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CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

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Recorder: HAROLD G. INGRAHAM, JR.

This session will include discussion on the activities of the:
- o National Association of Insurance Commissioners
- o Financial Accounting Standards Board
- o Actuarial Standards Board (ASB)
- o American Academy of Actuaries
- o American Institute of Certified Public Accountants
- o Securities and Exchange Commission
- o Committee on Actuarial Principles

Emerging issues in both statutory and GAAP financial reporting will be discussed.

MR. HAROLD G. INGRAHAM, JR.: Leading off will be Tony Spano. Tony's with the American Council of Life Insurance, and he monitors the activities of the ACLI Actuarial Committee. Tony's going to talk about the NAIC and the SEC. Next will be Jim Milholland, who is with Ernst & Young in Atlanta. Jim is a member of the ASB Life Committee. He will talk about the current activities of FASB and the AICPA. Third will be John Palmer. John's with Life of Virginia. John is Chairman of the Academy Committee on Life Insurance, and not surprisingly he's going to talk about the Academy. I'll talk next and I'm with The Hemisphere Group; I'm Chairman of the ASB Life Committee; and my discussion relates to the activities of the ASB. Our anchor will be Arnold Dicke, who is with Tillinghast in New York City. Arnold, among other things, is Chairman of the Society's Committee on Actuarial Principles, and that's what he's going to talk about.

MR. ANTHONY T. SPANO: The most significant current NAIC activity is one with which probably almost all of you are familiar, and it stems from concerns among the regulators over insurance company holdings of high yield securities. The first phase of this activity is to be completed at the June 1990 NAIC meeting, and will involve changes to the 1990 Annual Statement for Life and Health Insurance Companies. Likely to be adopted are the following:

1. The Mandatory Securities Valuation Reserve (MSVR) bond reserve classes will be expanded from four to six, and the reserve accumulation factors will be increased.

2. Greater reliance will be placed on ratings of public rating agencies, as opposed to the NAIC's Securities Valuation Office, and procedures for classification of privately placed issues will be revised.

3. Schedule D Part 1A of the Annual Statement, which shows a distribution of bonds by quality rating, will be expanded to provide for a breakdown between publicly issued and privately placed bonds.

The above proposals developed by a regulatory study group were unveiled at a meeting of regulatory and industry representatives in Washington on April 10, 1990. Although industry representatives expressed some support for the recommendations, there were concerns about the proposed increases in the annual required MSVR accumulation levels, and the proposed changes in the rating criteria and procedures for direct placements. The industry representatives plan to suggest modifications to the proposal when they meet again with the regulators on May 10.

What I've described relates to the first phase of the NAIC effort, and that phase is to be completed, as I said, in June 1990. The next phase will address questions such as whether limits should be placed on insurance company investments in high yield securities, and whether increases in the overall MSVR amounts are needed. The timetable for this later phase calls for a proposal to be exposed at the September 1990 NAIC meeting and adopted at the December meeting. The usual NAIC practice is to expose something, have it exposed for comment for three months or six months, and then take final action after that period.

MSVR STUDY

As if that were not enough activity on the MSVR front, I'll report now on a comprehensive MSVR study that is still in its initial stages, and is not expected to be completed until the end of 1991. This study is a continuation of long-standing NAIC efforts in this area, and was stimulated recently by the work of the NAIC's Special Advisory Committee on the valuation law, commonly called the Tweedie Committee. That Committee's principal assignment was to recommend a model law and regulation to implement the valuation actuary concept. In the course of its work, though, the Committee developed some major proposed changes in the nature, structure, and calculation of the MSVR. Under the Committee's proposal, all invested assets other than real estate will be subject to the MSVR. The MSVR would be split into a basic component, which would be a liability item, and an additional component, which would an item of ear-marked surplus. If the additional component were to exceed a company's surplus, the company would be required to restrict its operations.

This proposal was included in the Tweedie Committee's preliminary report. As you might expect, considering the fundamental changes that the Committee was recommending, the proposal proved to be controversial. It was therefore dropped from the Committee's final report, and turned over to an NAIC regulatory study group, which then reactivated an Industry Advisory Committee. The Advisory Committee was given a broad charge, which included defining the purpose of the MSVR, reviewing the MSVR recommendations of the Standard Valuation Law Committee and any other MSVR recommendations of which the Advisory Committee might be aware, reviewing the impact of the MSVR upon the actuarial opinion that will be required under the valuation actuary concept, and developing a comprehensive proposal for revising the MSVR. As you can see this is quite a broad charge.

The Society of Actuaries, incidentally, will be making an important contribution to this project, since the Advisory Committee will be making use of a Society study on asset defaults that has been recently started. The study is one of a number of projects that the Society has recently undertaken as part of its expanded research efforts.

At the NAIC meeting in March 1990, the Advisory Committee reported on one of the items in its charge. The Committee indicated it has agreed that the purpose of what it now refers to as an Asset Valuation Reserve (AVR), instead of an MSVR, is to:

- provide for default losses in excess of those contemplated by market value;
- capture and amortize gains and losses resulting from the sale of fixed income instruments carried at book value; and
- smooth out effects on surplus of market value changes in certain assets not carried at amortized cost.

As indicated, this MSVR study will be a long-term effort, with a projected completion date of the end of 1991. The more urgent regulatory priorities concerning high yield securities have recently commanded the attention of many of the same people who are involved in this MSVR study, so it's very possible that this timetable may prove to be optimistic.

