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CURRENT FINANCIAL REPORTING TOPICS IN THE UNITED STATES

Moderator: JAMES D. WALLACE
Panelists: WILLIAM CARROLL
ARNOLD A. DICKE
PAUL F. KOLKMAN
Recorder: JAMES D. WALLACE

- This session will include discussion on the activities of the:
  - National Association of Insurance Commissioners
  - Financial Accounting Standards Board
  - Actuarial Standards Board
  - American Academy of Actuaries
  - American Institute of Certified Public Accountants
  - Securities Exchange Commission
  - Actuarial Principles Committee
- Emerging issues in both statutory and GAAP financial reporting will be discussed.

MR. JAMES D. WALLACE: I am a partner with Ernst & Young which is one of the Big Six accounting firms. I am the director of the insurance practice for the midwest region of the firm. I am a CPA as well as a Fellow and accordingly spend the majority of my time on accounting and reporting matters for the insurance industry. I am going to address various matters with respect to activities at the FASB, the AICPA and the SEC. Paul Kolkman will cover developments at the Actuarial Standards Board and the American Academy of Actuaries. Paul is the Vice-President of finance for IDS Life Insurance Company. He is the chair of the Academy Committee on Life Insurance Financial Reporting. He is a member of the Life Operating Committee of the Actuarial Standards Board and the chair of the ACLI Committee on Financial Reporting Practices. William Carroll will cover developments at the NAIC. Bill is with the ACLI where he is involved in government relations, and he also is assigned to follow activities at the NAIC. He serves on many NAIC advisory groups. Finally Arnold Dicke will cover Actuarial Principles Committee activities. Arnold is a consulting actuary with the New York office of Tillinghast. Previous to that he was chief actuary of Provident Mutual Life Insurance Company. A couple of years ago Arnold was asked to form a committee on actuarial principles, and he has served as chairman of that committee since its inception.

I am going to cover issues evolving at the FASB, the AICPA and the SEC. The FASB had a flurry of activity in 1988 but really passed nothing of significance in 1989 for life insurers with the possible exception of FAS 105, which I will soon discuss. But first, I would like to comment on a couple of old pieces of business, FAS 96 and FAS 97.

FAS 96, which you may know, is the generic income tax pronouncement that will affect all corporations, insurance or otherwise. However, since it was issued in 1987 it has already been amended twice. And, it is not effective until 1992, although it is a final pronouncement. Accordingly, any discussion of FAS 96 is probably best deferred at this

time until nearer the required implementation date. However, the basic thrust of FAS 96 is to change the focus of the deferred tax calculation from an income statement perspective to a balance sheet perspective. It will probably have dramatic effects on a number of insurance company GAAP financial statements. One thing of interest in FAS 96 for insurance companies is that the policyholders' surplus account survived what is called the indefinite reversal classification. At some time there was a thought that deferred taxes would have to be provided on that account balance. The final version of FAS 96 will, in most cases, not require that.

FAS 97, another old piece of business, became effective in 1989. As I am sure many of you know, FAS 97 addresses the change in accounting for defined universal life contracts, investment contracts and limited payment contracts. A discussion of FAS 97 is well beyond the scope of this session. However, there has been a significant development with respect to that FAS 97 which deserves mention. There is a proposed AICPA practice bulletin, in draft form, that consists of 14 questions and answers regarding the implementation of FAS 97. Unfortunately, the FASB has expressed a jurisdictional concern over that practice bulletin. The FASB has indicated that it does not believe it is appropriate for the AICPA, or anyone else, to be issuing interpretations of its pronouncements. Consequently, this AICPA practice bulletin will not be issued until the jurisdictional issue between the FASB and the AICPA is resolved. Nonetheless, reportedly the FASB and the AICPA agree on the content of the practice bulletin.

I will mention some of the major items that are addressed in the draft practice bulletin. The first item relates to the definition of acquisition costs. It was clarified by this draft practice bulletin that FAS 97 did not change the FAS 60 definition of acquisition costs. However, it was also clarified that, for FAS 97 purposes, certain acquisition costs are not to be capitalized that would have been under FAS 60 -- specifically those that vary in a constant relationship to premium or insurance in force or are recurring in nature or are incurred in level amounts from period to period. Under FAS 60, generally if costs meeting those criteria were deferred, they would have been amortized in the year of deferral due to the mechanics of the amortization calculations. This would not always be the case for FAS 97. As a result, it was clarified that those items should not be capitalized.

