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**STATEMENTS OF ACTUARIAL OPINION
AND THE VALUATION ACTUARY**

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- o A discussion of the current status of the valuation actuary concept and regulatory requirements.
 - Current developments regarding the valuation actuary and related issues, including the American Council of Life Insurance and National Association of Insurance Commissioners (NAIC) positions/actions
 - Implementation of the valuation actuary concept
 - A top management perspective on the valuation actuary concept
 - Is there agreement on need?
 - Is there sufficient support?
 - Is the industry/profession ready to implement the valuation actuary concept?

MR. BURTON D. JAY: *As chairman of the Joint Committee on the Valuation Actuary I have been asked to set the stage for this panel by summarizing the current and recent activity of the various committees, task forces, and other groups that are involved in a material way in the valuation actuary movement. The joint committee is charged with the responsibility of staying current with all of these activities and helping to coordinate the efforts by providing direct input to the groups involved and making recommendations to the boards of the organizations to which the joint committee reports. Generally, our recommendations are to the American Academy of Actuaries (AAA) and Society of Actuaries (SOA) boards, though we also have a reporting relationship to the boards of the*

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Casualty Actuarial Society (CAS), the Conference of Actuaries in Public Practice (CAPP) and the Canadian Institute of Actuaries (CIA). There are representatives of each of these organizations on the joint committee.

It may be useful to digress just a bit with a little history of the valuation actuary movement. For many years the actuary's responsibility for valuation operated within a narrow framework of duties and responsibilities. All that was really expected was that the actuary make sure that the valuation process was performed accurately and that the reserves established met precisely defined minimum requirements as to methods and assumptions.

In June 1975, the NAIC adopted the requirement that the annual statement contain a statement by a qualified actuary providing his opinion that, along with meeting a few other requirements, the reserves established make a good and sufficient provision for all unmatured obligations of a company that are guaranteed under the terms of its policies. The Academy of Actuaries followed with recommendations and interpretations delineating the responsibility of the actuary in developing this opinion. This occurrence might be viewed as the beginning of the valuation actuary movement.

Later in the 1970s, the movement within the actuarial profession and the regulatory community began to expand to broaden the role and responsibilities of the actuary forming this opinion. This occurred with the increasing volatility of financial markets and interest rates and the introduction of interest-sensitive products. The valuation laws had operated on the theory that fluctuations in interest rates would occur only gradually and within narrow ranges. Changes seemed necessary if these conditions no longer applied. The thinking developed that it was no longer possible to prescribe specific statutory valuation standards that would be appropriate for all products under all circumstances. The product revolution and volatile economy lead to the recognition by many actuaries and regulators of a need to assign more responsibility to the valuation actuary in making a professional judgment as to the adequacy of reserves. This judgment was to be based on an analysis of an insurer's risks as opposed to a mere determination that reserves are at least equal to a rigidly defined minimum statutory standard.

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The 1980 amendments to the Standard Valuation Law (SVL) provided some relief to the rapidly changing conditions through its dynamic provisions for interest rate assumptions. It was recognized at the time, however, that this was merely an interim step. About the same time, much work was going on by the Society of Actuaries committee on valuation and related areas in defining and studying the C-1, C-2 and C-3 risks. Particular attention was given to the C-3 risk which is the risk of losses resulting from swings in interest rates.

The next significant step was the establishment in December 1983 of the Joint Committee on the Role of the Valuation Actuary in the United States by the boards of the AAA and the SOA. The committee was asked to make recommendations of the appropriate role for the valuation actuary and what is needed to affect and support this role. The final report of the joint committee was published in February 1985 calling for an official designation of a valuation actuary for each Life Insurance Company and that valuation principles, standards of practice, and qualification standards be established by the actuarial profession to guide and support the work of the valuation actuary. A much broader responsibility was defined incorporating professional judgment as to the adequacy of assets backing reserves as well as additional available assets for meeting a company's contractual obligations. An actuarial opinion and supporting actuarial report was described.

Since that report was adopted by the Board of the AAA and the SOA, the joint committee has been delegated the role of coordinating the implementation of the concept and securing its acceptance within the profession, the regulatory community and the industry.

Our monitor activities are conducted by dividing the groups into divisions, those related to regulatory bodies, those which are a part of three professional actuarial organizations and those sponsored by industry or insurance company management organizations. The list of players changes frequently, depending on what is going on, but I will give you a current list of the players in each of the three divisions that are most active at the present time and report on some of their recent and current activities.

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I. Regulatory Activities

- A. The NAIC Standing Technical Advisory Committee (STAC) and its Surplus and Solvency Subcommittee (SSS).
- B. The NAIC Life and Health Actuarial Task Force (LHATF).
- C. The NAIC Special Advisory Committee on Valuation Law Revision.
- D. The New York Insurance Department.
- E. Other insurance departments, where valuation actuary regulatory activity is underway or being discussed.

II. Professional Actuarial Activities

- A. The Interim Actuarial Standards Board (IASB/ASB).
- B. The AAA Committee on Life Insurance Financial Reporting (COLIFR).
- C. The AAA Committee on Qualification Standards.
- D. The SOA Committee on Valuation and Related Areas (COVARA).
- E. The SOA Committee on Life Insurance Company
- F. The CAS Committee on Valuation Principles and Techniques.
- G. CAPP Activities Related to the Valuation Actuary.
- H. CIA Activities Related to the Valuation Actuary.
- I. The Joint Committee on the Valuation Actuary.

III. Industry/Insurance Company Management Activities

- A. The American Council of Life Insurance (ACLI) Board of Directors.
- B. The ACLI Actuarial Committee.
- C. The National Association of Life Companies (NALC).
- D. Casualty industry activities related to the valuation actuary.
- E. The Health Insurance Association of America (HIAA) and other health insurance industry activity relating to the valuation actuary.

I will now go back and discuss some of these in a little more detail. The joint committee publishes a status report two or three times a year which covers the valuation actuary activities of each of these groups.

The Standing Technical Advisory Committee initiates and manages projects and reviews proposals for the NAIC Life and Health Actuarial Task Force. Its surplus and solvency subcommittee addresses issues involving the Standard Valuation Law (SVL). Last June the LHATF was given authority to study the recon-

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stitution of the SVL and the coordination of projects was assigned to the STAC/SSS.