CONSTANT YIELD METHOD FOR DEPRECIATING REAL ESTATE

I'm going to mention one other NAIC financial reporting item, and this relates to depreciation of real estate. A question under discussion within the NAIC for a while has been whether a method of depreciation known as the constant yield method should continue to be permitted for statutory accounting purposes. This method is analogous to the method used to amortize the outstanding principal on a mortgage loan. It depreciates a property at increasing annual amounts to achieve a constant yield on the book value of the property over its useful life. It's been in use since the 1950s, but has become more prevalent in recent years. Supporters of the methods say that it results in a more appropriate statement of earnings, facilitates more equitable distribution of dividends, and places comparable investments on equal footing.

At the NAIC meeting in March 1990, the NAIC group that has been considering the issue reached a consensus that the method is acceptable for statutory accounting purposes, provided proper safeguards for its use are in place. The group plans to await regulatory developments in New York before establishing these safeguards. The industry has been invited to participate in the New York regulatory process.

In agreeing to permit the constant yield method, the NAIC group has stated, however, that retroactive application of the method or other methods which result in surplus gain is not an acceptable statutory accounting practice. This means that a company cannot apply the constant yield method retroactively to real estate that has been depreciated by another method and treat the difference in depreciation amounts as a surplus gain. The constant yield method, however, can be applied *prospectively* to existing real estate.

SEC

I'd like to conclude now by reporting on two SEC matters, both of which relate to high yield securities. At the request of Senator Riegle of Michigan, Chairman of the Committee on Banking, Housing and Urban Affairs, the SEC recently completed a study entitled "Recent Developments in the High Yield Market." In requesting this study, Senator Riegle expressed concern about, among other things, the risk of defaults in high yield bonds to public investors, financial institutions, and pension funds.

The report contains two parts. Part I provides background information on the high yield market, including its characteristics as to structure, and includes data on the recent growth in this market. Part II discusses events during the summer and fall of 1989, including the heightened concern over the financial stability and credit quality of certain issuers of high yield securities. The report then focuses on the effects of those events on the high yield markets, and the actions that the SEC staff have taken to monitor these developments.

In reporting on recent SEC activities, the report mentions that the Commission has:

- attempted to improve the adequacy of information regarding high yield bond holdings and loan activity;

- identified risks that must be evaluated and addressed by organizations investing in high yield securities; and

- monitored the adequacy of disclosure by financial institutions regarding high yield bond holdings.

The report also indicates issues that the SEC feels should be considered further. Included in this list are improving the availability of information concerning price, liquidity, and other aspects of the high yield bond market, and developing centralized price or quotation systems. The report mentions, however, that any steps to increase the degree of regulation should take into account the implications and potential difficulties that may be involved.

Turning back to the subject of disclosure of high yield holdings, the SEC's Division of Corporate Finance wrote a letter in February 1990 to companies required to file with the SEC, expressing concern about the adequacy of disclosure by insurance companies of the potential impact of any material holdings of high yield securities. Companies were asked to provide such information as:

- the criteria used by the company to define its high yield investments;

- the carrying values and market values of the company's high yield investments;

- the dollar amounts of equity investments held in issuers of high yield debt securities; and

- the percentage of high yield debt and equity investments in relation to statutory surplus.

The SEC has not yet issued any report on the findings of this survey, and there is no indication as to when and if a report will be published. However, companies should be prepared for additional inquiries about their high yield holdings when filing future statements with the SEC.

MR. JAMES B. MILHOLLAND: After FAS 97, the news from the FASB and the AICPA is a little anticlimactic. While there are many subjects under consideration by both bodies, none are directed as specifically to the insurance industry as FAS 97, but several will require some attention. With the exception of accounting for other post-retirement employee benefits (OPEBs), none are as actuarial as FAS 97. I will briefly review those that have some significance to insurance companies and actuaries.

AICPA

Beginning with the AICPA, perhaps the most significant pronouncement is the draft Statement of Position (SOP) on Debt Securities Held as Assets. Under current accounting rules, generally FAS 60 and FAS 97 did not change this rule; companies hold bonds and other debt securities at amortized cost as long as they have the intent and the ability to hold the securities until maturity, which in my experience, is always.

The SOP would require three classifications in debt securities. The first classification is debt securities held as investments, which would be reported at amortized cost, in other words the current rule. To be classified as investments, the entity should have the ability to hold the securities to maturity and the intent to hold the securities for the foreseeable future.

The second classification is debt securities that are held for sale, which would be reported at the lower of amortized cost or market.

And the third classification would be debt securities that are acquired for purposes of trading, which would be reported at market value.

The SOP would apply to insurance companies, banks, savings and loans, finance companies, and other financial institutions. However, insurance companies would continue to report unrealized gains and losses of debt securities carried at market directly in shareholder equity.

Most of the discussion of the draft SOP has centered around the classification issues, especially the distinction between assets held for sale and assets acquired for the purpose of trading. There's been no discussion to my knowledge of the effect, if any, on the valuation of benefit reserves or the amortization of the deferred acquisition costs (DAC) for insurance companies, and I think that's a real oversight. If a significant proportion of assets are recorded at market, investment yields and spreads will be affected by the accounting for assets and might require some consideration by the actuary of the appropriateness of the benefit reserves and the amortization of the DAC, particularly under FAS 97.

The effective date of the pronouncement, if it is issued this year as it is expected to be, is for fiscal years ending after December 15, 1990. This means it may be applicable this year.

The AICPA Insurance Companies Committee continues to be active and is considering a number of items, including drafting guidance on accounting for reinsurance. The issues appear to be whether transfer of timing risk alone constitutes a significant transfer of risk, and whether liabilities should be reported gross, with a corresponding asset for reinsurance recoverables. This would be, at least on appearances, a big departure from current practice.