Second, the draft practice bulletin would clarify that universal-life-type amortization methods for deferred acquisition costs are the methodologies that should be used for investment contracts with significant revenues other than interest -- in other words, deferred annuities. However, for investment contracts with principally only interest for revenues, a FAS 91 approach is to be used. Essentially this means the prospective deposit approach. This would generally apply to immediate annuities that do not involve life contingencies. In either case, periodic unlocking of assumptions should occur just as is the case for universal life under FAS 97.

Next, the draft practice bulletin indicates that the prohibition against the continued deferral of deferred policy acquisition cost (DPAC) on internal replacements applies only to replacements of traditional life policies by universal life policies. For any other replacement, if the economics are such that the acquisition costs should not be written

off immediately, FAS 97 does not specifically require immediate write-off of the old DPAC balance.

Another important clarification in the draft practice bulletin is that nondeferrable acquisition costs should be excluded from the gross profit stream. If nondeferrable acquisition costs were included in the gross profit stream, the result is an indirect deferral of those costs, at least to some degree.

Also, the draft practice bulletin indicates that capital gains that have been specifically allocated to the universal life line should be included in the definition of gross profits.

Next, the draft practice bulletin indicates hindsight should not be used in the restatement period. That is, when previous years' financial statements are restated during the initial adoption of FAS 97, assumptions are to be selected in a similar manner as in 1972 when the audit guide was issued. That is, assumptions are selected consistent with the knowledge available at the period to which they apply. That is, knowledge of the past cannot be used to set those assumptions. As a result, unlockings can occur during the restatement period.

While there are a number of issues addressed by this draft practice bulletin, I am only discussing some of the more contentious ones. The final item I will address is the one that clarified that recoverability and loss recognition concepts apply to deferred acquisition cost balances on investment contracts but not to the liability. What that means is that if, for instance, a block of investment contracts, say deferred annuities, were in loss recognition, the deferred acquisition cost balance would have to be written down until the block were no longer in loss recognition. Once that balance is written off, there is no requirement to accrue more liabilities. That would not be the case for universal life or traditional life policies which would require additional reserves to be provided if the contracts were still in loss recognition after all DPAC had been written off.

So much for old business. The new business with respect to FASB is FAS 105. FAS is entitled "Disclosure of Information About Financial Instruments With Off-Balance-Sheet Risk and Financial Instruments With Concentrations of Credit Risk." That long name implies the focus of FAS 105 is on disclosures related to financial instruments. The financial instruments being referred to here typically are items that are not recognized in the balance sheet. They are referred to as off-balance-sheet liabilities. They are defined as any instrument that includes the contractual right to receive, exchange, or deliver cash or other financial instruments that result in cash in the future. FAS 105 does not change any accounting. It only deals with disclosures. The disclosure that will be required for these instruments, that currently is generally not required, is the maximum accounting loss that could occur if a party to the financial instrument fails to perform, and the underlying collateral turns out to be worthless. The FASB specifically excluded insurance contracts from the definition of financial instruments, other than financial guarantees and investment contracts. So, deferred annuities will get swept in, but I am not aware of any significant new disclosures that will be required for deferred annuities. However, while it does not apply to many insurance liability categories, it does apply to such things as interest rate swaps, financial guarantees, option transactions and many of

the other exotic activities that insurance companies are involved in. Accordingly, you can expect your companies to have a bunch of lengthy new disclosures for these items.

The other thing that FAS 105 requires is disclosure of concentration of credit risks. Concentration of risks in assets with similar characteristics have to be disclosed. FAS 105 is effective for calendar 1990.