The approach suggested by the Advisory Committee in December suggests that the ultimate goal is an Actuary's opinion as to the adequacy of the companies assets to enable it to meet its contractual obligations. This opinion would be separate from considerations for earnings reports, current legal solvency and tax payable calculations. It was agreed that this ultimate goal is not currently attainable. An interim goal will pursue a reconstituted SVL which focuses on the Actuary's opinion as to the adequacy of assets supporting the reserves on inforce business, together with the development of a minimum reserve approach which reflects the "risk position" of the company.

On recommendation of the STAC, the Special Advisory Committee on Valuation Law Revision was appointed by the NAIC reporting to the LHATF. The charge to the new committee is to develop a conceptual framework, then a draft of a new law and regulations which incorporates the concept of the valuation actuary considering solvency determination and coordinating all life insurance company lines of business.

The new law will utilize available valuation analysis techniques and reflect their feasible application. It will focus on an actuarial opinion as to the adequacy of assets supporting reserves on inforce business and be based on cash flow analysis or other appropriate emerging technology.

The New York Insurance Department is now in the process of preparing a regulation similar to 126 that will apply to single premium life business. A draft of this regulation has already been presented to the ACLI Actuarial Committee for review. It is intended for adoption this year and may apply to business written since 1982. There is also a plan to make regulation 126 apply to all annuities for 1987 statements, speeding up the original schedule. Next year the department plans to expand the New York Valuation Law and Regulations to cover universal life.

There is not a lot going on in the other states currently, with respect to valuation issues, though Washington State adopted a requirement that applied to 1986

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statements for an actuarial opinion on the effect of aids on the adequacy of reserves.

The largest number of committees and the other groups that the joint committee is monitoring is in the Professional Actuarial Division. A very important function in that area is the development and promulgation of standards of practice. A revised Recommendation 7 was exposed to the Academy Membership in the summer of 1986 as a discussion draft. Recommendation 7 is the practice standard relating the academy members who sign the Statement of Actuarial Opinion in the annual statement. The Committee on Life Insurance Financial Reporting has prepared a second revised draft of Recommendation 7 based on the many comments received on the first revised draft during its exposure period but has held off on re-exposure pending a clearer view of what the new Standard Valuation Law would look like. In fact, a number of actuaries believe that a revised Standard of Practice for Valuation Actuaries should not be adopted until the NAIC has adopted a new model law.

Earlier this year Interim Actuarial Standards Board expressed disagreement with those who would wait and asked its Life Operating Committee to request the Committee on Life Insurance Company Financial Reporting to recommend a practice standard for valuation actuaries which would focus on the adequacy of assets and incorporate modern technology. A confidential report to management would be required describing the assumptions and techniques used and the results obtained. A remaining issue among those involved in the project is whether cash flow testing or other recently developed techniques should actually be required in most situations by the new standard. It appears likely that the standard will not initially go quite that far.

The academy's committee on qualification standards exposed a new qualification standard for valuation actuaries in the form of a discussion draft in 1985 at the same time that the practice standard discussion draft was exposed. The qualification standards committee will develop a revised qualification standard document for exposure when the related practice standard exposure draft is available. We anticipate that this will all come together very soon and that both drafts will be out for exposure later this year.

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The Society of Actuaries research arm most involved in this effort is the committee on valuation and related areas. This is the committee that includes the familiar C-1, C-2, C-3 risk and combination of risks task forces.

The C-1 risk task force is completing a study of bond default analysis. The final report, which is expected later in the year, will address bond default and recovery experience with illustrations of the application of cash flow techniques.

The C-2 risk task force has recently completed a study on the adequacy of the 1980 CSO mortality table in view of AIDS, product anti-selection and various underwriting procedures. They have also recently produced a cash flow illustration of group health business.

The C-3 risk task force is producing a report on product by product cash flow techniques and plan to follow-up with a report on a combination of products with offsetting cash flow characteristics and coordinated dynamic investment strategies. The combination of risks task force has recently circulated their final report illustrating cash flow techniques combining C-1, C-2 and C-3 risks and including a thorough discussion of the C-4 risk.

The Society of Actuaries Board adopted a process for articulating actuarial principles at its October 1986 meeting. There now exists a framework within which the set of life insurance company valuation principles can be exposed and officially recognized. The Committee on Life Insurance Company Valuation Principles submitted a discussion draft of proposed valuation principles to the membership in April of last year. The document was revised, taking many comments received into account, and polished considerably. Earlier this week the Society Board approved the current document for exposure in accordance with its new procedure.

This committee has also prepared a *Valuation Actuary's Handbook* to provide guidance to practice valuation actuaries. This 350 page document was to be available for purchase this month, though I have not yet seen an announcement.

The CAS committee on valuation principles and techniques has recently been formed and met earlier this month to: (1) develop its statement of charge, (2) develop a format for valuation principles and techniques for property/casualty

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insurance, and (3) make plans to participate in this fall's Valuation Actuary's Symposium, which will be September 30 - October 1 in Dallas.

The Conference of Actuaries in Public Practice does not have a separate committee or task force on the valuation actuary, but utilizes its representative on the Joint Committee, in conjunction with its Committee on Life, Health and Casualty, to keep the conference abreast of current activities and to make sure the viewpoints of the consulting actuary and the conference are represented. The first draft of a conference report on the valuation actuary was circulated last June and is still under review. It was to have been presented to the conference board at its meeting earlier this month. Several sessions on the valuation actuary are planned for this year's annual conference meeting in the Fall.

Much is going on north of our border in the valuation area. I will merely skim highlights. In November 1985, the CIA's Committee to Evaluate the Role of the Valuation Actuary filed its report to the CIA council which concluded that the role should be broadened in three ways:

1. The actuary's opinion should encompass anticipated future new business as well as existing inforce;
2. The actuary should be responsible for monitoring the financial situation of the company on a continuous and ongoing basis; and
3. The valuation actuary should report to the company's board at least annually and more often if conditions warrant. This committee remains active to oversee the implementation of its report.