The Insurance Companies Committee has also decided that two task forces are needed to revise the Stock Life Insurance Company audit guide to address accounting and audit issues that have arisen since 1972, especially as a result of FAS 97. Topics would include expanding guidance on loss recognition and unlocking, and the project is expected to take three years.

The Committee has drafted implementation guidance on FAS 97, which is awaiting FASB clearance and should be filed this year. Probably most of you have seen that in draft form. It's in question and answer format, and addresses issues such as accounting for rollovers and when it is not appropriate to redefer deferred acquisition costs on internal replacements.

FASB

The Financial Accounting Standards Board has been equally busy. No, it is not going to reconsider FAS 97. Its plate is too full, it took long enough, and I don't think FASB wants to go back to it.

One big pronouncement which was issued this year was FAS 105 -- Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentration of Credit Risk.

The Board has been considering financial instruments and off-balance-sheet financing since 1986. This statement covers disclosure. The Board had intended to issue a much more comprehensive statement about including recognition and measurement of off-balance-sheet risk and accounting for financial instruments. However, the Board decided instead to issue two pronouncements, FAS 105 being the first.

Financial instruments include cash and any contract that imposes an obligation to deliver cash. This definition is very broad and is clearly intended to be inclusive, although insurance contracts other than financial guarantees and investment contracts are exempt from the requirements, as are pension benefits and other deferred compensation. Examples specifically included are swaps, options, and future contracts, and those are the kind of things that led to the original concerns that resulted in the pronouncement, although all the old mundane assets are included, even accounts receivable and accounts payable.

FAS 105 requires companies that have financial instruments with off-balance-sheet risk to disclose the terms and nature of the instruments, maximum losses, contract amounts,

and policies for requiring collateral or other security. The Statement also requires disclosure of information about significant concentrations of credit risk. Insurance contracts affected are deferred annuities and GICs. It also appears to me that the accounting profession through this pronouncement is addressing some of the concerns that valuation actuaries have had about the C-1 and the C-3 risks. In the accounting profession, the pronouncement is less specific to insurance contracts but more broad-based because it covers the entire spectrum of industries.

FAS 96, Accounting for Income Taxes, has been deferred for two years to be effective for years beginning after December 15, 1991. The deferral is mainly to give the Board time to reconsider the statement, and possibly make amendments. There are two main areas of controversy about the pronouncement as it was originally issued. The first relates to the complexity and the difficulty of compliance, and the second is with the stringent rules for recognizing deferred tax assets, which in short, would require a demonstration of the deferred tax asset realized out of deferred tax credits. The Board now seems a little more willing to make the rules less stringent and to consider aggregations and other techniques for making the compliance easier to do. Some of you have already complied. One of the stances of the Board is that, despite the fact that the pronouncement has been postponed, if you've already complied, you're not allowed to "uncomply" and go back to the old, you've got to stick with the new.

The rules for accounting for postretirement benefits other than pensions, finally known as OPEBs, will be effective for years beginning after December 15, 1991, and in some instances later. The exposure draft on this pronouncement was issued in February 1989, and probably is familiar to you if you have OPEBs, which most insurance companies do, or if you're considering funding products. Discussions now center around how to account for future plan changes. In other words, is it appropriate for the actuary to assume that plan benefit costs can be managed to certain levels, say relative to interest rates or inflation rates, or will the only changes that could be incorporated be those which are foreseeable and anticipated at the current point in time?

The exposure draft received over 450 comments, which is quite a large number. Most of the respondents agreed with the general concept of accrual accounting for postretirement benefits other than pensions, although frequent criticisms related to allegedly subjective and "unreliable assumptions" about future health care costs. One suggestion has been to make projections at current levels of costs and to treat increases as future events, which would be accounted for in future periods.

Finally, of some interest is an item called SAB-87. An SAB is a Staff Accounting Bulletin. This is a pronouncement of the FASB staff, which currently is reviewed by the Board before it goes out, but does not have the standing of an FAS itself. This one suggests that property and casualty companies disclose certain contingencies related to unpaid claim costs, when trends that provide the basis for reserves are insufficient, or insufficiently understood, or have been adjusted judgmentally. The accounting basis for this is FAS 5, Accounting for General Contingencies. Although the pronouncement is specific to property and casualty companies, the issue seems generic enough to also apply to life insurance companies, and Blue Cross and Blue Shield plans with material amounts of claim reserves.

That's all I have on specific issues at this point in time. There's also an issue of whether FASB is really doing the job that it should be doing. At least one major investment firm has suggested that FASB has not, that it has allowed itself to become too distracted with specific issues and has taken a position of distrust of companies' management and accountants and auditors. These critics assert that FASB has gone in the direction of regulating specific accounting issues while, in the meantime, ignoring more broad-based issues such as what is material. I'm not in agreement with that point of view because I feel that, with issues such as how you incorporate relative amounts of risks in the balance sheet, the FASB does have an agenda that needs to be addressed fairly specifically.

Another concern is the fact that many of the pronouncements of the FASB are adopted with a three to two vote. Some people, including one major accounting firm, believe that a three to two vote doesn't show enough support for an accounting rule to say that it is generally accepted, and that perhaps a four to one vote should be required in order for a pronouncement to become a requirement.

