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HAS THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC) ANNUAL STATEMENT BLANK OUTLIVED ITS USEFULNESS?

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Recorders: ANTHONY F. CROCKER
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- o Role of solvency surveillance
- o Role of the valuation actuary
- o Role of reinsurance
- o Role of integrated financial services
- o Role of the American Academy of Actuaries Committee on Life Insurance Company Financial Reporting Principles
- o Role of the American Academy of Actuaries Committee on Property and Liability Insurance Financial Reporting Principles

MR. JOHN O. MONTGOMERY: I am Deputy Insurance Commissioner and Chief Actuary with the Department of Insurance of the State of California. The purpose of this open forum is to obtain ideas for improving financial reporting to enable the regulators to better ascertain the financial condition of an insurance company.

At the March meeting of the NAIC (EX4) Blanks Task Force, an ad hoc study group was formed to present a course of study to that task force at its June 1985 meeting. The ad hoc study group, consisting of insurance department staff from nine states, met on May 3, 1985, (eight states were represented then) and decided on the following areas of study:

1. Reporting of Amounts Payable on Demand
2. Reinsurance
3. Multiplicity of Lines of Business for Life Insurance Companies
4. Holding Company Schedule

*Mr. Ransom, not a member of the Society, is a Consulting Actuary at Conning and Company.

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5. Market Values of Assets

(Not discussed as a separate project but possibly included is the study of analyses of Schedule D information such as bond matrices of interest versus duration and quality versus diversification.)

6. Factors in the Surveillance of Surplus

7. Schedule H Feasibility of Revising Columns

8. A Separate Market Conduct Statement

The NAIC (EX4) Data Base Management Task Force considered another project which is closely related to and definitely influences the future course of changes in financial reporting. This is the computerization of financial reporting such that statements can be prepared faster and more economically than by the largely manual system used presently. Computerization can't be effective unless it is cost effective to the companies in the preparation of financial reports.

Mr. William D. Ward is Director of Account Policy Research of Aetna Life and Casualty and will speak on the role of solvency surveillance and present some background on that subject.

Mr. Gary K. Ransom is a Consulting Actuary for Conning and Company and has been involved with the financial analysis of companies. He is going to present a financial analyst's view on casualty insurance with some remarks on life insurance. Mr. Ransom is a Fellow of the Casualty Actuarial Society.

Mr. Hugh J. McFarland is Vice President in the Reinsurance Financial Department at the Lincoln National Life Insurance Company and will speak on the role of reinsurance.

Mr. Walter S. Rugland is Consulting Actuary at Milliman and Robertson. He is a Vice President of the Society and chairman of many committees. He will speak on the role of the valuation actuary.

Mr. Richard H. Snader is Vice President and Corporate Actuary of the U.S. Fidelity and Guaranty Company and Chairman of the American Academy of Actuaries Committee on Property and Liability Insurance Financial Reporting Principles. Mr. Snader will speak on the role of that committee and also comment with a casualty actuary's view.

Mr. William J. Schreiner is Actuary of the American Council of Life Insurance (ACLI) and will give an independent view.

MR. WILLIAM D. WARD: By establishing some guidelines that suggest some faults within the present financial accounting system, we hope to stimulate your creative thinking about the problem.

A periodic statement describing the financial condition of the insurer is an essential ingredient of solvency surveillance. To perform the

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solvency surveillance task effectively and efficiently, the regulatory system must be provided timely information enabling it to quickly ascertain if a problem requiring regulatory attention exists and to ascertain the parameters of the problem.

In 1871, a speaker at the first convention of the NAIC used a story to underline the need for development of uniform reporting of financial condition:

I have in my mind now, and I mention it because it illustrates an evil that is going abroad in the land, a little incident that took place in my office a few days ago, when a canvasser came to me and wanted to know the character of a certain company. It is a company whose name I shall not give, for it is not a company in which I should wish to get my life insured. Upon asking me the question, not being willing to give my opinion, because as a commissioner I do not regard myself as the advocate of any company, I therefore refused to give any opinion. It is a company in which the item of deferred premiums, and premiums uncollected, and office premiums, and cash in the hands of agents, and \$100,000 in Albany, make up pretty much the entire schedule. Said he, "Mr. Paine, look at it: what do you call the best companies?" I said, "I suppose I can answer that very readily; the companies with the largest funds." Said he, "Look at the list; with the Mutual Life of New York the ratio of assets to liabilities is 107; with the Connecticut Mutual it is 114; with my company 150." And it was way up above that, and all made up of these uncollected premiums.

It is also interesting to read the agenda from the proceedings of the same 1871 convention [emphasis added]:

1. The laws relating to life insurance, and the forms required for making annual statements showing the condition of the companies.
2. The laws relating to fire and marine insurance, and the forms required for making annual statements showing the condition of the companies.
3. The laws relating to inter-state taxation, deposits as security to policyholders, and licensed by municipal authorities.

These priorities were the convention's entire agenda. The three main objectives for 1985 of the NAIC are [emphasis added]:

1. Fair, just, and equitable treatment of policyholders and claimants.
2. Reliability of the insurance institution as to financial solidity and guaranty against loss.
3. Maintenance and improvement of state regulation of insurance in a responsive and efficient manner.

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The reliability of an institution must be determined by some kind of disclosure on financial condition. In 1979 during the deliberations of the NAIC's accounting practices task force on a conceptual accounting framework, the task force stated that the objective of regulatory financial statements is to provide regulatory authorities with reliable financial information concerning an enterprise that is useful in assessing company operations with particular emphasis on the ability of the company to meet its obligations to current and future policyholders. Regulatory statements should present financial information in a way which recognizes, with an appropriate degree of conservatism, the continuing nature of the enterprise.

Additionally, this task force listed five objectives for which financial statements should be prepared and what their purpose should be:

1. Financial statements should be prepared so as to reflect the company's ability to meet its obligations, as they emerge, to current and future policyholders, claimants, and others.
2. Financial statements should provide sufficient objectively verifiable information to permit informed review and objective evaluation by regulators.
3. Liability evaluation should reflect the nature of the obligations, provide conservative recognition of the risks of adverse deviations from assumptions and the uncertainty of the future, and conform to statutory requirements.
4. Asset valuation, in aggregate, should be generally consistent with the evaluation of liabilities, in aggregate, and should be on a basis consistent with the function of assets in supporting the future obligations of a continuing insurance business.
5. Disclosure should be made of any material change in accounting methods which would affect consistency of financial statements from period to period.

In summary, the objectives of statutory reporting in my mind are to:

1. Demonstrate the insurer's continuing ability to satisfy its obligations to its policyholders and creditors.
2. Demonstrate that management is adhering to the standards of care and prudence in the management of funds entrusted to it.
3. Demonstrate that the insurer is in compliance with statutory requirements for the acquisition of assets, evaluation of assets and liabilities, and maintenance of surplus.

Having established the regulatory objectives and the purpose of statutory reporting, let us discuss solvency surveillance.

McKinsey, in its study of the NAIC's Surveillance System in the early 1970s, concluded that:

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The purpose of the financial condition surveillance system is to detect, as early and as effectively as possible, companies that are in financial trouble and to develop the information needed for appropriate regulatory action...

The key elements of the system direct the bulk of the effort where it is most likely to reveal material problems.

What then are the regulators concerns as they review the statements? The New York Insurance Department, in a series of lectures for its examiners some time ago, indicated it reviewed statements with the following concerns in mind:

1. Propriety of asset evaluations.
2. Compliance with limitations on asset holdings, both individually and in the aggregate, by classes.
3. Disallowance of items not admissible under the provisions of the Insurance Law.
4. Apparent adequacy of reserves carried.
5. Compliance with special reserve requirements.
6. Sufficiency of capital and/or surplus.
7. Compliance with minimum capital assets and deposit requirements.
8. Eligibility of asset acquisitions made during the statement year.
9. Legality of purchases and sales of assets.
10. Compliance with recommendations of the Department made in the filed reports on examinations.