The FASB also is involved in a few deliberations that have not become pronouncements yet. The one that you have probably read the most about deals with other postemployment benefits. It is not uniquely an insurance industry issue, but, rather, it will apply to all corporations. The issue is whether or not companies ought to accrue for liabilities with respect to postretirement benefits, such as health insurance benefits or life insurance benefits that are not already accrued for in the pension plan and currently are expensed more or less on a pay-as-you-go basis. The FASB has been holding discussions throughout 1990 on how to account for other postemployment benefits (OPEBs). The discussions have focused mainly on health care cost trends, discount rates, recognition criteria for experience gains and losses and management's intent and ability to make employee benefit plan changes. The liabilities that could come out of OPEB accounting for corporations are staggering. The conclusions from FASB on OPEBs are supposed to come out in 1990, but, as it stands for now, there are no final pronouncements.

Also of some interest is FASB's recent change in voting procedures. Back in 1977, FASB went to a 4-to-3 simple majority requirement to issue a pronouncement. Prior to that, it required a 5-to-2 vote. Last month the FASB voted to go back to a 5-to-2 requirement. Proponents of that approach believe that a FASB statement requires a greater perception of unity and concurrence than a 4-to-3 vote would suggest. Among others, Congressman Dingell noted in a letter to FASB that the majority voting standard was the standard for Congress, the Supreme Court and the SEC. But, FASB was not persuaded.

Now let me touch on a few activities at the AICPA. The AICPA did not finalize anything of significance in 1989 either, but there are a number of significant projects underway. The most significant has to do with debt securities held as assets. Here we are referring largely to investments in bonds, although it is much broader than that. Basically, FAS 60, which governs insurance accounting, requires insurance companies to carry their investments in debt securities, that is, bonds, at amortized cost, generally as long as the company has the ability and the intent to hold the security to maturity and as long as the bond does not have any permanent impairment. Recently many S&Ls, banks and insurance companies have been actively trading their portfolios and not holding these securities until maturity. As a result, a few rulemakers who have observed this have decided that certain bonds ought to be reclassified as trading securities or securities held for sale. That is significant because the accounting for those classifications is very different than amortized cost. In response to this the AICPA has developed a proposed statement of position (SOP) which would govern this area. What the SOP says is that at the time a bond is purchased, it must be placed into one of three classifications. Then, on every subsequent balance sheet date, it must be reevaluated to determine whether or not that bond should receive a change in classification. The classifications include the investments category which would require carrying the bond at amortized cost, bonds

held for sale which require carrying the bond at the lower of cost or market, and bonds held for trading purposes which would be carried at market. And, as you know, market can be very, very different than amortized cost. In order to continue holding bonds at amortized cost, which more or less is what most insurance companies do with their entire portfolios now, the ability and the intent to hold the security to maturity must be demonstrated. The ability to hold the security to maturity has to be for the foreseeable future which, for the most part, is one year. If the two-tier criteria cannot be met, then the securities would be classified as held for sale and carried at the lower of cost or market. This SOP is intended to be effective for calendar 1990. However, that is a pretty ambitious time schedule.

A few other matters the AICPA is looking into relate mainly to the property casualty industry, but they may eventually carry over to the life industry. They deal with reinsurance. The AICPA reinsurance task force has been attempting for quite a while now to define what transfer of risk in a reinsurance contract means. The issue is whether or not both timing and underwriting risk are needed to qualify a reinsurance contract to be accounted for on a GAAP basis as reinsurance. The final resolution of the transfer of risk issue may occur this year. There appears to be a lot of pressure on the AICPA to get the position paper issued. The AICPA reinsurance task force is also looking at fronting. There is another jurisdictional issue over who ought to be looking at the issue. Some believe that fronting is no more than significant reinsurance. Others believe it is a completely different matter. When the AICPA determines who it is that is going to address the issue of fronting, likely requirements that would come out of a resolution of the issue will be disclosures on fronting activities and disclosure of accounting for fronting fees.

Finally, in the reinsurance area, the issue of whether or not items in the financial statements should be carried gross or net of reinsurance is getting a lot of attention. The FASB is particularly interested in the area and there is some belief that reinsurance activities should be better disclosed. That is, some believe that gross amounts and reinsurance ceded amounts should be shown separately in financial statements so that total exposure can be gauged.