MR. JOHN J. PALMER: I'm going to talk briefly about some of the issues that the American Academy of Actuaries is addressing. I've worked on industry committees for a number of years now, but I still tend to get confused pretty easily about all these various organizations and groups and committees. Whatever is wrong with our industry or our profession, it isn't attributable to a lack of a sufficient number of committees to deal with the issues. The Academy generally focuses on issues that involve professional actuarial judgment. That is, issues which the actuarial profession is uniquely or especially qualified to address. Often it's difficult to separate the actuarial issues from non-actuarial financial issues, and from political issues, since many items of great interest intermingle all these types of issues. Nonetheless, we do attempt to leave the non-actuarial issues to other groups such as the ACLI or other trade associations.

I'm going to briefly discuss the current activities of a number of Academy groups that have a bearing on financial reporting. Time won't permit me to go into a lot of substantive detail on many of these. The Academy publishes a monthly "Government Watch" which reports on regulatory activities and the involvement of the various Academy groups. You can contact the Academy office or the appropriate committee chairperson for more details.

FINANCIAL REPORTING COMMITTEE

Let me turn first to the Academy's Life Insurance Financial Reporting Committee. Most of the work of this group has recently been in the area of assisting the ASB in drafting standards. Most recently, these have included standards for the cost of HIV-related claims and when to do cash-flow testing. The Committee is also reviewing the proposed standard on actuarial appraisals of insurance companies and blocks of contracts that was developed by the actuarial appraisal task force. I expect Harold will comment in more detail on many of these activities that involve the ASB.

You may have noticed that the Financial Reporting Recommendations and Interpretations aren't included in the current Academy Yearbook, as they have been in past years. This is because the Financial Reporting Committee is reformatting all of these to conform with ASB format, to be included in a loose-leaf Actuarial Standards Handbook,

soon to be distributed to Academy members. As part of this same project, the Financial Reporting Committee is also reformatting the Recommendations and Interpretations for Dividends and other Nonguaranteed Elements.

Finally, the committee is monitoring the FASB project on Interest Methods. As I understand it, the purpose of this project is to investigate how to take into account the time value of money for accounting purposes.

JOINT COMMITTEE ON THE VALUATION ACTUARY

The long gestating project to revise the Standard Valuation Law, incorporating a revised actuarial opinion and supporting memorandum, appears to be moving toward a conclusion. As you will recall, the Tweedie Committee presented a proposal to the NAIC some time ago. The regulators suggested significant changes and after an extended period of discussion and lobbying, most of the major differences have been resolved. Currently, it appears that the change in the law may be approved by the NAIC in December 1990, and the regulations thereunder perhaps by July 1991. Several significant issues remain.

The ACLI and National Association of Life Commissioners (NALC) have worked out a proposal for exempting companies of various sizes from various requirements. The NAIC has different sorts of views on how those exemptions ought to be cast, but the differences appear to be narrowing to a feasible consensus position.

Another issue is a transition period for the application of new rules to in-force business. Still another issue is the degree to which the revisions will rely on standards of the ASB. The NAIC people have suggested that the standards could be altered and possibly even countermanded by the action of the insurance commissioner. Would the ASB standards be envisioned as part of the law, or would they be more limited to simply extending specifications into areas which the regulators haven't yet addressed?

There also seems to be some discussion about the exact wording of the actuarial opinion -- whether these reserves should be required to be *appropriate* or *adequate*. There seems to be a difference of opinion on which one of those words ought to be used.

Finally, an open issue relates to the confidentiality of the actuarial memorandum. The industry would prefer to have the actuarial memorandum confidential. However, the process for full review of it, and the likelihood of outside assistance for insurance department review, makes it difficult to preserve confidentiality, and resolution of that issue seems still to be open.

COMMITTEE ON LIFE INSURANCE

This Committee, of which I'm currently Chair, deals largely with life insurance issues not otherwise falling to other special purpose committees. Thus, we sometimes end up with issues that have financial reporting overtones or implications. I'll mention some which may be of interest.

We've begun to take a look at the area of sales illustrations. We've gotten considerable comment from both regulators and from within the profession about the propriety and legitimacy of some sales illustration practices currently in use. This is tangentially a financial reporting issue in that, as you know, there are requirements in the Annual Statement Interrogatories disclosing dividend and nonguaranteed element practices. These are designed to work in conjunction with the Recommendations and Interpretations regarding determination of dividends and nonguaranteed elements that are contained in the Academy Yearbook.

The NAIC has recently set up a small working group to look at this issue. So we're not simply getting into areas totally on our own hook. Both we and the NAIC are just getting started in this area, and it's difficult to say where this will lead or what form any outcome will take. At the least, a review of the appropriateness and effectiveness of the Annual Statement Interrogatories seems in order. The questions (added to the Annual Statement at the suggestion of the Academy) may need to be more sharply focused, and enforcement of compliance with the Interrogatory requirements needs to be addressed. So far, the regulators seem unable to effectively monitor compliance, and conversely, some regulators have questioned the ability or the willingness of the actuarial profession to enforce compliance with its own published standards in this area.

Other possible approaches to the sales illustration issues might include applying some sort of smoothness tests to illustrated values, not merely to guaranteed values. This is obviously a very difficult and very sensitive issue, and a quick clean resolution should not be expected.

Our Committee has additionally taken on a task recently from the NAIC to provide advice on actuarial issues relating to accelerated benefit riders (not including, however, long-term-care accelerated benefit riders). These are riders which pay some portion of the face amount upon occurrence of a specific event, such as stroke or heart attack, or more generally upon proof of terminal illness. The major issues so far identified by the NAIC for us to examine are appropriate reserve requirements (if any) for these riders and, in the case of contracts that pay a reduced face amount in the prospect of imminent death, the appropriate basis for an actuarial equivalency.

