Small Talk Newsletter

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small talk

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From the Editor

by James R. Thompson

This issue of *small talk* tries to accomplish two main objectives: to discuss the peculiar problems of smaller companies in modeling CMOs and to present our usual legislative update. The pace of regulation has been increasing. The NAIC is providing us with many issues to cover. It is sometimes difficult to know where to begin.

One of the most significant developments is in the area of proposed guideline *XXX*. This NAIC-adopted model regulation deals with the reserving of term insurance and UL with certain guarantees. It is supposed to provide more theoretically correct reserves than the current standard valuation law with the unitary approach, because it considers the relation between the gross premiums and mortality by segments. The result, however, is to increase reserves significantly, especially for policies with longer guarantees and in the more select premium classes.

States that have passed *XXX* have generally done so with the provision that it will take effect only if states representing 51% of the population also pass it. Many states have not passed it

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Codification Coming Your Way

by R. Thomas Herget

Statutory accounting for life, health, and P&C companies has always relied on prescribed and permitted practices. These practices were promulgated by each of the 50 states. There was enough diversity in these practices that by the late 1980s, the accounting community (particularly the audit firms) no longer felt comfortable issuing opinions based on statutory accounting. The concern was that there was no single set of practices that companies adhered to.

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The NAIC responded to this by forming a committee of regulators to prescribe specific procedures and methods for compiling statutory financial statements. It was also its charge to define principles underlying statutory accounting.

For actuaries, it is certainly time to start paying attention to this regulation. It was approved at the NAIC's spring meeting in Salt Lake City in March 1998.

The codification documents can all be found on the NAIC's web site, naic.org. There is a preamble that attempts to identify the fundamental principles for statutory accounting. The preamble is followed by 90 Statements of Statutory Accounting Principles (SSAPs), which spell out the rules for codified statutory accounting.

My personal opinion is that one might find the preamble weak in establishing the fundamentals for financial reporting. Also, its stated objectives are not always supported (and sometimes contradicted) by the subsequent reserve requirements.

Some of the concepts in the preamble are that "SAP is conservative … but not unreasonably conservative." "Statutory accounting should be reasonably conservative over the span of economic cycles." "Valuation procedures should … prevent sharp fluctuations in surplus." "The income statement …

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should not be diminished in importance …" "Liabilities require recognition as incurred." "Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed."

For reserves, no new methodologies are articulated. The called-for reserve methodologies are identical to today's statutory reserve regulations. If these methods are applied, the reader might conclude that some aspects of the preamble are breached.

For example, annuity CARVM reserves are often worst-case and would thus not be "reasonably" conservative. Skyrocketing deficiency reserves caused by small-premium differentials could not be called "reasonably" conservative. The addition of profitable new business nevertheless can cause severe first-year losses, which would cause a "sharp fluctuation of surplus."

Thus, I maintain that the preamble, especially when coupled with its prescribed regulations, is insufficient to describe the fundamentals underlying an accounting basis. The actuary needs to look then at the Statements of Statutory Accounting Principles. Several of these SSAPs specifically address reserves.

Among other key points, *SSAP 50* distinguishes investment contracts from other insurance contracts. *SSAP 52* informs us that the income statement for investment contracts is to parallel the GAAP format. All other insurance contracts (traditional life, universal life, deferred annuities, accident and health, group, and so on) have an income statement identical to that which exists today for statutory.

SSAP 51 addresses life contracts. As do the other reserve-related SSAPs, this statement affirms the authority of the SVL, AOMR, ASPs and all of the actuarial guidelines. *SSAP 51* says deficiency reserves start from the paid-to point, not from the end of the current policy year. *SSAP 51* eliminates the cost of collection in excess of loading liability.

SSAP 54 addresses A&H (individual and group) contracts. It basically calls for the health model regulation that has been enacted, but not uniformly, in about half the states. It calls for a minimum reserve of gross unearned premium and also states that the reserves must make provision for all unmatured obligations.

SSAP 55 discusses provision for life and health claim reserves. It tells the user to fund for the cost of handling claims. Expenses to be provided for are both internal and external including direct and a provision for overhead.

SSAP 56 deals with universal life policies. The SSAP establishes the authority of the universal life model regulation.

SSAP 59 addresses credit insurance. It acknowledges that there is no effective NAIC model regulation so it goes into more detail. Hold the refund amount if higher than the reserve. Hold a gross premium reserve if necessary. For life, it recommends a Rule of 78 (R78) reserve or a mortality reserve. For A&H, it instructs the preparer to study the incidence of risk and select R78, pro rata (PR), mean of R78 and PR, or some other basis that reflects the pattern of insurance claims. Use the method selected for all contracts in this class.

Most of these SSAPs refer to specific appendices for the technical description of the reserve method. The appendices are a part of codification. For the most part, they recite verbatim provisions of NAIC model laws. The most significant appendices are:

- A–10, Health Model Regulation
- A–585, UL Model Regulation
- A–620, Accelerated Benefits
- A–641, Long-Term-Care Insurance Model Regulation
- A–820, Standard Valuation Law for Life and Annuity
- A–822, Asset Adequacy Analysis (AOMR)
- A–825, CARVM.