The AICPA also is considering updating the life insurance audit guide that was issued in 1972. If that is done, there will be two task forces to update the guide. One will address accounting issues and one will address auditing issues. Principally, it is FAS 97 that has caused the need to reassess the audit guide, although investment in many exotic assets have contributed to the need. The revision, if it is undertaken, will probably take at least three years.

For those of you who are involved with insurance agents and brokers, it looks like the AICPA task force that has been evaluating accounting for agents and brokers for 10 years or so is going to issue an exposure draft this year.

Finally, three quick matters with respect to the SEC. The first deals with Article 7 of Regulation S-X. Those of you who are involved with stock companies and 10K's know that Article 7 is the set of rules that governs accounting and reporting to the SEC for insurance companies. Article 7 is being overhauled, although largely it is cosmetic. The

overhaul is largely aimed at incorporating FAS 95, FAS 96 and FAS 97 which deal with cash flows, income taxes and insurance accounting. Those final amendments are awaiting a vote which will probably happen in the next couple of months, and I suspect we will have the new Article 7 by the end of the year.

Another topic is mutual GAAP. The AICPA insurance companies' committee recently met with the chief accountant and staff of the SEC to discuss various matters. Currently, mutual insurance companies that have to register with the SEC as a primary registrant or because they sponsor a mutual fund or a separate account or for other reasons, are able to provide statutory basis financial statements. The SEC indicated that it was reconsidering this exemption; that is, the exemption from providing stock life GAAP financial statements for mutual insurers, particularly those that are direct issuers of securities. They are also considering the current exemption from reporting on a quarterly basis. Where all this will go is really unknown at this time, but it looks like the issue of mutual GAAP may get revisited.

One last topic has to do with junk bonds. Many insurance company registrants recently got letters from the SEC inquiring about junk bonds. The questions asked in those letters addressed how the companies were accounting for junk bonds, what their provisions were, and how they determined the provision. While there are no specific pending proposals that have come out of this junk bond issue review, the SEC is very interested in accounting and reporting on junk bonds. Each company will have to evaluate over the coming years whether it will need to take specific write-downs or provide allowances for junk bonds. As long as the volatility in that market remains, you can expect this to be a topic of interest for the foreseeable future.

MR. PAUL F. KOLKMAN: My portion of this session is a summary of the financial reporting developments coming out of the American Academy of Actuaries and the Actuarial Standards Board.

The Standards Board has been quite active recently in the development and adoption of standards that affect financial reporting, but the ones I'm going to limit my comments to are those that directly affect the work of life and health actuaries. Those are the primary responsibility of the Life Operating Committee of the Actuarial Standards Board. The Life Operating Committee currently has four major standards or projects that are in one stage or another of development. Those are the HIV standard and the when-to-do-cash-flow-testing standard, both of which were first exposed last October, a standard for how to do actuarial appraisals of companies or blocks of business, and a project to reformat all of the existing financial reporting recommendations and interpretations. I'll cover each one of these in turn, starting with the reformatting project.

The reformatting project seems to be one of our least controversial projects. You may have noted that the financial reporting recommendations and interpretations disappeared from the *Yearbook* this year. The ASB intends to put out a spiral binder including all actuarial standards later this year, and the feeling was there was just no need to reprint the old ones in the *Yearbook*.

The reformatting project includes the standard on nonguaranteed elements. There will be very little change to this standard. It was adopted by the Interim Actuarial Standards Board, is very nearly in the format that the Board currently likes to see, and will probably be adopted without a new exposure. The standard on dividend determination and illustration for participating business is also being reformatted. There will be more changes to this standard, but the changes are primarily deletions. The art that comes to the process is trying to delete maybe a third of the original material without changing any authoritative content. If we're successful, and I think we have been, this standard will also be adopted without re-exposure.