In other areas that may be of some interest to you, we've also been monitoring recently the activity in Texas, which is designed to implement a law permitting the issuance of zero cash value policies. We've been monitoring the activity in Illinois, which recently put out a bulletin "clarifying" the application of the Commissioners Annuity Reserve Valuation Method to so-called "CD annuities." These are annuities that have a brief surrender period window during which surrender charges don't apply. It would also actually have an effect on annuities that have a cliff surrender charge, where there's basically a discontinuous runoff of the surrender charges.

Finally, we had a group monitoring an SEC inquiry into controlling the level of mortality and expense guaranteed charges in variable products. The mortality and expense charges, in actual practice, vary from about 75-125 basis points. The SEC's concern was that these charges were excessive and that somehow these excessive charges were being used to fund sales compensation. The SEC is quite concerned about controlling the

charges that companies make to fund their distribution expenses, and it was looking for some hidden slush, I guess, in this regard. We got interested because, at an early stage, the SEC seemed interested in having an actuary certify that the mortality and expenses charges for a company were not excessive, and we weren't quite sure how we could certify such a thing. We weren't quite sure how we could come up with numbers showing what they actually were. The SEC seemed to be under the illusion that companies account for these charges, so you could demonstrate whether or not your charges were excessive.

That issue seems to have died down for the moment. The SEC seems to be undertaking a more general review of regulation of insurance products and other similar kinds of securities, so I think the heat is off on that particular issue. But I think it's symbolic of some of the kinds of issues that we look at where actuarial input is needed.

In closing, I want to comment briefly on one thing I've observed over the years in the work of my Committee. What I've observed is that our efforts to achieve actuarially reasonable results from our various regulators have been seriously hampered by our inability to convince them that we, as a profession, have well-defined meaningful standards effectively enforced. I believe we're making good progress in this area, but much remains to be done to really make a sale to the regulators. We need to work much harder to make the standards we've developed an integral part of our practice, starting with our initial education program, and following up with continuing education programs. We need to continually review practices in our business against our standards of practice. If we don't take them seriously, we really can't expect others to take us seriously as a profession.

MR. INGRAHAM: I'll briefly discuss some recent standards of actuarial practice produced by the ASB Life Committee.

First, however, I'd like to say just a few words about the ASB itself. Many actuaries, unfortunately, are still relatively unfamiliar with the ASB, its standard setting process, and its reason for being. Some of our SOA members would appreciate the use of the French expression.

The ASB is an independent entity operating within the Academy. The ASB directs its operating committees, subcommittees, and task forces in the development of standards. And the ASB sets the priorities for all work undertaken by them.

When the operating committee responsible for developing a proposed standard has completed initial consideration of the standard, it presents the draft standard to the ASB for approval to expose to the Academy membership. Also, to be considered for exposure, a draft standard must be accompanied by a written report from Academy counsel Gary Simms advising the ASB of the draft's compliance with any applicable law or regulation. Following the exposure process, including any analysis of comments from respondents, the operating committee presents a final proposed standard to the ASB for consideration to adopt.

The ASB is the final authority in the matter of standards of actuarial practice, and it's responsible *only* to the Academy membership rather than to the Academy Board of Directors. The ASB also has made it plain that it won't permit the setting of rigid standards. Its members believe that standards of practice must be conceptualized and worded in such a way that they don't unnecessarily circumscribe an actuary's creativity in approaching new problems. In other words, the ASB endorses what it refers to as the "disclosed defendable deviation" approach. And the ASB has specifically instructed its operating committees "to avoid being overly prescriptive and to allow the actuary to deviate when he or she has justification."

The ASB recognizes that there are some situations where actuarial work is done in response to regulatory bodies or other professional organizations that have established rules or requirements not in accordance with generally accepted actuarial principles and practices. To deal separately with those situations, the ASB has adopted actuarial compliance guidance.

At present there are six operating committees: Casualty, Health, Life, Pension, Retiree Health, and Specialty (which is a sort of catch-all committee for when you don't know where else to assign a particular standard). A couple of outputs from that committee have been a standard of practice on risk classification, and one on expert witness work. There's also a Long-Term-Care Task Force.

Prior to 1990, the Life Committee produced four standards which have been adopted:

- Recommendations Concerning the Redetermination or Determination of Non-Guaranteed Charges and/or Benefits for Life Insurance and Annuity Contracts.
- How to Do Cash-Flow Testing for Life and Health Insurance Companies.
- Treatment of Reinsurance Transactions in Life Company Financial Statements.
- Methods and Assumptions for Use in Stock Life Insurance Company Financial Statements Prepared in Accordance With GAAP.

At its meeting a couple of weeks ago, the ASB revised and decided to re-expose a standard of practice that will provide guidance to the actuary in carrying out professional responsibilities in estimating and providing for the cost of HIV-related claims. This standard was developed by the Life Committee with the assistance of an ad hoc drafting task force. It's kind of unusual to re-expose, but I'll get to the reason why.

This standard notes that the margins in statutory reserves historically have not been set at levels intended to cover the excess mortality and/or morbidity resulting from epidemics of sudden impact and short duration, like the influenza epidemic of 1918-1919. In those instances, a combination of dividend reductions and surplus allocations served to cover the risks. However, this approach is inappropriate in the case of the HIV epidemic, because of its magnitude and potentially long-term nature.

As redrafted, the standard now makes clear that reserves should be increased directly to cover any excess claims cost, instead of alternatively making an appropriation of surplus. In determining the amount of such reserves, the actuary may take into account reasonably anticipated actions of the company, such as dividends and scale decreases or changes in nonguaranteed policy elements. Also, the actuary should determine the period over which any additional reserves should be funded.