The CIA committee on financial reporting is dealing with Canadian GAAP issues, setting more definite direction through the development of technique papers as well as formal recommendations. Finally, the CIA committee on solvency standards is studying the actuarial aspects of testing the solvency of all types of financial institutions with fiduciary responsibilities.

The Joint Committee on the Valuation Actuary recently distributed its April status report to its parent boards covering the activity I am reporting on here, in even greater detail. The committee also has developed a reflections paper,

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providing our current thoughts on our 1985 report in view of events which have occurred since that time, and a strategic direction statement outlining our concept as to who should do what and when to implement the valuation actuary concept. The boards of the SOA and AAA have reviewed these last two documents and have directed us to redraft and combine them into a single report to be resubmitted later this year. We would like to give this combined document rather wide distribution after it has been approved by the boards.

In our role of monitoring and influencing the ongoing activity, we recently provided input to the issue of whether the new standard of practice should require cash flow testing. Our position is that the new standard should be developed and describe the use of the new techniques, but stop short, for the present time, of making such tests mandatory.

The members of the joint committee and others involved with the valuation actuary movement recognize that the concept will not be implemented on a national basis without the support of the insurance industry and company management. In the Fall of 1985, the ACLI designated a task force on the valuation actuary to explore the concept of the valuation actuary, its origin, its progress, its limitations, and the form of the concept that should be supported by the ACLI as means to help prevent insolvencies. The task force met several times and developed a report that recommended that the ACLI generally support the strengthening of the valuation actuary to the extent that it does not infringe on proper management prerogatives or generate costs that are out of line with potential benefits. The task force report was adopted by the ACLI board in September of last year. Ian Rolland will cover the report of this task force and the Board's reaction in more depth.

The ACLI actuarial committee is monitoring the development of the 1987 amendments to the New York valuation law to expand elements of the valuation actuary concept to single premium life products. The committee is also following the work of reconstituting the Standard Valuation Law. The actuarial committee may recommend ACLI positions in either of these areas when it feels it is appropriate to do so.

The National Association of Life Companies (NALC) is a trade association for life companies generally regarded as representing the small-to-medium size

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companies. They currently do not have specific committees or groups assigned to valuation actuary matters, but the organization's executive director has been very active in keeping abreast with the activities, providing input of the processes and informing the membership. The primary concerns of the NALC is the cost of valuation actuary work to small companies. They would like to see a rather broad exemption for "safe, small" companies.

As you can see, there is much going on in the valuation actuary area and the movement continues to gather momentum. However, there are still divergent points of view among members of the actuarial profession as well as insurance industry management. You will get at least a taste of this from some of the other members of our panel. It is an interesting time to be an actuary! Do any of you long for "the good old days"?

MR. WALTER S. RUGLAND: I've been asked to address several questions with respect to the valuation actuary: Where are we going? What steps are planned? What does the current effort mean to us? What are the major issues and problems? What is my prognosis?

First of all; where are we going? We're going forward at a pace that's adequate to keep us from sliding backward. My comments start with the determination by the NAIC in June of 1986, to undertake a fresh look at valuation. At that NAIC meeting, the Life, Health, and Annuity Task Force requested authority of the NAIC to proceed with a study of reconstitution of the Standard Valuation Law. The project description specifically incorporated three items: 1) concept of the valuation actuary, 2) a basis for solvency determination and 3) coordination in the law of life, health, annuity, credit and miscellaneous lines of business.

The NAIC at that meeting authorized the project and a part of that authorization assigned a support role to the Standing Technical Advisory Committee (STAC). In October of 1986 the STAC came back back to the Task Force with a preliminary report as to the direction and the concept that should be pursued. It suggested the ultimate objective of the NAIC should be overall asset adequacy as reflected in current and projected balance sheet solidity. It also noted that that objective was not obtainable in the near term, but that it was important to move toward the ultimate objective and to address current needs utilizing available techniques.

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Let's discuss the concept "asset adequacy." The question is: Do current and projected assets support current and projected liabilities? We indicated at that time that technology is not refined enough to implement this concept and that the operational framework is unable to currently encompass it. So we told the NAIC that we must search for something else. Another issue is: Do current and projected assets support current and projected liabilities? It was pointed out that you can subdivide that into: Do current assets support current liabilities? It's with that in mind that we began to look for a near term view of how to reconstitute the valuation law.

In the report to the NAIC last October STAC also spent some time talking about the long term view. The long term view was identified as an opinion of adequacy of all assets. To set the stage for a proposal which incorporates this thrust, major efforts are needed. First of all, the actuary must be prepared to prepare a professional report on the adequacy of the company's assets as they are reported. Actuarial methodology, techniques and standards of practice must be developed to do that. It's envisioned that the report will be for management and subject to the normal exam confidentiality rules of regulators who use it.

A second item is that life insurance company management with the support of accountants, actuaries and others must structure a framework for reporting earnings for the current period which is essentially independent of the work produced and used by the actuary in providing the report on asset adequacy. In other words, earnings have one purpose. The actuary's view of asset adequacy has another purpose.

Thirdly, the regulators, with the support of actuaries life insurance company management and others, must establish an appropriate method for determining legal solvency. This would require a definitive basis for a current solvency test; this involves a test entirely separate from the report on asset adequacy. Asset adequacy analysis focuses on an extended growing business assumption, and the currency solvency test has a basis in actual current accounts as legally defined. An actuary's opinion or report on current inforce business liabilities may or may not be a part of the solvency test.

Fourthly, tax considerations need to be considered. This long term view is thought to not be attainable at this current time. The scientific basis for parts

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of it are lacking, obviously the structures are not in place, and there is significant operational discomfort with many of the concepts. On the other hand STAC told the NAIC that this described the best objective for the long term for valuation.

The preliminary report then said that the near term objective should focus on the qualified actuary's opinion of adequacy of assets supporting reserves for inforce provisions, and that that opinion should be based on cashflow analysis and other technologies. It should provide opportunity for the variation in the minimum reserve that's established depending on company risk management postures.

There are two components here: one is the actuarial opinion and the second is the dynamic solvency test. Dynamic solvency is a test which adjusts for a company's risk management posture. The dynamic solvency aspect says that we should recognize the current critical need for capital efficiency within the life insurance industry, and recognize also that capital is inefficiently allocated to reserves if the reserve formula is redundant in terms of the risk it covers. A dynamic approach that correlates the appropriate reserve level to the risk level involved should be a basic premise of the work in the near term with regard to valuation restructuring.