The following might be added to that list:

1. Has the company undertaken risks which, when related to the appropriateness of investments and economic conditions, threaten the security of the policyholders?
2. Can the company continue to be evaluated as a going concern or should it be viewed on a liquidity basis?
3. Will cash flow be available when needed?
4. Are short-term assets mismatched against long-term liabilities? Or are long-term assets mismatched against short-term liabilities? (Insurance departments are becoming increasingly aware of the dangers and risks raised by mismatch.)
5. Over the long haul, will the company be able to weather the ups and downs of economic cycles?

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6. Are any affiliates, subsidiaries, or reinsurers insolvent, threatened, or delinquent such that the solidity of the company is threatened?
7. Has the growth of the company been so rapid as to prevent its management and control?

All of us are familiar with the zone examinations, the triennial or quinquennial as the situation may be and, of course, the so-called special and targeted examinations conducted by the state. There are also the internal analytical reviews (including desk audits and electronic data processing (EDP) comparisons. What company has not received annually a letter from the New York Department about cross checks and so on? I have that in mind as a kind of internal analytical review.

In addition to the effort going on at the state level, there is the NAIC's support services office operation in Kansas City, otherwise known as the central office. Most particularly is the Insurance Regulatory Information System (IRIS) or, as it was previously known, the early warning system. A very important aspect of the surveillance system is that it is an aid to the states in effectively using limited resources. None of our states is able to review thoroughly the financial condition of all licensed companies immediately upon receipt of the annual statement. The IRIS system attempts to establish priorities, looks for unusual transactions and, in short, assists the state in its ongoing review and surveillance activities. The IRIS has two phases. The first is the statistical phase, made up of a data base which is developed from input from our annual and soon to be our quarterly statements. Additionally, a discriminatory analysis is performed from the data in the data base which is reported in the form of ratios. These IRIS ratios and this function are not intended to be a quality rating operation. These ratios are used for the discriminator characteristics; the ratios themselves are not determinative. The information developed from this discriminatory analysis is used in second phase, the so-called examiner team operations. Each year, shortly following the receipt of the annual statements in Kansas City, a team of examiners drawn from skilled field examiners and various departments comes to Kansas City to review the results of the ratios and the other information developed in the discriminatory analysis function. From this examiner team review further discrimination is made. These companies, often referred to as targeted for immediate attention, are then referred to the domestic state for their further review, surveillance, and examination.

Another valuable NAIC activity in the solvency surveillance system is the function carried out by the securities valuation office in New York City. Its annual valuation handbook provides the bond and preferred stock ratings, advising us whether we may carry certain of our bonds on an amortized basis or on a market basis. It also provides the means for determining the mandatory security valuation reserve (MSVR) increments. Recently, the office has added a holding company and a merger analysis function. The valuation actuary and the external auditors also play a vital role in the statutory surveillance function.

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The development of the present NAIC Annual Statement Blank format is outlined as follows:

1. Pre-1951. The blank consisted primarily of four parts:
 - a. Two fundamental financial statements (a Statement of Income and Disbursements and a Statement of Assets and Liabilities) with supporting schedules;
 - b. The Gain and Loss Exhibit;
 - c. The Policy Exhibit; and
 - d. Schedules of illustrations of premiums and dividend payments.

The Statement of Income and Disbursements contained in the old form of blank, was basically a statement of cash receipts and cash expenditures for expenses and policy benefits.

The statement of assets on page four segregated the company's assets into three major categories of "ledger," "nonledger," and "not admitted" assets (similar to our present Exhibit 13).

There were no specific instructions concerning the content of the various accounting classifications which were set up in the required annual statement form. There was a considerable divergence of practice in classifying expenses of certain types.

Except for the Gain and Loss Exhibit the general form of the statement used for reporting on the operations for the year 1950 was essentially the same as that adopted by the NAIC in 1875 and continuously used since that time.

2. 1951. The current blank is primarily a rearrangement of data presented in the pre-1951 blank; it also provides much additional information.

While the current blank was regarded as a great improvement over the superseded form, even its most enthusiastic supporters in 1951 believed it was not entirely free of imperfections. One commentator at the time observed that it was "questionable whether or not the Analysis of the Increase in Reserves which is still required in the Revised Blank has any real significance."

3. Revised Blank (Considered by the NAIC between 1979-1982). Between 1951 and now, a simplified or revised blank was considered. This blank was never adopted. It had some good and bad points:

- a. Salient features
 - i. Designed for fast data input
 - ii. Disclosed only significant details and financial information

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- iii. Excluded worksheets and detailed information in schedules
 - iv. Provided for note disclosures similar to those found in generally accepted accounting principles (GAAP) reporting
 - v. Provided for a manual of instructions and cross-checks to complete the statement
- b. Reasons for its rejection by the NAIC
- i. Did not meet all of the surveillance standards
 - ii. Failed to provide sufficient data to enable Insurance Departments to monitor compliance and to focus upon the problems of a targeted insurer.

While the current statement or a similar form has served solvency surveillance well for over one hundred years, recent events -- insolvencies, product developments, data processing technological improvements, growth in number and size of companies -- indicate a need to reexamine the current statement. There are some deficiencies in the current statement:

1. It attempts to satisfy too many and conflicting objectives, providing, in addition to information on financial condition, market conduct, statistical, general corporate information as well as accounting worksheets. This information is needed, but it is not needed for solvency surveillance as that function has been described.

Examples:

Market conduct --

Schedule M -- premiums, dividends

Accident and Health (A&H) Policy experience exhibit

Credit information

Statistical --

Exhibit of Life Insurance

Exhibit of Annuities

General Corporate --

Schedule L -- Annual election and minutes

Schedule G -- Salary

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Stockholder Information Supplement

Organization Chart

Accounting/Worksheet --

Reconciliation of Ledger Assets

Form for Calculating MSVR

Schedule of Examination Fees

2. It contains voluminous, detailed, significant data buried in non-essential information preventing early detection of troubled companies and promoting inefficient use of resources. The essential financial statements are too detailed, and the gain and loss exhibits inadequately reflect current products and risks assumed; product classification is outdated.
3. The statement lacks understandable organization of information; this confuses objectives.
4. It does not give priority to information; the ranking of data in an exhibit often presents the inconsequential before the essential.
5. The statement does not provide sufficient information, or present it clearly, to enable regulatory review of our solvency surveillance concerns.
6. The statement does not present clearly the nature of the obligations that the insurer has underwritten and, thus, prevents an informed review as to the presence of sufficient margin in the event of adverse deviation.

I would support these remedies:

1. Create separate filings to appropriate regulatory units to meet the other major objectives. (This lessens the amount of irrelevant data in the statement.) A market conduct statement would be filed with the appropriate market conduct people and include the premium, cash values, dividend illustrations, and complaint ratio information in it. A corporate governance report would be provided to the appropriate people.
2. Provide for development of data and filing as needed in multi-part statements, everyone would file a basic solvency statement. A large portion of companies might file detailed exhibits and schedules one month later to the central office and domiciliary states. A small targeted group then might be required to file very detailed information.