The ASB members believe that reserve strengthening represents the proper theoretical approach here. And they also note that, in this regard, the actuary certifying an insurer's reserves must state that the reserves make good and sufficient provision for the unmatured obligations of the company.

We received a number of comments on the original exposure draft of the standard suggesting other reasons why insurers might prefer different approaches. These included:

- insurance department scrutiny of reserve credits taken by ceding insurers,
- the fact that current federal income tax law doesn't recognize strengthened reserves for HIV purposes as deductible expenses,
- if an insurer sets up additional reserves to cover any excess claims cost attributable to the HIV epidemic, which subsequently are deemed excessive, it must secure regulatory approval to release those reserves.

The standard also reminds the actuary to recognize that lapse rates for the infected uninsured population will likely be significantly lower than the corresponding lapse rates for the uninfected population. This, of course, means that projections of future HIV-related claims could be seriously understated, unless this lapse differential is appropriately taken into account.

Another new standard in process provides guidance to the actuary in deciding whether or not to perform cash-flow testing, when giving a professional opinion or recommendation for a life or health company. This standard was developed by the Life Committee with substantial assistance from the Academy's Committee on Life Insurance Financial Reporting. As with the HIV standard, it already has been exposed to the membership, but it still needs more work, so it won't be presented until July 1990 to the ASB for consideration to adopt. The Tweedie Committee report last year set forth a basis and framework for development of standards, as to when to do cash-flow testing related to statutory reserves. This standard builds on that report, and also provides expanded guidance for when to do cash-flow testing in areas other than testing of reserves.

This is a particularly timely standard in the light of developments in recent years. Given the greater level and volatility of interest rates, group underwriting losses, the increased default risk associated with below-investment-grade bonds, and the emergence of interest sensitive insurance and annuity products, it has become apparent that cash-flow testing needs to be both more frequent and more sophisticated.

This proposed standard notes that the need for testing depends on the nature of the risk. Also, in the case of certain risks, even though large, the risk can be identified and the reserve can be tested without the necessity of multiscenario cash-flow testing. However, such testing becomes particularly important in cases where the magnitude of the financial effect of certain deviations from expected experience is not clear.

The standard makes clear that there are situations where cash-flow testing may not always be appropriate or necessary. For example, a valuation actuary may be able to demonstrate that experience will almost certainly be less severe than that provided for in the reserves. A typical participating life insurance policy might well fall into this category. Also, the considerable costs of formal cash-flow testing often preclude its effective use in making a preliminary feasibility review for a new product.

This standard concludes that there are practical limitations on the amount of cash-flow testing needed to support an actuarial opinion or recommendation. On the other hand, the standard requires the actuary to be prepared to explain in a report or otherwise, whether or not cash-flow testing was done, and if not done, why not.

Another important draft standard has been put together on actuarial appraisals, jointly sponsored by the Casualty and Life Operating Committees. It was approved last month for membership exposure by the ASB. This proposed standard was developed by a special task force chaired by Bob Shapiro. It was really a diverse and eclectic group consisting of life and casualty actuaries representing six consulting organizations and major accounting firms, also one corporate executive with broad insurance merger and acquisition experience and responsibilities, and two Wall Street investment bankers who aren't actuaries, also with substantial insurance experience.

The task force's mission was defined as follows:

> To develop a standard of practice for actuarial appraisals and/or analyses which provides consistency between life insurance and casualty insurance situations. The standard should provide guidance to developers and users of such actuarial reports, leaving room for variations in those items that differ between life and casualty work. Thus, this standard will deal with those issues that are universal to appraisals of insurers and other related organizations.

A vital purpose of this proposed standard is to have it play a strong role in maintaining a high level of market credibility for actuaries working in the areas of actuarial appraisals and mergers/acquisitions.

In drafting this standard, the task force addressed a number of critical issues including:

- How should the standard deal with the evolving research, technology, and literature in many areas?

- How should the standard reflect appropriate variations in perspectives on value?

- What is the appropriate basis for "earnings" in an actuarial appraisal? And, how should the actuary deal with the cost of capital, varying buyer perspectives, and different client needs?

- Is there such a thing as *one* intrinsic value for an insurance company?

Actuarial appraisal and analysis assignments are completed for a wide range of users with varying objectives and needs. This standard has attempted to reflect these realities in order to be of maximum value to both practitioners and the industries they serve. In this context, users include management groups, buyers, sellers, advisors, intermediaries, investment bankers, investors, analysts, regulators, and (last but not least) the IRS.

Finally, let me say a few words about a subject that I'm happy that John Palmer also commented on, and that's the subject of enforcement. The creation of the ASB has provided a sound basis for the promulgation of actuarial standards of practice. But the issue of enforcement of these standards, obviously important and significant, still requires serious further discussion and action. Otherwise, in the absence of enforcement, the standards could become relatively meaningless. In this regard, I urge all of you to read Jim Murphy's thoughtful article on this subject appearing in the April 1990 issue of *The Actuarial Update*. Jim's article points out that enforcement of professional standards requires several steps:

- the promulgation and publicizing of the standards throughout our profession and among our publics.

- a method for verifying compliance with the standards.

- an equitable yet effective disciplinary mechanism to deal with those (we hope very few) individuals who deliberately engage in activities without any consideration of the applicable standards.

The Academy's Executive Committee recently concluded that the biggest "holes" in the current system are compliance verification and monitoring. It also was unanimous in its belief that the primary goal of enforcement should be to catch any problem at the beginning rather than later. In other words, counseling and advisory services should be available prior to the need for discipline. With this in mind, the Academy intends to appoint a task force to consider how the Academy can best undertake an active approach to compliance monitoring.