Conspicuously absent is any reference to *XXX*. The drafters specifically excluded this because it was controversial and not widely adopted. There is a possibility it may be added as part of maintenance prior to the effective date.

The preparer of codified statutory statements is to comply with all SSAPs, all regulations listed in the appendices, all actuarial standards of practice, and all actuarial guidelines promulgated by the NAIC.

Several other SSAPs are noteworthy.

SSAP 83 calls for the establishment of a deferred tax liability/asset (similar to GAAP) on the statutory balance sheet. This is likely to create a receivable, given that the DAC tax has caused a significant prepayment of FIT.

SSAP 5 addresses when to establish a liability. It reflects the fundamentals underlying GAAP *FAS 5*, which also defines what a liability is and when to recognize it.

SSAP 5 defines three classes of occurrence: probable, reasonably possible, and remote. The preparer establishes a reserve if it is probable that a liability has been incurred and the amount of loss can be reasonably estimated. It is this verbiage, lifted from *FAS 5*, that has precluded the establishment of a failed New York Seven scenario cash-flow-testing reserve on the GAAP balance sheet. But now, this same wording exists along with Appendix A–822, which does call for the establishment of cash-flow-testing reserves if they exceed the formula-based reserves.

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The codification reserves would be established only on business issued after the effective date (currently January 1999 but likely deferred to January 2000). Business issued prior to codification's effective date would be reserved using state-of-domicile rules. Yes, this does imply several decades before reserves are consistently stated between companies.

There remains a chance that the resulting codification procedures may still not be certified by the AICPA as a valid accounting basis. A valid

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accounting basis is called an OCBOA (other comprehensive basis of accounting). Theoretically, an auditing firm could issue an opinion on a Moldavian basis as long as Moldavia's practices qualified as an OCBOA.

Codification may not become an OCBOA primarily because of the states' rights issue. Each state does not want to appear to give up anything when it comes to regulating insurance companies. To accommodate this, there remain several references to permitted practices and state variations throughout the codification document.

What this likely means is that the auditors would issue an audit opinion on the state-of-domicile rules, regulations, and permitted practices. The audit report would then contain a report or a footnote that reconciles state-of-domicile financials to codification financials.

Codification must be adopted by each state. About half the states would automatically adopt it. This is because the codification document was renamed the "Accounting Practices and Procedures Manual." This manual is currently referenced in the insurance regulations of half the states. The other half of the states must formally adopt codification. It has not been decided whether this is a regulation on the accreditation track.

After nearly seven years of work, it seems that we have been presented with a 51st accounting basis whose financial statements will be of little interest or value to anyone.

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Bank Alliance Niche for Insurers

by Paul J. Sulek

Editor's Note: *The following is a summary of Session 79, "Bank Alliance Niche for Insurers," held at the SOA Annual Meeting in Washington, D.C. and moderated by Paul J. Sulek.*

A panel of guest speakers discussed the bank alliance niche for insurers. They included Julie Williams, Chief Counsel for the Office of the Comptroller of the Currency; Steve Landberg, Principal for Sibson & Company; and John Hillman, President of Philadelphia Financial Group. This session was sponsored by the Smaller Insurance Company Section. The objective of the panel was to discuss insurance product offerings of banks and to examine what insurers, especially smaller companies, can do to successfully market products in partnership with banks.

Julie Williams gave a brief history of bank regulation as it pertains to insurance activities. National banks currently engage in a wide variety of insurance and annuity activities. Ms. Williams pointed out that the issue of state and federal regulation of banks is not new. Recent Supreme Court decisions in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commission* and *NationsBank v. Variable Annuity Life Insurance Company* have resulted in an increased focus on bank insurance and annuity sales. These cases also resulted in new and challenging issues. State laws that apply generally to regulate insurance will apply to national banks provided the law does not interfere with authorized activities.

According to Steve Landberg, banks have seen a marked shift away from regular deposits in the last 10 years. The number of financial advisors in banks is growing, while the life agency population has shrunk. The smaller bank distribution channels are generally third-party marketers and branches platforms. Landberg said that until this time, banks have tended to deliver insurance or investment products rather than managing a customer relationship over multiple products.

One key to success is understanding the bank culture that is often focused on organizational issues. Almost 40% of banks currently sell insurance, but what and how they sell varies considerably. They plan to increase insurance sales to achieve greater profitability. Banks primarily sell individual annuities. Insurers need to have a long-term perspective to create bank alliances. Well-designed products, marketing, selling, and service are essential. These will need to be reengineered for bank distribution. Focused strategies and tight organizational alignment are keys to success.

John Hillman presented a case study focused on life insurance. The life marketer is a late arrival compared to annuity sellers. New entrants include insurance carriers with significant resources and patience; Internet companies that are highly focused with unique services; and direct marketers. Mr. Hillman said that opportunities exist in the bank market because this is a real, evolving market. There is an extensive customer database with possibilities for greater efficiency and profitability.

The challenges to insurers are to be recognized as a new distribution channel, to integrate with existing channels, providing focus on packaging, not features, knowing how to sell, and becoming aware of compliance requirements. To succeed, it is necessary to commit to the channel, be open to changing banker groups, consider new products, incorporate technology, focus within a segment, and be patient.

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