Then there are the 11 financial reporting recommendations and interpretations. This presents a somewhat bigger problem because, again, we have the problem of wholesale deletions. For example, anybody who has read Recommendation Interpretation #1 on GAAP accounting for stock life insurance companies knows that it contains some really dated material. Some of the other recommendations may just be entirely deleted. The first two that we've looked at are Recommendation #2 which deals with relations with the auditor, and Recommendation #3, which is the GAAP reporting opinion. Current plans are to combine and expand these two. The first originally dealt with the relationship between the actuary for a stock life insurance company and the CPA doing the audit. We'll probably expand that to include stocks, mutuals, fraternals, HMOs, continuing care communities, and anything of that type, and the auditors will be expanded from CPAs to state insurance examiners, people from the SEC and the like. It's a pretty bland, noncontroversial recommendation. It just simply says to be nice and give people what they ask for, and we don't believe that this will be a controversial extension. The GAAP report and opinion will probably be deleted. To the best of our knowledge, very few people do a GAAP report and opinion. We believe that this recommendation is an anachronism of an earlier era when the actuarial profession was going to try to get the actuary to do a reporting opinion that then would be respected by the CPAs. That didn't happen. The CPAs now go leafing through work papers and collect far more information than is ever contained in the actuarial report and opinion. So, it simply becomes irrelevant, and, since it's irrelevant, we might as well delete the requirement. This change will probably not be adopted without exposure.

The next recommendation we'll be looking at is #1 which deals with GAAP accounting for stock life insurance companies, and, again, most of it will be deleted. We'll probably try to merge it with the standard that was adopted last year as a result of FAS 97, and we'll also try to sweep in Recommendation #6 which deals with GAAP accounting for participating business issued by stock life insurance companies. We'll also be redoing the materiality standard and the statutory opinion. We intend to have this reformatting project wrapped up by year end.

The next standard I want to talk about is the appraisal standard. This was approved by the Board for exposure at its April meeting. This was a joint effort of the Life Committee of the Standards Board and the Property Casualty Committee of the Standards Board. The feeling was there should be a single standard for actuarial appraisals covering both types of business. A small task force was set up including members of both committees, plus a couple of investment bankers. What this standard is trying to do is take all of the various reports and studies that people do to determine the value of a

company, a segment of a company, or a block of business, and split those studies into two classes. One is called an "actuarial appraisal," and it is to be done in a rather explicit way. The other class isn't an actuarial appraisal, and there are very few specific requirements. The intent is to draw a line between the studies that you can call an actuarial appraisal and those that aren't actuarial appraisals. The standard really doesn't prohibit anything. Those actuaries who like to use rules of thumb like multiples of GAAP, etc. can still do so, but you simply can't call them actuarial appraisals. I encourage you to read the standard and comment if you have an interest in this area.

The next standard I want to talk about is the when-to-do-cash-flow-testing standard. This is the standard closest to adoption. It was exposed in October 1989 with a comment date in February of this year. As you remember, this was a follow-up standard on the how-to-do-cash-flow-testing standard. It's intended to give actuaries general, broad guidance in deciding when to do cash flow testing. Generally, if you're doing work in an area in which others might expect cash flow testing to be done, you need to say whether or not you did it. Probably the most common comment received said the standard was simply too broad and too weak. There was also a set of issues around the relationship between cash flow testing and sensitivity testing and within one a subset of the other. And then finally there were several comments about the references in the draft standard to dividends, some people saying that projections of various sorts really aren't appropriate for determining current dividends.

In the draft that the life committee of the Standards Board reviewed earlier this month and sent on to the ASB for adoption, we left the scope broad. That was our original intent, and that's the way it was left. We strengthened the section on what you have to say if you're preparing a report, but not very much. We also eliminated all reference to dividends and nonguaranteed elements in the standard. It's entirely true the determination of current dividends isn't supposed to rely on projections.

On a slightly related topic the Property Casualty Committee of the ASB has drafted a how-to-do-cash-flow-testing standard that's quite similar to the one that the Life Committee adopted a couple of years ago, and in an act of real wisdom, I believe, the Actuarial Standards Board has asked why we don't try to make these two into one. So, they've assembled a small group of people to try to merge the how-to-do-cash-flow-testing standard for life and health companies and the how-to-do-cash-flow testing for P&C companies and try to get a common standard.