MR. ARNOLD A. DICKE: Let's begin with a little history. The Committee on Actuarial Principles was formed about a year and a half ago and charged with articulating a set of fundamental principles for the profession. Principles are a little bit different in nature from the kinds of things we've been talking about in this session. They're not a collection of rules that people have to follow, but rather something of a description of the kind of profession that we're involved in.

Let me talk about just four questions that are frequently raised about the work of the Committee:

1. Why have principles in the first place?
2. How do principles differ from standards?
3. What process is being followed by the Committee?
4. What responses has the Committee had to date?

First of all, why have principles? The short answer is because the Board of Governors of the Society a while back decided that it was in need of principles and appointed a committee. A somewhat longer answer is that, at the time the effort to write standards was initiated, it was thought that standards needed to be grounded in principles; i.e., that while standards need to be prescriptive and deal with specific situations, it might be a good idea to start out with a more global point of view and try to understand the scientific, mathematical and economic concepts on which the profession is based.

Also, principles can help us to define the area of professional competence to which we are staking a claim. This has become increasingly important. Increasingly, we see nonactuaries starting to carry out some of the procedures that we have always thought were specifically actuarial in nature. In fact, one of the responses that we received speaks to this. The comment was from a property/casualty actuary who is concerned about nonprofessionals "practicing" actuarial science. This actuary comments: "By stepping forward and calling actuarial science a profession, this discussion draft assists MAAAs, SOA and CAS members in setting themselves apart . . ." from nonactuarial practitioners. That is, in fact, one of its purposes.

Another reason to identify principles is to help outsiders understand what actuaries do and to make available a reference containing a synopsis of some of our ideas. This could be particularly useful when legislators and others in decision-making positions are considering action in matters on which we would like to provide input. It can be difficult to come up instantaneously with ways to express actuarial concepts in a single sentence or a catch phrase. Even the definitions of terms commonly employed by actuaries may require a series of logical steps that are not easily summarized. It was thought that it might be useful to have something already written down that could be perused at leisure by thoughtful people involved in the legislative and regulatory process.

Also it's impossible to think that a written expression of this nature will not, at some point, be referenced in court cases and similar proceedings. Whether or not it's intended, litigation is likely to become one of the things that principles are used for, and we need to keep this in mind as we're writing.

The second question we are asked is: how are principles different from standards, and why have both? In fact, that's the first thing our Committee thought about when we started discussing our assignment. We have a pretty good idea what standards are turning out to be, especially now that a number of drafts and finished standards have appeared. The Committee spent its early meetings trying to see if there is some way to look at all the various kinds of statements that can be made about the profession. We came to the conclusion that if we thought about principles as belonging to several different categories, we could see the relationship to standards better. Eventually, we settled on three categories. Principles at the most general level we began to call "fundamental principles"; the next level became "methodological principles"; and the third level,

"behavioral principles." Perhaps a better term for the final level would have been "normative principles."

From our point of view, fundamental principles were supposed to be those statements that seem to incorporate the results of the experience that has been gained by actuarial professionals over the years and that is not expected to change in the short run. Consequently, fundamental principles were envisioned by the Committee as rather general statements about the things that actuaries do; the central beliefs, so to speak, that actuaries hold.

Methodological principles, on the other hand, were envisioned as those realizations of the fundamental principles that are used in day-to-day work. Let us give an example: a fundamental principle about the time value of money likely would be stated in a very general way, avoiding, perhaps, any mention of interest rates. Interest rate structures would be brought in via the methodological principles that proceed from the fundamental principle. These methodological principles might describe the different types of methodologies that are appropriate for representing time value in different settings. For example, at one extreme interest rates may be introduced in a very general way, utilizing scenarios developed by means of a Monte Carlo simulation and incorporating conditions assuring the absence of risk-free arbitrage opportunities. Moving down one level, one interest rate, or a set of interest rates, possibly described by a force of interest function, is a methodology still in frequent use in pricing and some types of valuations. The other end of the spectrum of methodologies is the possibility of doing without an interest discount altogether, i.e., defining the single interest rate to be zero. So there are a number of different ways that the fundamental principle that money has time value can be realized in practice, and those realizations are methodological principles.

What we've been calling behavioral principles are prescriptive statements -- statements that say "the actuary should." None of our other principles are of this nature. The fundamental and methodological principles are statements about the way the real world operates as actuaries see it, and the ways that the real world can be represented in actuarial modeling. When we get to behavioral principles, then we're discussing things that prescribe the way an actuary ought to act. And because of this, behavioral principles are beyond the scope of the Committee. In our own terminology, we like to say that standards are behavioral principles that have been adopted by a professional body with the responsibility to do so. Thus, any prescriptive or normative statement about actuarial practice would be considered a behavioral principle, but only those behavioral principles which have been "officially" adopted are considered to be standards.

Next, let me say a few words about the process that was followed by the Committee in developing the discussion draft which all SOA members received in the mail. First of all, we put together a very small committee with very broad membership. The Committee has members drawn from each major practice area: life insurance, health insurance, pensions and investments. We even boast a joint Fellow of the Society of Actuaries and the Casualty Actuarial Society. While we have benefited from input by this joint Fellow about property/casualty practice, we are aware of our Committee's inability to cover this area adequately without direct CAS involvement. We also have always had one of the

practice areas covered by a Canadian Fellow, who was asked to do double duty and keep us informed about the work of various committees of the Canadian Institute of Actuaries.