In October we presented this concept. In December the NAIC Task Force approved proceeding with the concept as presented. STAC was then asked to convene the special committee and this was done on February 6. The Co-chairpersons selected were Robert Maxon, Corporate Actuary of the Aetna Life & Casualty and Carl Ohman, Corporate Actuary of the Equitable Insurance Society of the United States.

There was an effort made in convening the Special Advisory Committee to do a broad solicitation of members. The response has been amazing. Many people show up; all meetings are open, and all contributions are welcomed. Appointees include actuaries, lawyers, investment people, consultants, company senior management, and one company CEO.

The timetable for the committee is important to note. The NAIC Task Force said come back to them in March of 1987 with some more ideas in terms of the long

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term. We went back and said that it was premature to do anything more on the long term that has not happened and will not happen for a while. In October of 1987 there is to be a discussion paper for the short term. Whether it takes place depends on what the committee wishes to do.

There are some specific issues on which I would like to comment. One of them is the valuation actuary concept. What does the valuation actuary concept mean? I believe the valuation actuary, as a concept, means assurance given to management that the company's current financial structure provides the necessary resources to meet currently promised benefits as they occur in the future. The current effort of the Special Advisory Committee, focuses this concept on existing business.

There is a question before the advisory committee as to whether there should be an actuaries report, an opinion, or both. That will be discussed by the committee. John Montgomery of California has said that he would be satisfied with a report. Bob Callahan of New York said he would, too, but that he would also like an opinion. The important thing is that they both would like to have a documented basis for the actuaries analysis.

If we had an opinion what would it be? Well, in terms of public exposure, there has been an opinion in the 1985 discussion draft that came from the Academy's Financial Reporting Committee. It says: The anticipated investment cash flows arising from an allocation of assets equal to reserves and other liabilities, plus anticipated consideration to be received from the inforce policies, make appropriate provision, according to presently accepted standards of practice for the anticipated cash flows required by contractual obligations, and the related expenses of the company. The final opinion if there is one may have those characteristics. We're a long way from identifying whether there will be an opinion, and if so, what it will be.

The charge to the NAIC Special Advisory Committee is important to note. The committee is charged first to develop a conceptual framework. From that will be drafted a model law and accompanying model regulations to replace the current Standard Valuation Law. This will include among other things, incorporating the concept of the valuation actuary, considering solvency determination, and coordinating all lines of business. The new Standard Valuation Law and regulation will

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utilize current available analysis techniques and reflect their feasible application. It will have as its major focus an actuarial opinion on the adequacy of the assets supporting reported reserves which provide for inforce provisions. The opinion will be based on cashflow analysis and other emerging technology as deemed appropriate. The new SVL and regulation will also redefine the test for solvency as it utilizes reported reserves, so that the effectiveness of the company risk management procedures, as reported by the opinioning actuary, serves as a basis for the applicable minimum reserve level.

Since February the Special Advisory Committee has been meeting on a monthly basis. In April, it decided it should put together some working groups. These working groups are in place: the traditional life working group covers individual group and other types of traditional business; the interest sensitive life working group is self descriptive; the health working group covers individual and group issues; the annuity and pension is essentially asset accumulation products; a small company working group is dealing with small company concerns as they emerge; The investment matters working group is dealing with the structure of the balance sheet (assuming a specific interest is the MSVR and other types of contingency funds which the current statement requires); the reinsurance working group is dealing with reinsurance issues as they affect all aspects of valuations, especially letters of credits surplus relief, etc; the Federal Income Tax working group is to serve as a monitor for the impact of the proposed revision as it effects taxes; and the legal structure working group is trying to determine how the law ought to be put together.

Some of the issues being faced in the Special Advisory Committee merit comment. What should the minimum solvency test be? This is an attempt to structure the law so that there is a defined definition, but management's focus on this definition is less than on the one concerned with adequacy.

Another issue is how should the law look? One of the points here is whether the new law replaces the old law or whether it should be like has been done before, and say that for business issued after tomorrow, this new provision applies. Another item is whether the law should be a regulation as opposed to a law, and, if it is a regulation, how much law do you need to have other than to set the regulation.

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Another point which is being researched is to move valuation into the same format as the instructions to the annual statement. The States essentially say they will live with what the NAIC says with regard to the statement unless they choose to do otherwise and one of the thoughts here is that we might be able to do the same with the valuation process.

We also need to establish necessary authority in this revision of the law as well as scope out all the regulations in the approach to that authority. This includes who has responsibility and what the statutory charge is for the actuary as well as other people involved; to what extent should reliance be expected; and the overall question of responsibility.

The small company concerns say let's focus on the risk, but not over do it. Safe harbors, if possible, make sense, but I think there's general agreement that the small company should not escape a requirement for necessary work because it is small. It should escape if its risk posture is such that it doesn't need to do some of the work. If that's the case, all companies should benefit from that effort if they have similar postures.

Guaranteed funds effects have been recognized. It is not clear how the Special Advisory Committee will deal with them, but they will need attention. As for taxes, I believe that the tax implications will drive the implementation process of the suggested new law. If tax effects are not adequately addressed, and satisfied, we will not have a new law that's much different from what we have now.

The purpose of the Special Advisory Committee is to reach a consensus of all the constituencies involved as to how the valuation law ought to look for the next decade or two. Those constituencies include: management, regulators, professionals and, perhaps, the public.

What are my thoughts with regard to a prognosis? I believe there will be a change in the law. The question is which way it will go and how it will look. We have a unique opportunity in the industry and in the profession. Perhaps it's a one-in-fifty year opportunity to change the basic structure of an industry. The work requires a forward focus and needs to be in anticipation of what the industry will be like in 25 years. In the end, the result of this effort will reflect the wants of the constituents. That's the bottom line; we will get out of

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it what we wish to get out of it and the constituents will have a great influence on the future in which they will live.

MR. IAN M. ROLLAND: A couple of years ago, the ACLI formed a CEO Task Force to look at the problem of regulation for Life Company solvency. There were at least two motivating forces; large potential guaranty fund liabilities, and bad publicity for our industry such as resulted from the Baldwin-United calamity.