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3. Reduce the level of detail to significant quantities -- the aggregate of items of 5 percent or less; eliminate worksheets. Emphasis must be on the total picture of the company's financial condition that the numbers are describing and less on the accuracy and positioning of the amounts in each column.
4. Emphasize trends in cash flow, income, and product mix. The five-year historic exhibit is important and should not be buried between exhibits and schedules. It needs to be considerably reviewed and overhauled.
5. Provide for better information on the nature of the risks assumed by the company and the margins available in the event of adverse deviation (page 6). The analysis of increase in reserves should be completely overhauled, which was not done in 1951, to include not only reserves but also funds. It also should analyze the experience by risk (C-1, C-2, and C-3).
6. Provide better disclosure of whom the company relies upon for advice on investment, marketing, and management strategy. Who are its vendors? I hear a lot about poor investments but nothing about applying necessary underwriting standards to the people we purchase from or sell securities to.
7. Provide for the adequate disclosure of the impact of non-conventional products upon financial condition.

In summary, the current statement form handicaps solvency surveillance. Since the form has become a source of data for other needs, it has become increasingly difficult for the regulatory process to work in a timely manner.

Rather than continuing to add more disclosure elements to the existing annual statement form, we must rethink the purpose and objectives of the annual financial statement. To ignore the present statement's deficiencies any longer will only result in a deterioration in the quality of regulation and further escalation in guaranty assessments, departmental funding costs, state taxes, expenses of operating the insurance mechanism -- all of which are borne ultimately by the consumer. There is a need for members of the Society, regulators, and management to join together and address this problem.

MR. GARY K. RANSOM: On the property/casualty side of the insurance business, a key issue in solvency surveillance is the adequacy of the loss reserves; making that determination is one of the most important factors in solvency surveillance. It is the biggest item on the liability side of the balance sheet and also the item most subject to variability in the future. Conning and Company did a regulatory survey in late 1984 that was property/casualty-oriented dealing with various regulatory issues including the NAIC annual statement blank.

We sent the survey to about one hundred top property/casualty insurance companies of which forty-seven responded. We sent out a slightly different survey to the fifty insurance commissioners and

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received fourteen responses. We asked all these people to identify what the key issues are for the upcoming year, and solvency and guaranty fund issues came out well ahead. Certainly solvency in general was considered a critical issue for 1985 in the property/casualty business as companies are closing down and being taken over by Insurance Departments regularly. Another key issue that came out in our survey was the quality of reinsurance as property/casualty companies use more offshore reinsurance. How sure are they that they can collect that money from the reinsurers when the time comes? A lot of Schedule F's, which are the listings of all the reinsurers, show that in almost every company statement at least a half dozen companies are in liquidation. Will those companies in liquidation be able to pay the reinsurance recoveries when they are due?

The survey also asked specific questions relating to the property/casualty blank. We asked insurers if they believed that detailed information should be available to state insurance commissioners regarding the sales of loss reserves on both sides of the transaction. Loss reserve sales are when a property/casualty company gives a piece of its loss reserves liability to a reinsurer and also a smaller amount of cash, and the difference is a direct benefit to surplus. Ninety-eight percent of the respondents believed that there should be much more information concerning loss reserves sales. Loss reserve sales serve primarily as a surplus aid transaction, popular lately because many companies are losing surplus and are in need of surplus aid or additions to the capital and surplus. This kind of aid has become so frequent that practically everyone thinks there should be a lot more information on that issue in the blank. The State of New York now requires much new information in that regard in their 1984 blanks.

We also asked whether it is possible to analyze loss reserve adequacy without the information on loss reserves sales. Eight-four percent of the respondents said that it's not possible to analyze reserves based on Schedule P, the major loss reserves schedule. You cannot analyze reserves adequately without loss reserves sale information.

Finally, the most important question on the survey asked that given current reporting methods in annual statements, particularly in Schedule P, are state insurance departments provided with sufficient information for analyzing loss reserves adequacy. Sixty percent of the companies said that there is not sufficient information to analyze loss reserves.

We asked the insurance commissioners what they thought the deficient areas of the property/casualty blank were. At the top of the list was transactions between affiliates. Topics on cash flow and on loss reserves were all critical issues to the commissioners. To summarize, they believed it was all too little, too late.

We also asked the commissioners what the most difficult aspect of monitoring solvency in the property/casualty side was. The number one issue was determining loss reserves. And the number two issue was that the insurance departments do not believe they have adequate resources to analyze the loss reserves. On the one hand, a lot of

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companies think more information should be provided, and on the other hand, the insurance commissioners don't think they have enough people and resources to analyze that information. We have to keep that in mind when making necessary changes to the annual statements. The commissioners also were talking about the need for more examiners and actuaries to cope with the voluminous paperwork. According to the survey results from the insurance companies, most state insurance departments fall behind significantly in solvency monitoring.

As a stock analyst, I certainly have a different point of view from commissioners or other industry observers. My question is whether capital should be invested into or taken out of a particular company. To the degree that one does not want to invest in a company that can't pay its claims, our views certainly overlap. But stock analysts are more frequently interested in the companies which favorably stand out from the rest. From that perspective, how do we at Conning and Company use the NAIC blanks? We are very dependent upon those blanks. When we look at the whole realm of stocks that could be analyzed or followed, the insurance analyst is swamped with information compared to other industries. There is no other industry that supplies such a substantive, uniform document on the companies in that industry than insurance. From our point of view, the NAIC blank is critical to our analysis despite the problems it might have.

On the property/casualty side, we computerize a lot of the information in the blank. We have a financial audit report which summarizes what we think are the key operating ratios, plus the NAIC tests, and the triangles of loss development. In just two pages, this report shows what we think are the most critical items on a historical basis as well. With that you can find problems that might need more probing. We also have a complete computerization of Schedule P, the loss reserve schedule, and we can look at that in any number of different ways. We use that for every stock that we follow. We are always looking at the loss reserves because they are critical to any company.

On the life insurance side, we also computerize a detailed expense analysis. We use that often because we believe a low-cost, low-expense life insurer is going to be a better investment than a high-cost one. Jackson National is a top company these days, but it wasn't a few years ago. There were a lot of questions about its accounting for the new universal life policy, but the main item we looked at was that it was a low-cost, low-expense ratio provider. That alone was the source of our recommendation for that stock.

On the property/casualty side, looking at reserves has helped us tremendously on many occasions. Going back when Loew's bought CNA, we looked just at Schedule P and made an accurate determination of what its reserve position was. More recently, another company in California has been having a lot of problems. We determined that this publicly traded company was in trouble two years ago just by looking at its loss reserves. At the end of 1981 its profile looked good, and all of a sudden it looked bad at the end of 1982. It took close to eighteen months before the people in the stock market recognized that fact, and the stock plummeted. Another example is a company in New Jersey,

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which writes excess surplus business and is now all closed down in the hands of the insurance commissioner. We knew that was going to happen a year before it happened, just by virtue of the Schedule P loss reserves.

We also have ongoing reviews of all the top publicly traded property/casualty companies. Most of those are not necessarily in trouble, so we don't find big problems. But when we look at the reserves, we raise a lot of issues and questions that we can talk about with management. The Schedule P information and discussion with management have usually given us an accurate appraisal of the loss reserve position. There are certainly problems in Schedule P, but the management discussions cover a lot of that.

While we have had a lot of success is using Schedule P, there certainly are problems such as the loss reserve transfers already mentioned. Another problem is the switchover from occurrence policies into claims-made policies. An occurrence policy is attached based upon date of occurrence of an accident. Claims-made policies are attached based on the date of the filing of the claim, which has happened mainly in medical malpractice but also now in general liability. These are the kinds of problems that may lack a good solution. You can always break down the annual statement into more detail, but I'm not sure the marginal benefit of getting that additional information is very useful.