Second, we developed a list of consultants -- people whose names we were familiar with from around the profession, who'd written or discussed these kinds of topics through the years. This group of about 30 consultants was sent some of the earlier drafts and asked for comments, and we tried to reflect the consultants' comments in the later drafts. We went through quite a number of drafts by the end of summer 1989.

In August 1989, we got together with some of the principle setting committees of the Casualty Society, trying to look for common ground. It was a very positive interchange. Those of you who have been involved in interfacing between the various actuarial organizations that proliferate in North America know that joint meetings don't always turn out to be happy exchanges, but this one did. It seemed like we were on an interesting tack, in that while our Committee was focusing on fundamental principles, the Casualty people felt that what they had been working on would best be classified as methodological principles. Both the groups seemed genuinely appreciative of the work done by the other. For our part, the Committee intends to adopt the excellent CAS format for our own methodological principles.

Finally we got to the stage where we were ready to send out a discussion draft, and that's what members have received in the mail. You may be interested to know that a number of other actuarial societies made the draft available to their members, either by having the draft mailed directly to their members, or by sending out notices that the draft was available. In fact, all the national and international actuarial organizations in North America were involved in the process.

The discussion draft asks for comments by July 2, 1990, by the way, and if any of you haven't written yet, we're expecting you to get busy! After July 2, 1990, we intend to take all of these comments and try to build them into another draft -- an exposure draft. This two-step process that we're following actually is something else that we adopted from the Casualty Society. I recently discovered that the Canadian Institute is also using it in Canada. The labeling of the draft as a "Discussion Draft" is intended to communicate that this is something we're just proposing doing. We'd love to hear about it, and we're prepared to make major changes if you give us input that we can use. So, once again, this would be a very good time for you to give us that input, rather than at the stage of exposure draft when things get a little more formal.

When we put out the Exposure Draft, we're going to respond in detail to any response we receive. Comments to the discussion draft will be answered in a more general way. However, we will try diligently to use your comments to develop a better draft. The Exposure Draft should be finished and prepared to go out by the end of the year, and if we can do it soon enough, we may have responded to comments and made changes in time to actually present a final draft to the Board early in 1991.

That's the process we're going to be following. We have tried to keep it as open as possible to anyone who has input to be made, and we really do encourage you to respond to the discussion draft.

Finally, what sort of responses has the Committee received? Well, they go to both ends of the spectrum. I'll give you one from the negative end of the spectrum to begin with: "Fundamental principles -- and the associated material threatened in the Discussion Draft of March 1990 -- are worthless. There is no audience for the material that can make profitable use of it." The choice of words was great! I appreciate responses that are colorful.

Another response along this line was actually the conclusion of a very thoughtful three-page letter from a very distinguished actuary. The writer set forth a lengthy quote from Plato, that began: "the rules which have been laid down do represent the fruit of experience -- one must admit that. Each of them has been put forward by some advocate who has been fortunate enough to hit on the right method of commending it and who has thus persuaded the public assembly to enact it . . . ."

And the writer goes on to say: "Apparently the Committee on Actuarial Principles consist largely of bean-counting Aristotelians."

That's certainly the worst we've been called. Although, I've always considered myself an Aristotelian, and as a financial reporting type, I guess I'm a bean counter! So that really is no insult at all -- just one more very descriptive phrase.

Happily, we did get positive comments. I read one before. Here's another one:

> Having a standard set of definitions and principles will prove useful for rigorous discussions. Also, the documentation of these fundamental principles should prove useful when actuaries find themselves in conflict with nonactuaries over risk related matters.

And that says a lot about what we're actually trying to do. With your comments we hope we'll do it better than we have so far.

MR. MICHAEL BAUER KUTTLER: I've two comments. First in reading the actuarial principles, I found they helped me see things in a new light in that laying down the basic principles allowed me to think about other possibilities than the basic things that we do all the time. So I found that really useful.

MR. INGRAHAM: One of our respondents suggested they might be particularly useful as study material in the SOA Education and Examination Committee's Fellowship Admission program, and that has considerable merit.

MR. KUTTLER: My other is a simple question. Will there be any one place where all the actuarial standards of practice will be published, so we don't have to keep all the little booklets?

MR. INGRAHAM: Definitely, yes, in April 1990.

MR. JOHN R. MCCLELLAND: I have a question for Tony Spano. Do you expect the changes to the MSVR to be effective for 1990?

MR. SPANO: Yes, the Annual Statement had actually been closed for 1990. But now it's been reopened to consider these changes that I described that are to be acted upon at the June NAIC meeting.

MR. MCCLELLAND: Do you think that they will be changed from what has appeared in print so far?

MR. SPANO: That's very possible. I don't know if there are people in the audience who are intimately involved with the process. If anyone would like to comment on this, I would welcome it.

MR. WILLIAM D. WARD: I'm Chair of the two MSVR advisory groups. We will be meeting very soon with the regulatory working group to develop the final proposal, which will be submitted to a joint meeting of the regulatory working group and my advisory group on May 10, 1990 in Washington, preparatory to its submission to the NAIC Blanks Committee. A question was asked whether the proposal that was exposed at our April 10 meeting will be the one that ultimately appears in the 1990 Annual Statement. At this point, I suspect something very similar to that will probably appear. There will be a significant modification in the Annual Statement to allow for that. Whether or not it will be the MSVR proposal that is put in there will have to await the next meeting that we will have with the regulatory group. There is some strong support for a phase-in. We will probably be discussing, if that be the case, the mechanics of the phase-in. There have been several alternative proposals submitted. Also we will be discussing just exactly how the new categorization and how the formula will work in terms of the private placements.