One of the recommendations of that Task Force, which I had the honor to chair, was that the ACLI form a group to look into the concept of the Valuation Actuary. It was the feeling of our group that, although there might be many problems to overcome in implementing it, the concept held great promise in dealing more effectively with Life Company solvency.

I should add that there was also an unspoken feeling that moving away from rigid statutory valuation formulas and toward the valuation actuary would enable our industry to make much more efficient use of capital. There is among CEOs a belief that many current statutory reserve requirements are redundant.

Here is a summary of the report of the ACLI group which looked into the valuation actuary concept:

1. Support strengthening the role of the valuation actuary, to the extent this does not infringe on proper management prerogatives or generate excessive costs;
2. Support regulatory requirements to require either the Board of Directors or someone designated by the Board of Directors to appoint a qualified actuary to perform the duties of the valuation actuary;
3. Support regulatory requirements that the valuation actuary make a public statement of actuarial opinion on the adequacy of reserves;
4. Oppose regulatory requirements that the valuation actuary make a public statement of actuarial opinion on the adequacy of surplus; and

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5. Do not oppose reasonable regulatory requirements for the valuation actuary to test a minimum number of possible future scenarios in developing a statement of actuarial opinion on reserve adequacy.

The recommendations of the ACLI Group were conditional on an understanding that there would be no more regulatory involvement in surplus determination than there is at the present time; that minimal lines of business or risks would be excepted, and that standards of practice would be determined by the actuarial profession.

In the meantime, the regulators are surely interested. The NAIC is working on the concept, and New York has already enacted a statute and promulgated a regulation implementing the concept with respect to annuities.

Now that reality is beginning to stare us in the face, how have some of our CEOs reacted? Please note that I have not conducted an official poll. But I have overheard talk here and there, and it may not surprise you to know that I have one or two opinions of my own on the subject. The following are a few of the most important concerns which are being voiced.

1. The significant expense involved. The small companies, which many view as presenting the most serious solvency risks, are the very companies which will not be able to afford to engage the services of a valuation actuary. Although most of us feel that so-called "small companies" must not be totally exempt from the process, it would appear to me that some specifics of compromise will have to be worked out in this area. A related, and equally serious problem, is how the State Regulators will be able to find and pay for the necessary actuarial talent to review the opinions which will be flowing in.
2. The effect of altered statutory reserve requirements on federal income tax liability. The risks here are serious, indeed. It is not realistic to think we can go to Washington and very easily persuade the tax writers to let us deduct higher reserves than the states are requiring. Depending upon the shape that new valuation statutes may take, we may be faced with having to write a whole new Federal Income Tax Act. Not a pleasant prospect!

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3. The fear that in practice the valuation actuary concept will result in widely varying levels of reserves from company to company. What does this do to the "level playing field" we all so ardently desire? Indeed, if market forces do result in this scenario, what does it say respecting the theory that the concept will protect the solvency of our industry? To put it another way, the worst of all possible worlds is the one in which we spend enormous resources to implement a system, and then the system does not work.
4. The fear that regulators will merely add to the rigidity and complexity of the current system of valuation rather than replacing it with the flexibility and efficiency of the new system. My own view here, is that there must be a careful transition from the old to the new involving a highly intelligent blending of them both. The process of getting this done cannot -- repeat -- cannot be rushed. It may be that we CEOs ought to participate in the discussions with both the actuarial profession and the regulators. The balancing of the competing interests of company solvency and efficient use of capital surely is a subject of sufficient importance to claim the attention of the CEOs.
5. Proper level of surplus. This will be a serious and contentious issue. I would remind you that the ACLI group has stated flatly that their support for the concept is conditioned upon surplus being "off-limits." If this is to be the case, then the guidelines for the valuation actuary will stipulate very conservative reserve levels. It's my impression that both the profession and the regulators are deeply concerned in this area. In summary, then, "we cannot have it both ways."
6. A generalized, uneasy fear that supporters of the concept tend to believe they can use the valuation actuary, or balance sheet, as a tool to cure the problems of bad or fraudulent management. I think we all ought to agree that there is really no regulatory tool which can protect us from bad or fraudulent management.
7. Last and most important, the deep-seated fear that the valuation actuary will usurp the prerogatives of management, especially in the area of investment activities. It is surely recognized among my peers that the advice and counsel of an actuary can be invaluable in our investment operations.

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It is also, feared, however, that the Valuation Actuary's tools, if coupled with inordinate power and inflexibility, will stifle the ability of management to earn a good return on company assets. Credit and maturity are the two risks we can take to generate a good return. The valuation actuary should not be empowered to shut down our ability to assume and manage them.

I conclude that we have a complicated and serious public problem, namely, how to regulate the life insurance business to achieve the proper balance between A) protecting the public against company insolvency, and B) allowing Life Companies to make the most efficient use of capital. Many thoughtful people in our industry believe we can modify the current statutory system of valuation to achieve the desired goal. They maintain that we ought to make a serious effort to do so before we embark fully on the valuation actuary concept. Others feel a greater sense of urgency that fundamental change is needed.

I tend to place myself in the group with those who seek some change. I think less reliance on rigid statutory formulas and more reliance on the professional opinion of the valuation actuary as to reserve adequacy will improve our ability to deal with the solvency issue and will, at the same time, enable us to make more efficient use of capital, i.e., rid us of the need to hold redundant reserves.

This is all conditioned on the promise that the process of change and the implementation of the valuation actuary concept will be managed carefully, deliberately, and with full participation and cooperation of three critically important groups: the Actuaries, the Regulators, and the CEOs. If we have this, I believe we can be successful.

MR. I. EDWARD PRICE: Today I plan to cover three main topics. First, I will describe my understanding of the main goals of the valuation actuary approach and provide some comments on each. Then, I will present some concerns regarding the valuation actuary approach and briefly discuss each of these concerns. Finally, I will turn to alternatives to the valuation actuary approach -- that is, alternatives to an environment in which reserves are determined based on the judgment of an actuary not subject to any specifications in law or regulation.

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Goals

The first topic is the goals or the hoped for benefits of the valuation approach.

