Small Talk Newsletter

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the map, it makes sense to get some assurance that you can proceed in your projections with data you have received. A second check would be to test the credibility of the cash-flow information. If you get data with an asset database as a source, check it against your fixed-income portfolio manager's security quotation system. Take a low-, medium-, and high-level interest rate scenario and get comfortable with the prepayment and extension of the assets. Unfortunately, some security quotation systems may use the same prepayment model that is used to generate the cash flows from the asset database. In this case, you could potentially be checking bad data against the same bad data.

When it comes to making decisions about investing in software or databases used to model assets, it often pays to determine what resources are available within the company before spending money for a complete system. With a little creativity and knowledge of the relationships within a company, you might be able to prevent spending unnecessary resources on an outside system.

Dale Hall, ASA, is with Westfield Companies in Westfield Center, Ohio.

Entering the Equity-Indexed Market through Alliances

by Jerry F. Enoch

The November 1997 issue of *small talk* contained an interesting article, "Equity-Indexed Annuities: Feasible or Flawed for Small Insurers?" by Andrew S. Chow, which thoroughly explored some of the pitfalls facing small insurers who want to issue equity-indexed annuities. One way that small insurers can face the problems of entering the equity-indexed marketplace, as well as many other ventures, is through alliances with other companies. Lafayette Life, a company with less than $1 billion in assets, has chosen to enter the equity-indexed marketplace, and an important component of its entry into the marketplace is the formation of alliances.

The equity-indexed marketplace appears to be well-suited for the formation of alliances. An alliance can address the problem of inadequate asset mass and investment expertise, and it can also address other problems that particularly plague the small company that is considering entry into the equity-indexed marketplace, such as policy drafting and filing, marketing and training materials, administration, valuation, and cash-flow testing. The simplest structure for an alliance is to have one primary company and one or more secondary companies. The primary company performs all functions for itself; the secondary companies rely on the primary company to perform some functions for them.

Synergies

By grouping together, all companies benefit by pooling premiums to reach the critical mass necessary to purchase the needed investments. This is crucial because derivatives are sold only in relatively large quantities. The primary company can actively develop the necessary investment expertise. The secondary companies can learn from the primary company, which is much easier than learning independently.

The primary company will have developed an investment policy for its own equity-indexed products. Developing and maintaining an investment policy for equity-indexed products is a substantial undertaking. That policy should be agreeable to the secondary companies and should become a part of an investment management agreement between the companies, under which the primary company will manage the investments for the equity-indexed products. The agreement can allow the secondary companies to hold their own assets.

The policy form, actuarial memorandum, and other filing materials of the primary company can serve as the basis of the policy filings of the secondary companies. In addition, the filing experience of the primary company is a great benefit to the secondary companies. Obviously, the policy characteristics must appeal to the secondary companies for the alliance to succeed. Similarly, the marketing and training materials of the primary company may be directly applicable to the secondary companies, or they may provide the basis from which the secondary companies can develop their own material.

Equity-indexed products present unique administrative challenges. In fact, the design of an equity-indexed product is often limited by the flexibility of the administrative system. The primary company will own, or have access to, an administrative system to administer the equity-indexed business. The primary company may make its system—or full administration—available to the secondary companies for a fee. A competitive advantage can be obtained by selecting a primary company with a flexible administrative system. In fact, flexibility to meet a niche may be a small company's advantage. Of course, it is important for the administrative system to work on January 1, 2000.

Valuation and cash-flow testing of equity-indexed products are major undertakings. In these areas, also, alliances offer advantages over independent operation. The primary company can easily perform valuation for the secondary companies in the same manner as it

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performs them for itself, or it can provide any desired consultation. Alliances offer several possibilities for meeting the challenge of cash-flow testing. The primary company may develop the cash-flow-testing methodology and perform cash-flow testing for the secondary companies or provide them with advice. Alternatively, the companies may jointly develop their cash-flow-testing methodology. Either approach seems preferable to working independently. Regardless of the process used, each company must be knowledgeable and comfortable with the cash-flow testing that is performed on its business. Fees could be included in the administrative agreement or could be independent.

Requirements for Success

In any alliance, certain conditions must be met for the alliance to succeed. The needs of each party must be met and the costs to each party must be less than the benefits. The companies must have similar values and should be able to operate in a relationship of trust. The primary company should be very open and communicate well. This is important to earn and maintain the trust of the secondary companies and to provide the secondary companies adequate knowledge of their equity-indexed business, for which they are ultimately responsible. The secondary companies need not have any relationship with each other.

As in virtually any enterprise, agency issues are important. In consideration of an alliance, each company will need to consider the degree to which the agents of the other companies are in competition with their own agents. Because equity-indexed products can be sold through various distribution channels, conflicts with agents can be minimized in alliances whose members use different distribution channels or concentrate in different regions of the country. Also, it may be desirable to structure administration so that the primary company does not know the agents of the secondary companies.

Availability

Despite the appeal of alliances, few companies are actively seeking these types of arrangements for equity- indexed products. Lafayette Life is actively pursuing such alliances. To date, Lafayette has entered into alliances with three other companies for equity-indexed business. We currently issue an equity-indexed, single-premium annuity and are developing an equity-indexed, flexible-premium annuity and an equity-indexed universal life policy. The company believes that alliances provide an attractive means by which small companies can profit from the interest in equity-indexed products.

Jerry F. Enoch, FSA, is Vice President and Actuary at Lafayette Life Insurance Company in Lafayette, Indiana.

Compromise on Guideline XXX in Works

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The National Alliance of Life Companies (NALC) hosted a meeting in Chicago on April 2 to discuss possible alternatives to the impending XXX regulation. A tentative agreement was reached by the attendees. This proposal will be presented to the Life and Health Actuarial (Technical) Task Force at its meeting in June.

Who Attended

There were 29 people present with at least six others on the speaker phone. Every possible faction of the industry was represented: mutual and stock, large and small, companies and consultants, industry representatives, and regulators. In addition, the American Council of Life Insurance (ACLI), and the NALC were represented. Bob Barney of Compulife Software also participated. Mr. Barney has been very vocal to governors and insurance commissioners about his opposition to XXX.

Basic Reserves

The new methodology (named "JVE" at the meeting) is very similar to the methodology contained in the XXX regulation. The primary difference is that a company must use its current premium scale for determining segments and premium ratios. This would generally create traditional "humpback" reserves for the period of intended level premiums. For example, a 20-year term product with premiums guaranteed for five years would have to set up 20-year "humpback" reserves.

In addition, the five-year exemption provided for in the current XXX regulation has been eliminated.

Minimum Reserves

Minimum reserves are defined similarly to the definition contained in XXX. Segments and premium factors, however, will be based on current premiums. Except for the difference in mortality tables, these net premiums are calculated the same as for the basic reserves. Premium deficiencies, if any, will be calculated based on guaranteed premiums.

Basic Mortality Table

A new set of selection factors will be developed modifying the 1980 CSO table. It is anticipated that the selection period may be 20 years, with longer periods possible at the younger issue ages. It is also anticipated that these factors will reflect the new preferred classifications of underwriting. It will also be more reflective of current mortality levels with appropriate statutory margins.

Minimum Mortality Table

A more aggressive set of mortality tables will be developed for the minimum

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