The last standard I want to talk about is the one I consider the most interesting, that's the HIV standard. This standard was originally exposed in October 1989. We received about 30 comments. The comments fell into two areas. The first is the most interesting to me -- that is a small minority of well-considered, thoughtful comments basically questioning the need for a standard in this area at all. I found this interesting because it was the first time that the basic need for an exposed standard has ever been questioned. The second group of comments related more to details on the standard itself. There were concerns about possible misinterpretation of the wording about the actuary's role in documenting or developing a company's strategy to deal with the HIV situation, some concerns about the wording in the draft with respect to the use of future offsets in reducing any potential reserve liability that you might be setting up, and then the real

confusion was over paragraphs 5.2 and 6.1. Paragraph 5.2 said that if you need extra reserves, you should set them up, and 6.1 said that in any opinion you should say that the extra costs have been covered by reserves or you've made provisions for it as allocated surplus. There's a contradiction there, and a lot of people commented that we should eliminate it.

The Standards Board considered all of these comments, and the draft that we have now has a stronger rationale for the need for such a standard. Although some people may still consider it lacking, it was strengthened. We have reworded the sections on the role of the actuary in determining and documenting company policy to simply say when you're doing this work you ought to ask around to see if the company has such a policy, but you're not responsible for putting one together. On the issue of reserves versus surplus appropriation, the Board has come down firmly in favor of reserves. The new paragraph 5.2 is pretty clear, and on its face it's simple, but within the context of other standards it becomes rather confusing.

If you're signing an opinion on statutory reserves, and if you've done aggregate cash flow studies, and convinced yourself that the reserve meets statutory minimum requirements and is adequate under all scenarios including a high HIV claim scenario, then the actuary probably should have no problem in signing off and saying that reserves are good and sufficient. On the other hand, if this standard takes precedence over such considerations in signing an opinion, then you probably should determine whether or not you need an extra reserve for HIV in determining your aggregate reserve which you will then cash flow test. So, there is a question of which standard comes first. This standard is going to be re-exposed with a comment date of September 1, 1990. I would encourage anyone with an interest in this area to read it and comment, especially if you're a valuation actuary.

MR. WILLIAM CARROLL: My assignment is to cover the NAIC portion of the program. Fortunately, I have some news. The NAIC met last week in Baltimore and adopted an important part of its agenda for dealing with high-yield securities. So, I'll report on it yet in some detail, and then I'll mention five or so other items that are on the NAIC agenda and are in various stages of completion.

First, with regard to the changes, it adopted changes in its bond quality rating system and in its mandatory securities valuation reserve (MSVR) calculations, and these changes are effective for 1990. This required a suspension of its rules. Under the normal rules last December it finalized statutory reporting requirements for 1990, but it makes its own rules, and it may change them whenever it wishes.

The action has four major parts: an expansion of the MSVR categories from four to six, a phased-in increase in the annual increment factor, greater reliance on the use of public rating agencies for publicly-traded issues, and a supporting requirement of increased annual statement disclosure. I'll go over each of them. Recall that the current -- and when I say current I'll always mean December 31, 1989, and new as what was adopted -- requirement had four classes. The names were Yes, No Star, No Star Star and No. These names are now 1, 2, 3, 4, 5, 6. We don't need to understand the old words, but the split from four to six came about by taking the yes category and dividing it into three

categories: 1, 2, 3. Recall that the Yes category had a 2% MSVR maximum. That's replaced by three categories. The highest has a 1%. The 2 category has 2%. And the 3 category has 5%. One of the advantages of this increased refinement is that by creating a 5% class the NAIC takes less pressure off the decision of classifying. Previously, the NAIC valuation group had to choose between a 2% reserve requirement ultimately or a 10% requirement. The other three classes that were the three No classes merely become 4, 5 and 6, and retain their current maximums of 10% and 20%.

The second thing they did was to phase in an orderly manner an increase in the annual increments. That's the terminology used in the MSVR. It lacks good terminology. I tend to call the annual increment factors the normal cost. This is the first rate that you get when you multiply the rates by the bonds in each category. You then adjust it by multiples. It depends upon how large your MSVR is relative to the maximum, and then you adjust for capital gains or losses. So, I'll call that the normal cost of an increase. And for those familiar with the way -- what's underlying the MSVR, these normal costs are actually equal to the maximums in each category divided by "the number of years necessary to reach the maximum." And so rather than just increasing the normal costs, the NAIC chooses first to increase the divisors, and then to grade these divisors in a straight line, creating a sort of a hyperbolic grading. Fortunately for those who were resistive of this process, it's a gentle grading in the beginning, and it's also deferred one year. So, this aspect of the proposal doesn't really take place until 1991. It's graded over five years in a hyperbolic manner deferred one year.