Other problems are inherent in the nature of the reporting: changes in the mix of business or changes in reinsurance transactions; retrospectively rated business; foreign exchange transactions; claim processing changes; and loss adjustment expense billing changes. Those things are going to be there no matter how you adjust or refine the data in the statement. Our strategy at Conning and Company is to look at it every possible way. We look at every conceivable test and see if all those tests outline a range of answers. Sometimes the range is narrow, and it is easy to draw a conclusion; sometimes the range is wide, and it is not so easy to draw a conclusion. We are most interested in the companies that we buy as compared to the ones that we sell. The annual statement data really just spots red flags for us to look at. Market conditions, competition, market leadership, distribution system, management capability and structure, and other intangibles go into a "buy" recommendation.

Though the annual statement has problems, it provides an excellent starting point for the stock analyst. For any necessary changes, you have to consider how much additional benefit you get from making those changes. I'm not sure at this point that adding a lot of refinement or additional data to the property/casualty blank will necessarily give us a lot more to work with.

MR. HUGH J. MCFARLAND: I work for a company which acts as a professional reinsurer. My company's posture is such that it would support additional or new ways of disclosure if both meaningful and not unduly burdensome. However, any comments I make are mine and do not necessarily reflect the view of my employer.

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The NAIC blank contains a wealth of information. It is always nice to have several years' copies in front of you when you are looking at a particular company for one reason or another. However, much of the blank is support for basic financial statements. This may be valuable or useful information, but additional complexities don't seem necessary in something that is just adding to the development of basic financial statements. My company prepares monthly financial statements on both a statutory and GAAP basis. Come year end, the NAIC blank almost becomes an intrusion to the cycle that has gone on in the preceding months. The NAIC blank is not the only set of financial statements in existence. This means that it will be more difficult than in the past to generate interest in a project to modify the blank if the end result is perceived to be additional disclosure or complexity.

Is the blank useless? I believe regulators strongly believe that the blank is more important than ever because of the increasing complexity of our business, and reinsurance is no exception to this trend. On the other hand, companies have less attachment to the blank because many of us are required to report to management or shareholders on another basis. This is not to say that statutory accounting is not important. After all, this is the basis upon which we are regulated. It is just that the environment is different than it was when the NAIC blank was the only set of financial statements for both the company and the regulators. If the blank is useless, it is because regulators feel its information is inadequate, while companies feel it excessive. This will be a difficult obstacle to overcome.

The overall regulatory level of our business must be remembered. While all industries probably feel that they are the most regulated, I don't think anyone would deny that we are a pretty highly regulated industry. Each state we do business in has something to say about it. We have the triennial exam process where all the books are open, with more frequent exams possible in special situations. This is a powerful form of disclosure, albeit somewhat retrospective.

Reinsurance is essentially a vehicle for passing one or more of the risks of our business from one company to another. Some reinsurance is used for financial planning purposes and is considered by some to deserve special treatment, but simply stated, the financial statements should reflect the net retained position of the company. If a situation involves a value judgment as to whether risk is truly transferred, additional disclosure is the solution, not arbitrary treatment.

The current blank already has a lot of reinsurance information. Just consider Schedule S and focus on reinsurance ceded. You can find out who the reinsurer is, what kind of reinsurance is used, how much is in force, the reserve credit taken the past two years, and the premiums ceded. Amounts recoverable from reinsurers are included as well as a series of difficult to understand interrogatories.

Elsewhere in the blank is fairly detailed premium information by line of business with much the same information for commissions and expense allowances. Claims are also shown by line of business both with

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respect to development of the year-end liability and incurred benefits. Reinsurance information is shown other places in the statement, but for the most part it is a carry-forward of the information already mentioned. Sometimes the reinsurance data in the annual statement can appear to be fragmented and somewhat inconsistent from place to place, but there is a lot of information in there.

The most recent proposal to modify the NAIC blank appears to substantially expand reinsurance disclosure. There would be an asset and liability item for reinsurance, and even more important, there would be the supporting information later in the statement. The income statement and a cash-flow statement would be prepared for each line of business and each line would show direct business as well as reinsurance assumed, ceded, and retroceded. This would be somewhat like the current page five allocation in the blank. Major supporting schedules would include premium, reserve, benefit, commission, and dividend information, which presumably would also have reinsurance implications. Balance sheet support would be provided for the reinsurance items. A reinsurance arrangement deemed to have no "risk transfer" would be treated like a loan on the balance sheet, thereby negating its impact.

There are some potential problems with the currently proposed format of the NAIC blank. While some problems are general, they also apply to reinsurance:

1. If allocation of expenses, investment income, and other such items is intended with respect to reinsurance, it will complicate preparation. The current page five breakdown of gain from operations is somewhat analogous. Quality varies from company to company, sometimes substantially.
2. It seems like the direction is toward more, not less disclosure as was intended or implied by the earlier effort to simplify the blank. It may be difficult to change directions.
3. Can we continue to justify the effort necessary to produce an expanded blank in a world where other financial statements are just as important to some? I am not speaking of basic financial statements, but the supporting information and all the other additional information that goes along with the blank.
4. How do you define an arrangement that does not have risk transfer? Some risk is always transferred, so what is an appropriate level? Treatment as a loan implies the possibility of retroactive adjustments. Clarification on this issue is needed, and there is a move in this direction.
5. Given current complexities of reinsurance, the burden of major change may fall more heavily upon reinsurers. Smaller companies even now have problems when it comes to the reinsurance reserve credit in the current NAIC blank.

There are also some benefits of additional disclosure:

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1. Financial statements of the assuming and ceding companies would be more parallel, although they should never be expected to mirror. This will happen for no other reason than more focus on reinsurance.
2. Concern for expanded reporting requirements might generate a higher quality of information between companies reinsuring business.
3. Additional disclosure would also make regulators feel more comfortable. This is very important. We have worked with several insurance departments to explain the nature of some complex transactions, and this has been helpful.

Before we start a new project to redesign the NAIC blank, let's step back and ask a few basic questions:

1. What is the purpose of the NAIC blank? It is to assure solvency or provide financial information? If both, which is more important?
2. Who is the real audience for the NAIC blank? Regulators are concerned with solvency while insurance companies also ought to be concerned with the quality of companies with which they are doing reinsurance business. Are these different types of disclosures?
3. Should solvency regulation and financial disclosure encompass different reporting time frames? March 1 may seem like a long time for someone waiting to see a company blank, but it does not seem nearly as long to the preparer. Some have suggested splitting reporting in some way. I think that idea has a lot of merit.

Whatever direction is taken, it must be recognized as a long and difficult process. If it is to be done, let's do it once and do it right.

MR. WALTER S. RUGLAND: The NAIC Statutory Blank reports the results of the application of the Standard Valuation Law to a life company's year-end "inventory." Actuarially, that's probably what we perceive to be its main function.

Additionally, the blank reports the financial condition of the company on a basis defined by the NAIC in various implicit and explicit ways:

1. It creates an income statement that is of little information value to management, owners, or insureds. Why bother? What value is there to surveillance?
2. It results in a balance sheet that reports, to a large measure, unrealistic values for assets, inappropriate values for many liabilities, and surplus amounts which, as a result, mean little in the long run.
3. The annual statement does little to earn the privilege of being a measure of assurance (real or relative) that a given life insurance

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company will be able to provide current insureds, and those near-term purchasers, the benefits the company has promised or is promising.

The statutory blank's more important purpose of function is that it provides a safe harbor for management; if management satisfies the arbitrary and archaic rules of its reporting format, the regulator or courts will not take over the company. If management does not satisfy those rules, it loses the company. The blank is also a safe harbor for the insurance regulating bureaucracy and its groups of followers. These people live off the data assembled in the blank, producing irrelevant examinations and promulgating unfounded ratings and warnings. In my mind the whole thing is an example of featherbedding at its best! And the life insurance industry is not currently in a position to condone this type of inefficiency.