Solvency

I believe that there is general agreement that the primary benefit -- or, at least, a key benefit being sought is to produce a greater assurance that insurance companies will not fail.

First of all, reserves alone cannot assure solvency. Companies need to have adequate surplus and they need to be well managed. For example, if today's underwriting process develops a book of life or health business with an undue exposure to AIDS, there are no rational premiums or reserves which are large enough by themselves. Does such an event fall within the range of "reasonable assumptions" or "plausible assumptions" -- or does it fall in the range of assumptions which should be classified -- as suggested by the Academy's working draft revised Interpretation 7-B -- as an event which while "possible" can be considered "remote." Obviously, there are many other examples of potential management failure -- ranging from concerns about dishonesty to excessive reaction to competitive pressure to the apparently mundane, but potentially fatal, conditions like the inability to process transactions efficiently and accurately.

John Montgomery, in a paper presented to the Actuarial Research Conference last October and excerpted in the April issue of *The Actuary*, provided a clear statement of the regulator's concern. He said, "The regulators need to be aware of the deteriorating financial condition of an insurer in time to protect its policyholders from consequences of insolvency." On the company level, we need to be in a position where we can recognize potentially significant financial deterioration in time to take action which will protect the company, including its policyholders and any stockholders. On the industry level, we need an environment, including appropriate valuation law and regulation, which will provide greater assurance that companies won't fail. The public relations and public interest reasons driving this need are obvious. In addition, a simple and very significant management concern is that solvent companies are often required to pay for the mistakes of insolvent companies.

I believe that the types of cash flow and other studies suggested by the valuation actuary approach have already provided actuaries with tools they can use to

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help their management to better manage their companies. They've also aided actuaries in persuading management to seek and accept that help. I believe that this work will continue to develop in a very positive way. As I will explain later, I do have significant concerns that we are quite far from being in a position to go beyond using these tools for internal management purposes. We should not move so quickly, with undeveloped and undefined tools, or with undefined standards of judgment accompanying the use of such tools, that the result is less rather than greater assurance of company solvency.

Efficient Use of Capital

The next benefit which is generally viewed as being of great importance is the efficient use of capital. For many, this is synonymous with lower reserves. For companies to be able to compete effectively, they need to be able to use capital efficiently. For example, consider two companies with similar fundamentals in terms of claims, investment results, expenses and taxes. Now assume that they require a different dollar amount of return for a particular product either because they have different return on equity (ROE) objectives or, as is particularly relevant to this point, they have different amounts of equity required or attributed to the product. Their prices will likely be different. If this merely reflects difference management views on ROE and risk, this result may seem reasonable. But if the more aggressive companies ultimately fail and the more conservative companies are assessed to pay for those failures, then the result seems less reasonable.

The proposed valuation actuary structure attempts to provide balance by, in effect, saying that companies who manage their business -- particularly their assets -- conservatively, or prudently -- will be permitted more flexibility in using capital if they so choose -- and by saying that those who manage their business less conservatively, perhaps even imprudently, will have their capital constrained by the requirement to hold higher reserves. The threat of higher reserves will presumably encourage companies to manage risk more prudently. My concern is that there is a fair chance that the theory won't work because the system, as proposed, places unreasonable pressure on actuaries to make judgments which have significant impact on their companies and because the tools and standards to support these judgments are not yet adequate.

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I don't want to leave the subject of using capital efficiently without going beyond the company perspective. While I am concerned that we don't yet have a workable approach, I do believe that the need to use capital efficiently is quite important. The strategies of life insurance companies vary greatly, but I believe they have at least one common factor. That is, they will need to be executed in an environment which includes competitors, both domestic and global, who have different capital constraints. While this competitive environment will be particularly important for companies who choose to enter non-insurance financial services businesses, it will also be important for those who remain within traditional insurance businesses. Increasingly, the competition will include the likes of Nippon Life and Nomura Securities -- who have a very long term perspective, indeed. So the need for efficient company management of capital is there -- I'm just not yet convinced that the valuation actuary approach is an effective way to meet that need.

Professionalism

The last benefit is professionalism. All of us share a sense of loyalty to the actuarial profession. Many of us feel that there is a sense in which we "owe" something to the profession which has enabled us to achieve professional stature and to earn a living. I am part of that group and instinctively applaud actions which extend the scope of the professional actuary. So when a proposal is made to require that a particular report or opinion be made by a qualified actuary, I approach the proposal positively. But I do get concerned when actuaries are placed in the position of providing opinions without having tools they need to properly develop those opinions, or where those opinions may be interpreted as providing unrealistically high assurance of solvency. I am also concerned when actuaries are placed in a position where the potential for conflict with their management may seem so extreme as to influence their judgments.

Now I would like to more explicitly list and comment on some concerns most of which I have already referred to in discussing the hoped for benefits of the valuation actuary approach.

My first concern which I have labeled "Technical" relates to the current state of the art. Previous speakers have clearly indicated that a great deal of effort has taken place and is still underway. Here, I would like to focus only on the assumptions which the valuation actuary uses in the cash flow testing to support

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his opinion. I believe that setting these assumptions is a key concept for the valuation actuary approach to be successful. The following is mostly quoted from the current Academy working draft of revised Interpretation 7B. With respect to reserves, "the tests must be met based on assumptions selected by the actuary which contain sufficient margins to cover future reasonable deviations from expected assumptions." Then with respect to any internally designated surplus, the tests are to be based on "assumptions which contain sufficient margins to cover plausible deviations from expected assumptions." Finally, this is followed by "good actuarial practice does not require that the actuaries tests include paths of future interest rates that, while possible, can be considered remote."

The valuation actuary approach seems to assume that we will be able to adequately define terms such as "reasonable," "plausible," "possible" and "remote." I'm skeptical that we will be able to do an adequate job of this over the next year or two, although perhaps we will be able to do so at some point in the future. I am particularly concerned about our ability to reach the point where there is reasonable assurance that these terms are being used consistently enough by the actuaries -- both consultants and employees -- who provide services to the many life insurance companies in the United States.

My next concern relates to the natural business environment in which actuarial opinions will be delivered. This environment will likely include, for some actuaries, management which has a strong desire for lower reserves, so that capital may be used more efficiently. This may include companies in weak capital positions with respect to their current businesses or companies looking to finance substantial expansion. Whatever the case, it seems to me to be unrealistic to assume that, under natural business pressure, the results will be reasonably consistent across the industry (whatever "reasonably" consistent may be).