The third part is greater reliance on the public rating agencies' ratings, rather than relying on its own standard valuation office (SVO) in New York City, and probably the reason for this is that its previous Yes category which was generally regarded as investment grade did contain, in the nomenclature of Standard & Poors, BBs and Bs, whereas the investment community regarded BBBs as the lowest investment grade. So, over the years some issues that are classified as noninvestment grade by the public agencies have crept into the Yes category within the NAIC. Now, this particular change was quite controversial because there were those who argued that the NAIC was correct in recognizing that there were some bonds that were rated by the public agencies as below investment grade but which, in fact, were creditworthy, and people holding this argued that this was because the NAIC and the statutory standard ought to be different from the standard applied by Standard & Poors and Moody's and other agencies.

Now, let me mention Duff & Phelps. The fact that I used Moody's nomenclature does not mean to grant any preference to one over the other. I find it easier to speak about the capital letters rather than the upper case and lower case letters, but the NAIC procedures manual gives equal standing to Moody's, Standard & Poors and Duff & Phelps.

Coming back to the point, those making the argument that the NAIC ought to, in some cases, classify things in a more favorable manner than the public agencies, point out that the public agencies are concerned primarily with timeliness of payment. Pay less attention to collateral so that in instances the most typically-cited example has been public utility issues where they have a very good ratio of debt to capital, and the fact that they might get into some cash flow problems and become in default does not mean that

the investor's going to lose his money, but that argument did not prevail. The SVO office will no longer have discretion to rate publicly-traded issues any higher than the highest public rating agency rates them. They will have discretion to rate things more conservatively.

The fourth part of this action that was adopted is really supportive of the other parts. Schedule D, Part 1A, which now shows a distribution of bonds by quality and by maturity duration, will be expanded to show these six categories, and for the first time it will separate publicly- and privately-traded issues. This action is effective this year, and, incidentally, this does not require state approval. When the NAIC adopts changes to its annual statement blank, they automatically become state requirements because the states, in their laws and regulations, have cited the NAIC blank and its supporting instructions and accounting procedures as applying in the states unless otherwise superseded by state laws. So, this is one place where the NAIC has the power to act directly rather than merely make model laws or regulations which would then have to be taken up in each of the states. And the reason I mention this is that the second phase of the NAIC agenda dealing with high-yield securities is to suggest limits on bond holdings by the various classes. It has not yet come out with a first public exposure. It promised to do it this year and to complete the project this year, and it is likely that it is going to do something like suggest that Classes 5 and 6, that's in default and CCCs, should have maybe no more than x% of the company's assets, and Classes 4, 5, and 6, x plus y%, and 3-6, x plus y plus z%, etcetera. So, some kind of a cumulative limitation is what I think is being contemplated. The reason I say *suggest* is because here most people believe the NAIC does not have the power to do this. The most it can do is, in this case, make suggestions. I suppose it can make a model law on assets, but looking at regulatory history in the United States, the NAIC does not have model law on assets. Each state has sort of gone its own way over the years, and generally the state of domicile laws apply, and this junk bond kind of situation is one where you might expect states to make their laws apply extraterritorially, but there's no NAIC model. So, the NAIC has no model to change. It wants to act on this issue. So, what it is liable to do is to put together some kind of a policy statement urging states to put in place these kind of rules. That completes my discussion of the item that was addressed at the NAIC meeting. It actually moved forward with adopting some important parts of it.

I'm now going to talk about five other items that are in progress: (1) a more comprehensive review of the MSVR is considered being expanded to cover all assets; (2) there will be some further guidelines on constant yield method of depreciation of real estate; (3) status of the valuation actuary being incorporated into the standard valuation law moved forward; (4) it is working to develop rules for loan securities, and it is going to deal with the NAIC's collateral requirement for loan securities; and (5) lastly, it formed a group to discuss the possibility of taking some of the information that you find in a SEC registrant's 10K, the management and discussion analysis part, and perhaps putting some of this into disclosures in the statutory annual statement.

