability in statute or regulation to predict all the forms of these products and also the environment in which these products will operate. Perhaps it is clear procedures and policies and guidelines for applying judgement to these policies that are needed rather than objective standards that are probably doomed to failure in any given number of cases.

MR. DAY: I agree that we need both. The issue on objective standards goes more to the value of assets at a certain time, and it is the objectivity of the valuation procedure and whether or not you have assets that needs the most remedy. I am inclined to think that we need to go more to the use of the file approach with rescindable approval and standards of certification by the company and by the product designer that clearly establish some responsibility which will be taken seriously and then some general kind of definitions based on the nature or the intent of what the product is to serve. I don't think there are many life insurance products that are not transmutable over to banking and the reverse. The implications for the financial structure and the regulatory structure are obvious in both settings. It is quite clear to me that it would not be a problem to find somebody that will take the mortality exposure and leave you with whatever else you are really interested in. The product issue outside of allowing a reformation of the product in the event of the insolvency of the company clearly stating what the priority of treatment will be in the event of either insolvency or rehabilitation or liquidation and proving product definition in that sense as well as guaranty fund obligation I think is a priority. But where we need objective standards are for those who want to say they are affiliated investments even though they can't be liquidated and even if they were wouldn't produce anything like their statement value. We need some objective standards so that we get in and force people to deal with the problem. There is a natural progression in a human sense that occurs where creative people get exposed, exposed people get nervous, nervous people get desperate, desperate people get further creative, creatively desperate people get criminal, and then you get a real problem. At the same time there is a natural denial of that that goes on in that mechanism. Psychologically people are not able to admit that they have got the problem they

have and that's when you need to be mitigating the problem. We need some standards that allow us to say, "if you can't deal with reality, we can; you have had your turn, and now we are going to take ours." Those are the objective triggers on what constitutes impairment, what constitutes insolvency for the purpose of rehabilitation and/or liquidation that we need to think through. I also don't want to personally make rehabilitation versus liquidation decisions without the guaranty fund having clear standing to comment on whether they think a rehabilitation or a liquidation is more desirable. I do not want to use anybody's money other than a company's money or a qualified lender's money to rehabilitate a future competitor under any circumstances, but I think the re-regulatory process we are going through has a lot of permutations at different levels. It means we have to stop doing some things, we have to start doing others, and re-deploy all our resources and maintain also the voluntary compliance responsibilities so we are not trying to have states do it. In fact it is sort of self-fulfilling by the industry and for those who don't comply; then they get brought back onto course. I can describe the outcomes better than I can describe how to do it also.

MR. GARY DROWN: We are one of several Indiana companies that have significant amounts at risk through the guaranty fund on Baldwin United. You alluded in your response to Walt Miller's comments for the need to do something more of what you haven't done much of yet, and that's market surveillance. This is one of the two major categorical recommendations that came out of the McKinsey Study some ten years ago. It is an arena where looking at a few more trees might be more helpful than looking at forests. It is something that companies are very uneasy in pointing fingers at. I think this is something that would be extremely useful to the industry if the regulators would do a bit more relative to those who distribute products. Could you say a few more words about that.

MR. DAY: I think we do a lot more of it than people understand that we do, and we are improving our ability constantly. We had 350 life companies on our early warning watch list last year and have a like amount this year. They fall into two or three categories and being on the list by itself isn't conclusive of anything. I have received a number of letters, one of which said that using their GAAP assets, they were clearly going to be able to respond to any policyholder needs in the future and why did we have them on the watch list. We suggested that they take their GAAP assets down to the bank and arrange for a line of credit that is clean and irrevocable since I am not satisfied that GAAP assets in fact work to pay policyholder obligations. But we are doing a lot more surveillance. The thing that is tough about that in terms of informing people of what we are doing is it's tough to advertise. We are not going to publish that list any place. The examination handbook and a variety of other procedural documents we have allow for the right thing; it's how we administer it that really will determine whether we succeed or not in bringing about the results. The handbook has always recommended, suggested and allowed systemwide exams within holding company structures. We have worked very hard to get that to occur in a number of priority structures that we felt required an entire simultaneous exam since it is very hard to have sick parents and not have kids that risk catching some part of that. I think that has worked better in the last two years than it has worked in my experience. We do have to define both the due process rights of companies in that setting as well as how we get assured compliance at the state level. But I think we will be continually amending that process, and the cumulative valuation plus the cash flow modeling adjuncts to the IRIS (Insurance Regulatory Information System) ratios that are being proposed will further strengthen and improve

the process, and it is working. This year we asked all the domiciliary states to give us an update before the IRIS test of what their intervention had produced in the course of the last year, which had not been done before. We have zone financial coordinators that monitor the state by state intervention and action based on the IRIS results. So the follow-through is what we are really attempting to emphasize, and that's where the payoff is. The problem with just saying, "It's easy, people, file statements," and then you can put them in a machine and then review them is that you are massively exposed to a garbage-in, garbage-out problem. Even knowing there is going to be some hands on oversight currently, if necessary people will file garbage anyhow. And as it ages it begins to stink and so you know it's garbage. There are some additional needs that have to be responded to, but we are doing much more solvency surveillance than we did. The creation of the examination oversight task force gives us a mechanism to get the interstate process to respond quickly. We are emphasizing more sampling, more priority exams, more accounts segregation in exams, more mini-exams, more use of data processing as an examination tool and as a solvency surveillance tool, but we still have some gaps. Since Equity Funding, for example, it has been absolutely imperative in the mind of any reasonable and objective observer that you be able to test the company's own information and data processing system as to how reliable it was. So far, three states have a system that is capable of doing that. The cost of the system is now one-tenth of what it was five years ago, but states have not been able to get approved in their budgets. They will get it approved in their budgets when the industry walks into their appropriations hearings and says, "We demand that they have that, because we are sick of paying for other people's problems." That, I think, is more constructive than saying we want off the guaranty fund risk, but we are in fact doing a lot more than I think people realize in those areas. More remains to be done, but we are simultaneously creating the new system as we faze out the old systems, so there will be a period when we have a parallel system. That's where we are now. Thank you very much.