My third concern has to do with the management of surplus -- this relates closely to my second concern. It seems clear that the senior management of some companies, including mine, views the management of surplus levels as falling within the domain of senior management. These companies will prefer to minimize the legal or public role of either regulators or valuation actuaries in influencing surplus levels. The valuation actuary may be a member of senior management and, in any event, will hopefully participate in, or provide input

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for, such management decisions. However, the senior management of many companies will likely resist providing the valuation actuary with the independent responsibility for determining which internally designated level of surplus must be maintained.

My fourth concern deals with state insurance departments. Most state insurance departments employ relatively few actuaries. Providing significant flexibility in reserve levels would seem to provide a significant administrative challenge and might even be counterproductive from a solvency perspective. Insurance departments might well be in the position of needing to rely heavily on the valuation actuary's opinion. The opinion may come to be viewed as containing greater assurance, or even guarantee, of reserve adequacy than is possible. This might place both the actuary and the regulator in an uncomfortable or even untenable position. It would certainly be unfortunate to be in a position where regulators take credit if things go well, while the actuaries become the scapegoat if things go poorly.

The last concern relates to federal income taxes. Federal income taxes should not be the driving factor in developing a valuation system. The variety of views within the industry regarding the appropriate level and allocation of federal income tax certainly rivals the variety of views on the valuation actuary approach. However, the current tax structure is substantially affected by statutory reserve levels and we need to be mindful of federal income taxes as we move forward.

I clearly have some real concerns that we are not even close to the point of having developed a workable system where reserves and designated surplus are determined based on the judgment of a valuation actuary. My dominant concern is that we will end up with a system which, while seeming to provide more flexibility for the efficient use of capital, will fail to provide assurance of fewer insolvencies.

But criticizing a proposal is always easier than initially crafting one. In this case, the work done so far has been of great help in providing tools and concepts to help companies better understand and manage their businesses. So a natural question for a supporter of this proposal to present to me is "If you don't like the proposal, what is a better alternative?"

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The short answer to that question might be "I don't know." But I should add that we are dealing with a difficult challenge. The goals of greater assurance of solvency and more flexible use of capital sometimes seem contradictory. Finding a system which accomplishes both will be difficult. So neither I nor others involved in this area should be discouraged because we haven't quite found the right answer yet.

Now, I will very briefly review and discuss some suggestions that have surfaced. At a recent meeting of one of the committees dealing with this issue I was asked if I was an advocate of the status quo. My answer was "No, not really" -- but that I was an advocate of the opinion that a new approach should be judged as truly better and workable before we leave the status quo. I'm mindful of the significant time and effort required for a major change in valuation approach. The resources committed, the length of the process and the potential financial dislocation for many companies suggest that we need to be sure that any new approach is really workable and that there's adequate provision for orderly transition. So, I am not really an advocate of status quo, but I do have significant concern about the alternatives presented so far.

One of the concepts that has emerged from some of the committee work is the notion of a well-defined reserve level from which deviations would be permitted or required on the basis of a valuation actuary's opinion. An approach with a well defined minimum may indeed be workable. It is not yet far enough along to draw firm conclusions. As ever, my prime concern with such an approach would relate to solvency that for the minimum not be too low and that qualifying for it not be too easy. In addition, I would hope that the new system would not have adverse implications under the current tax structure.

One other area under current discussion relates to whether valuation actuaries should be required to deliver an opinion in addition to a report. My basic view is that an opinion is probably necessary. Despite the risks of misinterpretation, I do believe that the current requirement for providing an opinion is reasonable and that something like it should survive. With respect to the report, I would like to say this. Management should want a report. The valuation actuary should want to provide one both to indicate what his opinion is based on and to comply with existing professional standards. But somehow the emerging

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structure should be such that the valuation actuary supports the management process without usurping senior management's prerogative.

In conclusion, I would say that the activity surrounding the valuation actuary approach has been of great benefit to the management of Life Insurance companies. While I do not believe we have yet found a fully workable approach, I do hope that constructive work will continue in this area and I look forward to participating in it.

MR. JOHN O. MONTGOMERY: Under the five commissioners that I've served in California, I've always told them that I'm an advisor. The role of the valuation actuary is as an advisor to management. That should be his primary role. Therefore, I think it's quite important that the valuation actuary report present alternatives to the management for its review. It is quite important that the actuary be viewed as an advisor and not usurp the management position of a company. Similarly, I do not usurp the position of the commissioner, and the actuarial task force of the NAIC functions as an advisor to the NAIC.

With regard to the retroactivity of the law, I believe that it would not be allowed under most state constitutions. However, I think that the advisory committee should explore the legality of voluntary compliance because I think eventually under the new law it will be more efficient for a company to do it all.

Walter Rugland also presented a very ambitious time schedule. I don't think it's going to turn out that way. It may be 1989 before he gets through, and the NAIC won't get through with it before 1990 or 1991. This will give us much more time to develop standards. I'm counting on the proposed law to be into the legislatures in 1991. If the legislation process follows the same path as with the 1980 amendments, it will take two or three years, i.e., somewhere in the middle of the 1990s, before we really get everybody lined up. This is a long process.

Another thing that is of concern to company managements is that regulators do not play around with the surplus. In order to not do that we're going to have to establish some solvency bench marks. This is going to be one of our projects in the solvency surveillance area of the NAIC. So, I would expect that the financial reporting associated with this will be greatly changed. The process is

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already beginning, and by the 1990s there is likely to be an entirely different financial statement than there is now.

MR. GARY CORBETT: I agree that Valuation Actuary concepts should not operate in such a way that they prevent life insurance company management from taking intelligent risks. However, a company should hold surplus commensurate with the degree of risk undertaken. There are essentially two ways for regulators to require companies to hold sufficient assets to cover risks. The first is by increasing reserve levels and the second is by requiring surplus to be held over and above reserves. I much prefer the latter approach since it permits a regulator to work with a company with low surplus before the company becomes legally insolvent, the result if required surplus is incorporated into statutorily required reserves. The required surplus approach has been used for some time in the U.K. and, in all likelihood, will soon be the practice in Canada.

