Article from:

# Small Talk Newsletter

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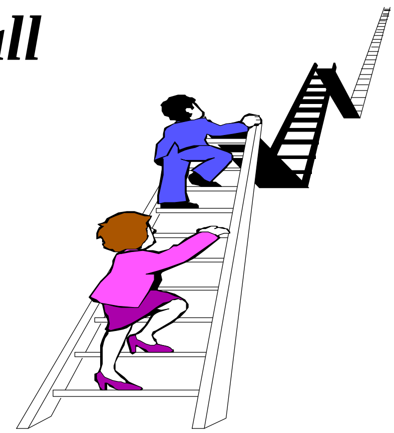
# *The Unified Valuation System: A Small Company Perspective*

***by James R. Thompson***



The Unified Valuation System (UVS) is the name for a proposed revision of the Standard Valuation Law (SVL). This is being developed by an Academy committee (dubbed the Wilcox Committee after the chairman). The Academy was asked by the Life and Health Actuarial Task Force of the NAIC to come up with a revision of the SVL.

The committee was supposed to take a fresh look at valuation in general and not just tweak the current SVL. It began holding monthly meetings in 1997 and by year end had produced a written progress report. Last year they held more monthly meetings and produced another report, which was presented to the NAIC in December.

There are some new and different ideas in it. It is the purpose of this article to discuss some of these, especially as they relate to smaller companies.

## Scope and the S Curve

EACH YEAR THE valuation actuary is supposed to submit a balance sheet and income statement, various certifications and a list of certain assets. Now the actuary certifies only the reserves, an item in the balance sheet. He does not deal with surplus. The Risk Based Capital calculation is often handled by the accountants.

A key feature of the new law is the use of the S curve approach and various action levels. The actuary must certify that the reserves, in light of the underlying assets, are adequate at least Xn% of the time. There are different percents. If the actuary cannot certify to the highest level, there are certain action levels, called the Company Action, Regulatory Action, Authorized Control and Mandatory Control Events. Essentially, as the percent certified becomes lower and lower, the company goes from submitting a corrective action proposal to coming under regulatory control.

We have various levels of action under current procedures. In the UVS, the key is that the reserves are determined not by a set formula, but by the judgment of the actuary based on stochastic results. At the most recent (March) meeting of the Committee, I asked about the S curve upon which the reserves are based and learned that the theory behind this has not yet been developed. It will be based on multiple scenarios and the company must be able to survive some percent of the time. The model regulation contains an example for term insurance worked out by Tom Herget of PolySystems. Examples for other lines are expected by December.

Implicit in the level of reserves is not just the current statutory reserves as we know them, but also the concept of Risk Based Capital. Riskier lines of business (and underlying assets) will require higher RBC and hence higher reserves.

At the March meeting, there was some discussion of how to phase this in.

Two proposals were made: determine the reserves by the S curve and keep an RBC formula, or the opposite, determine the reserves by formula (as at present) and set the RBC by the S curve.

The meeting emphasized that this committee was using this as an opportunity to go from a formula base to a stochastic base. This is theoretically correct since reserves should be adequate most of the time (with the X% defining most). We only use formulas and established mortality tables and interest rates to make things easier. The Committee is aware that significant research must be done to develop procedures. At the March NAIC meeting, the Society of Actuaries mentioned a research role it could play. I cannot foresee this law passing without some established procedures.

## Tax

A SIGNIFICANT IMPEDIMENT is how the IRS might view a stochastic definition of reserves. The IRS has previously been accustomed to a formula approach. The key is that the IRS has stated that the method of computing reserves is whatever the NAIC says it is (without state approval). Only the mortality table and interest require 26 state approval.

If confronted with a stochastic method by the NAIC, what is the IRS likely to do? One possibility is to bring the matter before the Secretary of the Treasury for a ruling.

## Reviewing Actuary

AFTER THE VALUATION actuary submits his or her opinion, a reviewing actuary must review the work and submit an opinion accepting it. The fees of this reviewing actuary are to be paid by the company. This may sound redundant, but we must remember that under the UVS the reserves are determined with more actuarial judgment. They are not formula-driven.