So without doubt, this blank needs revision. More importantly, before we start revising it, we need to know what the blank is for; revisions need to be validated against a list of clear and concise objectives. It is inappropriate for any of us to consider suggested changes in format, reports, and so on, until we have a consensus on why we're doing it.

I hope these objectives, when they are agreed upon, do not perpetuate the notion that the blank should provide data for market review activities, rate filings, or complaint lists. These are classic conflicts of interest because they conflict with the goal of providing assurance that benefit payments will be made and that the company will not go into a future bankruptcy.

Before addressing the role of the valuation actuary with regard to the statutory blank, let's define some terms. In response to the recommendation of the Joint Committee on the Valuation Actuary in the U.S., and as authorized by its Board, the Academy is preparing proposed model legislation which would:

1. Establish statutory responsibility of the valuation actuary, essentially putting in the statutes that a company has a valuation actuary.
2. Require the valuation actuary to be appointed by the company's Board of Directors and be accountable to it.
3. Require the company to inform commissioners of all the states in which it does business, of that appointment and any subsequent appointments of a new valuation actuary.
4. Require that any financial statements published by the company should include the statement of opinion of the valuation actuary, as part of the published item, not as a staple on a piece of paper, and that any summary published include the name of the valuation actuary and indicate that a statement of opinion has been furnished.

Why is this being done? The model legislation is based on the premise that the Standard Valuation Law no longer accomplishes its intended

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purpose of measuring a company's economic health or of assuring policyholders that benefit payments will be made.

The legislation also assumes that we have a basis for legal determination of solvency. In other words, there will be a minimum standard reserve basis set up for testing solvency. So that the opinion can focus on economic health, the objective of the action are as follows:

1. To require a designated qualified actuary to render an opinion on the capacity of the company to deliver on its promises and to have that responsibility on a legal basis.
2. To allow each jurisdiction, state by state, to be assured through this actuary's opinion, to know who the actuary is, and to be informed of changes in actuaries giving that opinion.
3. To require the actuary's opinion to be part of the financial statement.
4. To maximize objectivity of the actuary, yet preserve efficient and effective use of available actuarial skills and in-depth actuarial knowledge of the situation at hand.

The second recommendation of the Joint Committee suggests a different type of opinion than we have used in the last ten years. This is the suggested opinion that came in the Joint Committee Report. It is a two-tier opinion:

1. The reserves established in the statement are such that the related anticipated policy and investment cash flows will make a good and sufficient provision for all future obligations on a basis sufficient to cover future reasonable deviations from expected assumptions.
2. Such reserves and additional internally designated surplus are such that the related anticipated policy and investment cash flows will make a good and sufficient provision for all future obligations on a basis sufficient to cover future plausible deviations from expected assumptions.

The first of these speaks to the reserves as being appropriate to meet reasonable deviations from expected assumptions. The second suggests that the capacity of the company is such that it can meet all plausible deviations from expected assumptions.

The essential change here is that the current actuary's opinion utilizes a premium valuation which will turn into a cash-flow analysis on various sets of scenario conditions. Additionally, the Committee expects the valuation actuary to present an actuarial report to management.

The Financial Reporting Principles Committee of the Academy has been working on Standards of Practice with regard to their proposed new responsibility for the valuation actuary. The vehicle for this work is a revision of Recommendation 7. The Academy's Financial Reporting Committee has come up with what will be called an interim opinion.

USEFULNESS OF THE NAIC ANNUAL STATEMENT BLANK

Instead of the one just mentioned, the interim opinion suggests that we start out with this:

The anticipated investment cash flows arising from an allocation of assets equal to reserves and other liabilities plus anticipated considerations to be received from the in-force policies make appropriate provision, according to presently accepted actuarial standards of practice, for the anticipated cash flows required to contractual obligations and the related expenses of the company.

Recommendation 7 will describe the accepted actuarial standards of practice. It is anticipated that this will be updated from time-to-time as our understanding of the situation grows and as accepted actuarial standards change.

Given these developments and the concern within the NAIC about the apparent practices of some companies with regard to their internal financial capacity, the NAIC appointed a special working group to suggest interim steps which might be taken to assure regulators that the current actuary's opinion on the reserves as being good and sufficient to provide for future guaranteed obligations had considered items which the regulators and the profession believe to be important.

I am chairman of the special working group, and it is our intent to suggest to the NAIC some specific approaches that it can take to create more validity with regard to the actuary's opinion. Our report will be considered in October by the task force of the NAIC. If it is acceptable at that time, Mr. John Montgomery is going to suggest it for adoption by the NAIC at its December meeting.

Our emphasis will be on developing a process for more effective surveillance suggesting methodology and approaches to be used by regulators in better executing their surveillance activity.

We believe there is room for definitions such that the burden of proof rests with the actuary making the opinion rather than the regulator. Additionally, we intend to suggest that the NAIC require appropriate documentation of the work product of the actuary making the opinion as he develops the basis for the opinion, and that the documentation be available for review if deemed appropriate by the regulators to whom the opinion was submitted. We also intend to focus our attention on the idea of third part opinions, the scope that they may have, and the authority of the regulator to obtain them.

The Academy already has made significant changes in its disciplinary process paving the way for the valuation actuary concept to be adopted. For the NAIC, there are some specific issues yet to be resolved with regard to non-Academy actuaries accredited by individual states; the issue of discipline or at least removal of accreditation needs to be addressed. It's my hope that the NAIC will use the Academy's disciplinary process for Academy members and establish in some way a similar process for those non-Academy members whom it wishes to allow to retain accreditation.

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More importantly, the NAIC could require Academy membership for all valuation actuaries and eliminate its need to deal with this issue. By establishing the Academy membership requirement, the NAIC would also not need to concern itself with a promulgation of standards of practice. However, even if non-Academy members were deemed qualified to render actuarial opinions, I believe that by remaining silent on standards of practice, the NAIC would essentially require non-Academy members to follow those Academy standards of practice because they would in fact be the definition of sound actuarial practice.

The suggested Recommendation 7 statement of actuarial opinion begins in this manner:

I, Walter S. Rugland, am a member of the American Academy of Actuaries and meet its qualifications to act as Valuation Actuary.

The words "and meet its qualifications to act as Valuation Actuary" are new to the opinion, and it is believed that this positive affirmation on the part of the valuation actuary is critical to the long-term integrity of the concept.

The Academy Committee on Qualifications is suggesting for Board approval exposures of revised qualification standards for actuaries signing statutory opinion for life and health companies. This revision contains more definitive discussion of the education requirements and alternate routes to their satisfaction. Additionally, the experience standard is significantly tougher in the proposed standards of qualification. Three years of experience under the supervision of a valuation actuary is proposed.

MR. RICHARD H. SNADER: I am a casualty actuary by trade employed by a property/casualty company with a relatively small life insurance subsidiary. I am also chairman of the Academy's Committee on Property and Liability Financial Reporting Principles. My responsibility is, thus, to give you the perspective of that committee with regard to the questions being addressed in this forum.

I can give you my impressions as an individual. My point of view is conditioned by a total lack of understanding of life insurance financial reporting principles and issues. It is further conditioned by a conservative personality that tends to resist change and rushes to embrace the status quo.

With that warning I plan to address three issues:

1. The feasibility of computerized financial statements,
2. The efficacy of a consolidated life/property and casualty blank, and
3. The Casualty Actuarial Society's view of the valuation actuary concept.

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Computerization

Property/casualty companies are accustomed to reporting large volumes of transactional data in electronic form to their various statistical agencies. It therefore would be feasible technically to report detailed financial data electronically as well. Electronic reporting of financial data need not be more detailed than current hard-copy reports. The reported data could be an electronic version of information now provided in printed statements; it could be provided as diskettes.