MR. ROLLAND: I don't disagree with any of that. Determining appropriate levels of surplus is still a pretty inexact process. We have done a lot of work on it internally within the Lincoln National trying to come up with what we call target surplus levels based upon the degrees of risk that we are taking in each area of our business. We actually look at whether we've matched assets and liabilities in certain product lines. What you learn is that this process sometimes doesn't work and what you come up with initially may drive you to business decisions that aren't all that appropriate at times. The operating people are always arguing with the actuaries about whether those formulas are proper. It is an inexact process and it is still developing. All I suggest is that given the present state of the art there is concern among company management that a regulatory focus on surplus will interfere with their ability to run the business in a way that they think is proper.

I think there's general agreement among company management that these concepts make sense, but I don't think we're really going to know how the CEOs will ultimately react to them, until we see what the specifics are, where the actuary is going to be involved, and how what the actuary does is going to affect our ability to run our businesses.

MR. ROBERT CALLAHAN: In New York we have already implemented a form of the valuation actuary concept for annuity and GIC business. Beginning in 1982

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we required an actuarial opinion and memorandum as to the adequacy of the assets in support of the liabilities in order to use the higher set of valuations interest rates for GIC business. We expanded our laws in 1985 to require the actuarial opinion and memorandum regardless of whether the higher or lower set of valuation interest rate was used and the opinion requirement was extended to all annuity business issued after 1982. We are working now to extend the opinion requirement to all annuity business.

I am now concerned about the structured settlement business, and I believe the opinion and memorandum requirements should be extended to such business. The same techniques used in the GIC area would be appropriate here. I am also concerned about unauthorized reinsurance. If a company can make an agreement with an unauthorized insurer and get a letter of credit for the difference between statutory reserves and the reserves it carries in the statement then all our efforts on reserve levels will be in vain.

MR. EDWARD ROBBINS: Can you possibly give some sort of advance reading, not violating any confidence, of the changes from the 1985 version of the standards of valuation actuaries discussion draft to the current unexposed draft?

MR. JAY: I can give you a couple thoughts. We are still debating some of the main issues among the members of the joint committee. One issue is recognition that the delegation of responsibility for appointing a valuation actuary by the board to higher management is not inconsistent with our goals. Our original report specified board appointment as the only alternative.

We have recognized that a lot of confusion and disagreement has accompanied the words "reasonable" and "plausible" that appeared earlier in the report. Our thought now is that there may be a way to avoid some of that by specifying that the opinion apply only to assets equal to the reserves. Further, reserve testing and the opinion would be based on reasonable deviations without using that specified word. It's not clear whether these troublesome words will survive in either the new standards of practice or new laws. Perhaps a way to approach the more severe test, i.e., "plausible" deviations associated with designated surplus, is to restrict its use to confidential report to management.

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MR. RICHARD KLING: Some of the points relating to the management issues I think are even more far-reaching than might have been mentioned. I work for a company that has a fair understanding of the proposal and we've had a significant amount of debate. But my company is also a subsidiary of a larger corporation which in turn is a subsidiary of another large corporation, American Express. Anything that affects the capital structure and dividend flow in my company is going to be very important to the managements of the other parts of the organization. Even though there is good understanding at the first level, we've got a significant challenge to be able to deal with the practical implication of issues throughout the levels of management in the entire organization. I think we'll need to have a fairly definite proposal before we can really get into the issues with management at higher levels in the organization. The proposal needs to be reasonable and above all it should not usurp or infringe on other activities.

MR. RUGLAND: I think everybody would agree with you in general terms, that as the specifics of the proposal take shape you'll see the battle lines forming depending on whose turf is being invaded.

MR. ROLLAND: I'd like to respond to Mr. Callahan's earlier comments. I think the things Mr. Callahan pointed out really demonstrate the need for a new system or for a revision of the present system because it seems clear to me that the present laws and approaches simply don't deal adequately with the more complex and diverse business that we're in today. On the issue of the ability of some companies to reinsure business and avoid reserve requirements, I think that's just a further demonstration of the inadequacies of the present system of valuation that exists here in the United States. When an actuary in some other jurisdiction is willing to submit an opinion that a lower level of reserve than required by statutory valuation procedures in the United States are adequate and sufficient in that other jurisdiction, it leads to the problem you described and suggest to me that we need some reform. If you're looking for a level playing field, you won't find it with the diversity of state regulation in practice.

MR. CALLAHAN: Yes, and that may suggest that there is a problem with state regulation.

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MR. ROBERT DOWSETT: Mr. Price in his comments said something to the effect that the decisions required of actuaries are too great under the valuation actuary approach, at least with the techniques we've got in place now. I think we may be unrealistically high in our expectations of the actuarial profession in moving along this line. I guess I don't agree because I think there are a lot of actuaries that are involved in pricing the products. If they can price the products and get management approval on price, it seems to me that they should be able to get management approval for the valuation side of things.

MR. PRICE: Let me just make this observation. I think as valuation actuaries become more involved with the management of capital, we are finding ourselves much more involved with the investment side of the company. There is much less willingness on the part of the CEO and the chief investment officers to rely, if you will, as freely on an actuary's advice and views on investment matters as they do on pricing matters.

MR. JAY: I agree with what Ed said in this regard. We do a lot more work with the investment people and members of top management on pricing compared to valuation. I think that the actuary should be looked to for advice on capital questions as well as pricing questions. I hope that what we're doing will tend to lead us in that direction.

MR. ROLLAND: First, I think that pricing and valuation are going in opposite directions. I think companies are designing products which essentially permit repricing every year. At the same time we're trying to have the valuation issue focus on the long term. Whether the same people, i.e., actuaries, can do both of those things or how you establish the relationship between them is one of the issues at hand.

Here is what Ed specifically said "my concern is that there is a fair chance the theory won't work because the system as proposed places unreasonable pressure on actuaries to make judgments which have significant impact on their companies and because the tools to support these judgments are not adequate." I think that everybody recognizes this problem, and it's got to be resolved if something is going to happen. I think Ed was also saying that the constituencies have to come together, and we have to figure out a way to deal with the problem.