One state, New Hampshire, already has a reviewing actuary in force. Why this is done under the current regulatory environment is not known. All nonfraternal domestic companies must submit this additional opinion by March 1, the same day as the valuation actuary must submit his.

The reviewing actuary is definitely a cost issue for smaller companies. What if they have a very traditional and uneventful block of business and assets. Why bother with this? When we get to the stage where we want to include some small company exemptions, we should keep this in mind.

## Viability

ANOTHER REQUIREMENT IS the viability report. Annually the company must submit a five-year plan including a new business projection. Many companies make such plans now. Sometimes a department can require one, but the actuary is usually left out of it. Many is the actuary who does not even know his management has one.

One would think a logical place to begin is the cash flow testing memorandum. Then add the new business. Today managements may include or exclude the valuation actuary's work. Under the proposed UVS, the valuation actuary must opine on the viability report. This is a significant more to involve the actuary, who is guided by professional standards, in the process.

This also will be an expensive process, although not as expensive if an asset adequacy analysis has already been done, since the expense is then only the extra expense. Currently, many small companies may not do an annual memorandum; so this is more likely to be a big increase in expense.

Also, what if a company's situation does not change much from year to year? Can the previous year's plan be used with slight updates? Perhaps when we get to the point where the UVS is close to being finalized, we can lobby for some exemptions. Perhaps doing a five year plan every 3-5 years unless there has been a significant change in operations could be considered.

### Conference Call

IN APRIL THERE will be a conference call on the UVS. I will be following this. It would be a good idea for some other small company actuaries to begin following this also. But in light of the need to develop a body of knowledge to be used in calculating the S curve probabilities for various lines of business, the introduction of the UVS is still years away.

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## Reflections on the Supermergers of 1998

*by Jacqueline Bitowt*
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*The following is an excerpt from the February article in* The Actuary.

Among the thousands of words written about 1998's supermergers, perhaps this phrase from *Fortune's* Jan. 11 issue describes the year best: "biggest by a mile, according to any dollar-volume measure, against any other year, adjusted for anything, as a percentage of whatever you want."

What has pushed the merger machine into high gear? And why this point in time? "A number of factors have fueled the acceleration of M&A activity," noted Terry Lennon, executive vice president, Metropolitan Life Insurance Company, who launched MetLife's mergers and acquisitions (M&A) department. "One is the need to drive down per-policy expense rates by increasing critical mass and eliminating redundant operations. A second is to add competencies or products to one's business portfolio. Another is the desire to find companies with complementary products and services so that you can cross-sell to each other's customers."

*Fortune* summed it up neatly: "Dozens of industries still carry heavy overcapacity; stocks are still strong; capital is still abundant and cheap," said the Jan. 11 article in predicting another gigantic wave of mergers this year.

### Ego: The Dark Motivator

A number of observers see a less rational driver: the minds of executives

*(continued on page 12, column 1)*

### Headlines from NALC Group

*continued from page 7*

NCOIL believes that states should determine whether or not Codification should become an accreditation standards by utilizing the four-year seasoning process reserved for the consideration of new model laws or regulations, and be it further

RESOLVED, that if the NAIC adds Codification to the Accreditation Program, the accreditation standards should affirm that:

* Codification does not preempt state legislative and regulatory authority, and may be subject to modification by practices prescribed or permitted by a state's insurance commissioner or legislature; and
* any new standards shall not apply to the regulation of companies licensed and writing business only in their state of domicile; and be it further

RESOLVED, that NCOIL encourage all states to review Codification and compare it with their current statutory accounting requirements to decide what, if any, changes should be made to existing states laws, regulations, and bulletins to determine how Codification is best applied within each respective state.

As a result of the work of the NALC, the final resolution includes language that states that Codification would not preempt state legislative and regulatory authority and may be modified by practices prescribed or permitted by a state's insurance commissioner or legislature. The NALC originally brought the issue of Codification to NCOIL and has been working on compromise language since that time.

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