Electronic reporting implies accelerated or continuous reporting. Continuous reporting is not necessarily desirable; indeed, it is probably undesirable. The detailed information property/casualty companies now prepare for their statistical agents is not provided continuously. It is provided periodically like our financial statements are. We should not assume that continuous computerization will result in faster reporting, and deadlines should not become more stringent than the current ones. Faster reporting suggests that financial values can be produced mechanically without human intervention. But most financial reporting computation is already computer assisted. The time required to prepare financial reports is not needed for computations; it is needed for examination, investigation, analysis, and reflection. Financial values are not determined automatically by computer programs. Basic data input must be reviewed for reasonableness. Anomalies must be investigated and corrective action taken when needed. The final product must also be reviewed extensively for reasonableness.

In particular, claim reserving in the property/casualty field relies heavily on the informed judgment of the actuary. Informed judgment is stressed over rigid, "cookbook" approaches. Judgment is required in intermediate steps as well as in reviewing final results. Because of the inherent variability of the claim settlement process, expected reserve values fall within a wide range of possible outcomes, permitting wide latitude in applying judgment. Management has its opinions about where the reserve value should fall in these ranges.

In conclusion, electronic reporting on a modest scale will benefit insurance departments by easing their computational burden, but the notion of accelerated or continuous reporting of financial data is both impractical and undesirable.

Consolidated Statements

The idea of consolidated statutory statements at first seems appealing, but on closer examination it loses some of its appeal. The material I was presented with showed a single format for all lines of property and casualty business combined. Consolidated balance sheets, summaries of operations, cash-flow exhibits, and other supporting statements are not very meaningful. Companies do not operate as if they are single, monolithic entities. Therefore, it is not logical to portray them as if they are single entities in which the distinguishing characteristics of their segments are submerged by force-fitting financial data into one all-encompassing format.

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Most company systems are not geared for this format and would have to be completely retooled. Balance sheets, operating statements, and other exhibits should not be compiled by individual line of business. Thirty property/casualty lines would have to be added to the nine lines in the life blank. Not all information is easily allocable to line of business.

Current allocations of investment income, capital gains, and operating expenses are arbitrary in many respects and often produce anomalous results. Not all financial information is easily classified into direct, assumed, and ceded components, and it's illogical to attempt such allocations. Cash-flow items particularly do not lend themselves to refined allocations. How do you break down a bond sale into its direct, assumed, and ceded components, for example?

Assets should not be commingled. A combined Schedule D is probably not desirable. Separate Schedule D's are preferable because of different investment requirements for life versus property/casualty. Different parameters are involved in comparing assets and liabilities. For example, the property/casualty portfolio should ordinarily be shorter and more liquid.

Alternative

Instead of simplifying things, a consolidated statement increases complexity. A preferable alternative might be a consolidating statement which can be presented in a condensed format. This format would show consolidated data but would also clearly show the basic components of the enterprise separately. The overall format would be less elaborate, not more elaborate. The consolidating format would consist only of the balance sheet and summary of operations.

An example is shown in Exhibit 1 which is for a nameless company. We have a balance sheet and a summary of operations. There are five basic column headings: Life, Property/Casualty, Other, Eliminations, and Consolidated.

Financial items are displayed only for the segments to which they apply. Supporting exhibits and schedules would be custom-designed to support the individual segments and not the consolidated operations. Extensive footnote disclosure should accompany this type of presentation and would be used to report on intercompany transactions. Special emphasis could be placed on transactions between insurance and noninsurance segments.

Valuation Actuary

Casualty actuaries are somewhat bemused if not befuddled by the recent developments concerning valuation actuaries. The Society, of course, has taken a leading role in championing this concept, and the casualty actuaries are looking on from the sidelines. So they responded in the most natural way that they could -- forming a task force. And the

EXHIBIT 1

USF&G Corporation
Consolidating Balance Sheet
(\$ thousands)

June 30, 1985

ASSETS	Property/ Casualty	Life	Other	Eliminations	Consolidated
Investments:					
Fixed maturities, at amortized cost	\$2,667,827	\$355,157	\$ -	\$ -	\$3,022,984
Equity securities, at market:					
Common stocks	1,407,115	319	-	-	1,407,434
Preferred stocks	34,593	3,523	-	-	38,116
Short-term investments	177,649	22,006	17,733	-	217,388
Policy loans	-	27,961	-	-	27,961
Mtge. loans & other long-term investments	77,427	61,155	127,920	(17,494)	249,008
Total investments	4,364,611	470,121	145,653	(17,494)	4,962,891
Cash	33,006	3,859	1,365	-	38,230
Investment in subsidiaries	136,434	-	1,367,247	(1,503,681)	-
Accrued investment income	97,998	11,853	6	-	109,857
Accounts and notes receivable	450,077	7,317	170,986	-	628,380
Receivable from sale of securities	718,189	-	-	-	718,189
Reinsurance recoverable on paid losses	32,250	-	-	-	32,250
Deferred policy acquisition costs	291,335	47,030	-	-	338,365
Property & equip., at cost, less accum. depr.	82,128	-	22,433	19,663	124,224
Other assets	328,820	2,111	271,512	(354,476)	247,967
Total assets	\$6,534,848	\$542,291	\$1,979,202	\$(1,855,988)	\$7,200,353
LIABILITIES					
Unpaid losses, loss expenses & policy benefits	\$3,061,187	\$350,924	\$ -	\$ -	\$3,412,111
Unearned premiums	1,066,534	-	79,552	-	1,066,534
Securities sold subject to repurchase	358,525	-	175,070	-	438,077
Short-term borrowings	-	-	-	-	175,070
Other policyholders' funds	57,003	40,834	-	-	97,837
Dividends payable to stockholders	-	-	33,237	-	33,237
Deferred income taxes	(802)	9,092	2,889	-	11,179
Payable for securities	414,210	-	-	-	414,210
Other liabilities	251,746	5,007	368,283	(354,476)	270,560
Total liabilities	5,208,403	405,857	659,031	(354,476)	5,918,815
STOCKHOLDERS' EQUITY					
Capital stock	\$ 70,949	\$ 2,000	\$ 155,836	\$ (73,399)	\$ 155,386
Paid-in capital	526,228	21,775	266,021	(586,189)	227,835
Net unrealized apprec. (deprec.) of equity securities	89,400	(997)	88,912	(92,691)	84,624
Net unrealized loss on foreign currency translation	(7,272)	-	(7,272)	7,272	(7,272)
Retained earnings	647,140	113,656	867,616	(756,505)	871,907
	1,326,445	136,434	1,371,113	(1,501,512)	1,332,480
Less: Treasury stock, at cost	-	-	(50,942)	-	(50,942)
Total stockholders' equity	1,326,445	136,434	1,320,171	(1,501,512)	1,281,538
Total liabilities and stockholders' equity	\$6,534,848	\$542,291	\$1,979,202	\$(1,855,988)	\$7,200,353

USF&G Corporation
Consolidating Balance Sheet
(\$ thousands)

June 30, 1984

ASSETS	Property/				Eliminations	Consolidated
	Casualty	Life	Other			
Investments:						
Fixed maturities, at amortized cost	\$2,203,729	\$242,199	\$ -	\$ -	\$ -	\$2,445,928
Equity securities, at market:						
Common stocks	1,055,454	42,046	30,923	-	-	1,128,423
Preferred stocks	24,412	2,900	-	-	-	27,312
Short-term investments	83,991	12,346	675	-	-	97,012
Policy loans	-	29,602	-	-	-	29,602
Mtg. loans & other long-term investments	10,864	26,608	94,016	1,570	-	133,058
Total investments	3,378,450	355,701	125,614	1,570	-	3,861,335
Cash	22,752	2,066	405	-	-	25,223
Investment in subsidiaries	-	-	1,113,418	(1,113,418)	-	-
Accrued investment income	91,259	8,088	7	-	-	99,354
Accounts and notes receivable	346,870	5,281	86,772	-	-	438,923
Receivable from sale of securities	552,219	-	-	-	-	552,219
Reinsurance recoverable on paid losses	60,410	-	-	-	-	60,410
Deferred policy acquisition costs	235,522	45,427	-	-	-	280,949
Property & equip., at cost, less accum. depr.	77,806	-	115,171	(48,792)	-	144,185
Other assets	211,220	3,099	196,912	(322,970)	-	88,261
Total assets	\$4,976,508	\$419,662	\$1,638,299	\$(1,483,610)	-	\$5,520,859
LIABILITIES						
Unpaid losses, loss expenses & policy benefits	\$2,442,789	\$248,853	\$ -	\$ -	\$ -	\$2,691,642
Unearned premiums	851,025	-	-	-	-	853,025
Securities sold subject to repurchase	-	-	-	-	-	-
Short-term borrowings	-	-	154,841	-	-	154,841
Other policyholders' funds	48,040	37,325	-	-	-	85,365
Dividends payable to stockholders	-	-	28,226	-	-	28,226
Deferred income taxes	28,588	19,207	3,119	-	-	50,914
Payable for securities	368,019	2	-	-	-	368,021
Other liabilities	253,065	5,281	285,869	(322,970)	-	221,245
Total liabilities	3,993,526	310,668	472,055	(322,970)	-	4,453,279
STOCKHOLDERS' EQUITY						
Capital stock	70,579	2,000	145,709	(72,842)	-	145,446
Paid-in capital	172,454	21,775	134,909	(215,655)	-	113,483
Net unrealized apprec. (deprec.) of equity securities	(75,678)	(6,491)	(86,029)	82,169	-	(86,029)
Net unrealized loss on foreign currency translation	(3,123)	-	(3,123)	3,123	-	(3,123)
Retained earnings	818,750	91,710	1,090,458	(957,435)	-	1,043,483
Total stockholders' equity	982,982	108,994	1,281,924	(1,160,640)	-	1,213,260
Less: Treasury stock, at cost	-	-	(115,680)	-	-	(115,680)
Total liabilities and stockholders' equity	\$4,976,508	\$419,662	\$1,638,299	\$(1,483,610)	-	\$5,520,859

EXHIBIT 1 -- CONTINUED

Consolidating Statement of Income
(dollars in thousands except per share data)

	Six Months Ended June 30, 1985				
	Property/ Casualty	Life	Other	Eliminations	Consolidated
Revenues:					
Premiums earned	\$1,323,442	\$ 97,615	\$ -	\$ -	\$1,421,057
Net investment income	243,205	22,551	(2,463)	(574)	262,719
Other	662	-	26,296	(17,740)	9,218
Total revenues	<u>1,567,309</u>	<u>120,166</u>	<u>23,833</u>	<u>(18,314)</u>	<u>1,692,994</u>
Expenses:					
Losses, loss expenses and policy benefits	1,148,219	98,351	-	-	1,246,570
Underwriting, acquisition and operating exp.	420,879	15,736	35,633	(18,314)	453,934
Dividends to policyholders	18,298	572	-	-	18,870
Total expenses	<u>1,587,396</u>	<u>114,659</u>	<u>35,633</u>	<u>(18,314)</u>	<u>1,719,374</u>
Operating income (loss) before income taxes	<u>(20,087)</u>	<u>5,507</u>	<u>(11,800)</u>	<u>-</u>	<u>(26,380)</u>
Provision for income taxes:					
Current (benefit)	156	(2,634)	8	-	(2,470)
Deferred (benefit)	181	(744)	-	-	(563)
Total	<u>337</u>	<u>(3,378)</u>	<u>8</u>	<u>-</u>	<u>(3,033)</u>
Operating income (loss)	(20,424)	8,885	(11,808)	-	(23,347)
Realized gains (losses) on investments	<u>12,415</u>	<u>830</u>	<u>(2,045)</u>	<u>326</u>	<u>11,526</u>
Net income (loss)	<u>\$ (8,009)</u>	<u>\$ 9,715</u>	<u>\$ (13,853)</u>	<u>\$ 326</u>	<u>\$ (11,821)</u>
Earnings per common share:					
Operating income (loss)	\$ (.36)	\$.16	\$ (.21)	\$ -	\$ (.41)
Realized gains (losses) on investments	.22	.01	(.04)	.01	.20
Net income (loss)	<u>\$ (1.14)</u>	<u>\$.17</u>	<u>\$ (.25)</u>	<u>\$.01</u>	<u>\$ (1.21)</u>

EXHIBIT 1 -- CONTINUED

Consolidating Statement of Income
(dollars in thousands except per share data)

	<u>Six Months Ended June 30, 1984</u>				
	<u>Property/ Casualty</u>	<u>Life</u>	<u>Other</u>	<u>Eliminations</u>	<u>Consolidated</u>
Revenues:					
Premiums earned	\$1,003,312	\$ 73,652	\$ -	\$ -	\$1,076,964
Net investment income	210,023	17,777	2,514	-	230,314
Other	368	-	12,891	(9,967)	3,292
Total revenues	<u>1,213,703</u>	<u>91,429</u>	<u>15,405</u>	<u>(9,967)</u>	<u>1,310,570</u>
Expenses:					
Losses, loss expenses and policy benefits	908,372	68,592	-	-	976,964
Underwriting, acquisition and operating exp.	339,231	13,196	14,497	(9,967)	356,957
Dividends to policyholders	18,687	692	-	-	19,379
Total expenses	<u>1,266,290</u>	<u>82,480</u>	<u>14,497</u>	<u>(9,967)</u>	<u>1,353,300</u>
Operating income (loss) before income taxes	<u>(52,587)</u>	<u>8,949</u>	<u>908</u>	<u>-</u>	<u>(42,730)</u>
Provision for income taxes:					
Current (benefit)	(19,527)	(2,450)	57	-	(21,920)
Deferred (benefit)	(83,072)	4,089	305	-	(78,678)
Total	<u>(102,599)</u>	<u>1,639</u>	<u>362</u>	<u>-</u>	<u>(100,598)</u>
Operating income (loss)	50,012	7,310	546	-	57,868
Realized gains (losses) on investments	<u>35,780</u>	<u>(1,546)</u>	<u>(1,137)</u>	<u>(48,502)</u>	<u>(15,405)</u>
Net income (loss)	<u>\$ 85,792</u>	<u>\$ 5,764</u>	<u>\$ (591)</u>	<u>\$ (48,502)</u>	<u>\$ 42,463</u>
Earnings per common share:					
Operating income (loss)	\$.93	\$.13	\$.01	\$ -	\$ 1.07
Realized gains (losses) on investments	.66	(.03)	(.02)	(.90)	(.29)
Net income (loss)	<u>\$ 1.59</u>	<u>\$.10</u>	<u>\$ (.01)</u>	<u>\$ (.90)</u>	<u>\$.78</u>

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task force has acted quickly. It has made a report already to the Casualty Actuarial Society Board of Directors, and in that report, the task force concluded that "the principles underlying the Society of Actuaries/Academy of Actuaries joint committee report apply in full measure to property/casualty companies in general and to casualty actuaries in particular." The Board, however, is not entirely convinced; questions remain unanswered.

For example, how many valuation actuaries should there be? Should there be one valuation actuary for a multiline company? We feel there is a need to distinguish between life and property/casualty. No one individual could possibly serve as the valuation actuary for both types of insurance in a multiline operation. In fact, it is possible that a single life individual might not be able to completely fill the valuation actuary role for all aspects of a complex property/casualty operation. Currently, the casualty actuary who issues an opinion on claim reserves is not necessarily the individual who selects the assumptions or establishes calculating procedures. There is concern over the notion that one individual, the valuation actuary, would play such a key role in making decisions affecting the company's statement of financial condition. This could be viewed by some as usurping management's prerogatives.

Revised Academy Interpretation 8-B, which is the property counterpart to Interpretation 7, advises the casualty actuary to consider the inherent variability of conditions affecting claim payments and provide for adverse development, or adverse deviations, if required by circumstances. The actuary is further advised to consider the time period over which reserves will extend, current and expected rates of return, and expected cash flow from assets. It would seem, therefore, that the opinion expressed in accordance with Interpretation 8-B can be made only after appropriate consideration has been given to all the elements specifically stated in the opinion wording suggested in the Joint Committee's final report. Perhaps, then, such specific wording as suggested by the Joint Committee appearing in the opinion statement itself is unnecessary.

MR. WILLIAM J. SCHREINER: I will present an independent view on the question "Has the NAIC annual statement blank outlived its usefulness?" This is a most enviable role as it does not require me to come up with new ideas -- I can just poke at those of others -- or present arguments that are consistent from one point to another -- a most difficult requirement. My objective is to look at some of these items from an untraditional perspective to stir up some new thinking.

Has the NAIC Annual Statement outlived its usefulness? Today the blank is a balance sheet, a summary of operations with a capital and surplus display, a statement of changes in financial position, two tables of analysis, fourteen exhibits, two pages of historical data, life and annuity exhibits, thirty-one general interrogatories, and fourteen notes and seventy schedules or parts of schedules as well before we come to the State Page. I doubt that one could find a better example of disclosure overload.

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Regulators love checking the arithmetic in the annual statement regardless of its materiality. They also love reporting on everything that possibly can be reported on regardless of its pertinence to solvency. Therefore, the first conclusion that one must make about today's annual statement is that it is about to implode simply of its own weight. For our second conclusion, look at the most important solvency reporting exhibit -- the balance sheet. On the left-hand side of the page, assets are valued on several different bases depending on the nature of the asset: market value for common stock, amortized value for bonds, and so forth. Is there any rational meaning that can be placed on the sum of the nominal values of the assets? Similarly on the right-hand side of the page, you find nominal values for liabilities that do not and cannot reflect the real value of those obligations. Consider the wide range of valuation bases that are permitted for life and annuity products. Those valuation bases can apply to the same product issued by the same company or the same product issued by different companies, and you will have valuation bases as shown by those companies. After you get the sum of the assets and the sum of the liabilities, each of which properly might be termed imaginary numbers, you subtract one from the other to determine whether a company is solvent and will be permitted to continue its business.

Mr. Montgomery's proposal now has ten pages and thirty exhibits. That might look like a big improvement over the current version. Unfortunately, it's still minutia-oriented. Those thirty exhibits are designed to back up the primary statement presentations and to verify the footing of those numbers. This proposal perpetuates the major regulatory problem that currently exists -- too many regulators spending their time cross-checking entries, rather than evaluating the financial condition of the company. What can be done? First, establish the purpose of the annual statement. It should be exclusively a financial document which assists the regulators in evaluating the company's ability to fulfill its promises. Anything that does not contribute to that end should be ruthlessly eliminated. It should contain a balance sheet, an income statement, a cash-flow statement, and maybe a schedule of assets. No market or management conduct information should be included. That information should be supplied separately if needed. It should not be a document for cross-checking entries. If the regulators are concerned about the accuracy of the material figures, they should require an independent certified public accountant to opine on whether or not the document was properly prepared.

From a solvency viewpoint, consolidated statements for affiliated companies are not needed. Consolidated statements are income-driven and are not solvency-oriented. Related companies do not fail as a group, they fail individually. What may be needed, however, is segregation and display of transactions between affiliated companies and perhaps, ultimately, some level of regulatory control over transactions between affiliates.

The instantaneous or continuous annual statement allows access to the company's records automatically by the regulator on a computer-assisted basis. This breaks down to nothing more than a review of cash

USEFULNESS OF THE NAIC ANNUAL STATEMENT BLANK

accounting. Cash accounting for evaluating the solvency of commercial enterprises was abandoned by the accounting community several centuries ago, when accrual accounting was invented. A more effective way of achieving more timely reporting would be to have quarterly reporting of the basic financial information.

Regulators also love market value valuations, at least of the asset side of the insurer's balance sheet. Unless you are willing to evaluate the liability side of the balance sheet on a market value basis, you don't get anything from a market value valuation. Of course, that implies using judgment in establishing the value of those liabilities -- something the regulatory community is not comfortable with. I am not even sure that using market value on both sides of the balance sheet is useful unless, of course, you are going to liquidate or sell the company today. But the current market value of the assets, by itself, does not tell me anything about a company's ability to meet its obligations. For example, if I own government bonds that will pay me \$1 million fifteen years from now, and I owe someone \$1 million payable fifteen years from now, the fluctuating interim market value of that asset has nothing to do with the simple fact that I will meet that obligation.

The regulators are asking the financial statement to do too much. No financial analyst is going to come to an investment decision about a company solely on the basis of its financial statement; he or she will also evaluate the marketplace, the company's products, and other pertinent information. Insurance companies get into trouble by selling their product too cheaply.

Companies make promises that cannot be met from the price they charge for their product. Ultimately, the financial statement will show this. However, long before that happens, it will show in the marketplace. Anyone who is significantly better than the marketplace is wrong. A company with a premium 15 percent better, or an interest rate 1 percent better than its neighbors should set off a regulatory red alert. Therefore, it is not enough for the regulators to sit in their offices reviewing financial statements. There is much with respect to financial solvency that the marketplace can tell them, and they should be pursuing this information.

Who is this valuation actuary, and what is he or she supposed to do? I suppose the valuation actuary is to form a judgment as to whether or not a company is going to be able to make good on its promises. Where does actuarial judgment come from? One becomes an actuary by passing examinations, and none of those examinations has a judgment major or minor. Some actuaries have terrific judgment; others have terrible judgment. Some are liberal; some are conservative. Whatever the outcome of the valuation actuary debate, it should not be based on purported virtues of actuarial judgment.

In all this talk about the valuation actuary, what are the state regulators supposed to do? It seems clear that the regulators are already legally charged with the responsibility of judging whether or not a company is going to make good on its promises, and moreover, they are the sole party which has the legal ability to take steps to protect

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the public from unsound companies. Simply put, the valuation actuary is already in place and is called the state insurance regulator.

I suppose some might say that the insurance departments do not have the financial or personnel resources to do this job. There are literally thousands of state insurance regulators. There are 670 in New York, 600 in Texas, and so on. Even if you allocate two-thirds of their staff to property and casualty matters, New York by itself has over 200 regulators available to regulate life and health insurance companies. And how many companies actually need close supervision -- 50, 100, 200? The manpower is already in place, it only needs to be used effectively. Now, some may say that you cannot afford to pay enough money to attract the right people to do the job. In 1983, state tax collections from life and health insurance companies were \$1.5 billion. The money is there. What you are really saying is that the public doesn't want to spend its tax money to appropriately regulate insurance companies. They would rather have highways, schools, and welfare. Well, if the public is not willing to pay for appropriate supervision directly, is it the role of the actuarial profession to create an indirect, duplicating cost to that public via the creation of the valuation actuary (a creation which has no secure legal standing and is going to be dragged into court every time a company goes bankrupt)? A cynic might say that the valuation actuary is nothing more than a shield -- a safe harbor -- for negligent regulators.