Again, maybe the most important one is this notion of a comprehensive study of the MSVR. It has already formed an industry advisory group that's been working since last year. Its work was interrupted because most of those people had to work on giving advice regarding the MSVR changes that I previously reported on, but this group is to

look at the nature, the structure, the mechanics of the MSVR, and to expand it to include all assets or at least for every asset to decide whether or not there should be an asset base reserve. I think one of its jobs will be to eliminate the name "MSVR" and get us to think about something called an asset valuation reserve (AVR).

It did make one report in March before its work was preempted by the changes to the MSVR, and in that report it pointed out that it reached some tentative agreements on the three purposes of an asset valuation reserve: to provide for asset defaults, to capture and amortize gain and loss from sale of fixed income assets carried to the amortized cost, and to smooth out surplus effects of market value changes for assets not carried at amortized cost. Its target had been to complete work by the end of 1991 which I have taken to mean that it would have a work product available for discussion by the end of 1991 and with extreme good fortune have something that might be adopted in 1992. The reason I'm questioning the possibility of getting this adopted quickly is that this will require some look at an appropriate reserve for mortgages. It gets down to looking at real estate. I think the job is an enormous undertaking, and when it gets down to the details there will be controversy.

Second, and a less important item, although for those companies involved, in many cases, it is a very substantial item, is the use of the constant yield method for depreciation of real estate. There are variations of this method, but the basic idea of it is to achieve a constant yield over the life of the real estate asset, and under one variation the carrying value of the assets goes down like a curve of a mortgage balance with level mortgage payments. Under another version the internal rate of return is determined by forecasting all of the ins and the outs, and the depreciation is set each year in such a way as to achieve the constant yield. So, depreciation becomes a balancing item. The NAIC became aware of the use of this method a few years ago. Its emerging issues task force dealt with the issue. For those of you not familiar with NAIC structure, it has within the accounting practices task force an emerging issues working group, the intent of which is to answer questions quickly and give quick advice to states or companies seeking advice. One of its rules is that it only discusses an item at two consecutive meetings. If it can't reach an opinion, a consensus, then this is told to the person asking the question. If it feels the matter's important, it may recommend to its parent that some working group be assigned to discuss this. So, in this case it reached no consensus by a vote of 3-to-3 on this thing. The question came back in the fall of 1989, after it had gained further information about the use of the method, and it was negative toward it at that time. It was persuaded to carry it over while a study was done. This led to a decision point in March of this year where it decided, at least this is my wording of what it decided, that the constant yield method is an acceptable method for statutory accounting provided proper safeguards are in place. And the question at the same time is being discussed in New York State where both the statutes and regulations are involved, and the New York member of emerging issues volunteered to share his work with the NAIC and be of assistance in helping it to develop proper safeguards. Industry members were invited to join. People from outside of New York-domiciled companies were invited to join in the work effort. A joint ACLI and Life Insurance Council of New York (LICONY) task force was formed.

In June the chairman of emerging issues of the NAIC Emerging Issues Group in reporting this matter announced that he expects final action in September. So, this group is working under the gun to get something done.

The next item is just a status report on the incorporation of the valuation actuary into the standard valuation law. This is work that's now being done by the NAIC Life and Accident and Health Task Force. It's supported by the industry. It's supported by the actuarial profession. There are two parts that the NAIC has to accomplish. One is the adoption of changes to its model law; I use law to mean an act of the legislature and regulation to mean a regulation promulgated by the commissioner. There are two documents. The model law document is more basic. The regulation flushes things out more. The actuarial task force agreed, and I believe unanimously agreed, that the model law was ready for exposure with the hope of adopting it in December, and it does not expose something like this unless there's a general consensus. This is not quite a recommendation for adoption, but it means that there's a strong enough consensus among these members that it is willing to put it out for exposure.

The second task is that it should put together a model regulation. Work has come far along on it. There are still about six outstanding items on which it does not agree, and so it has not exposed it, but it has identified the issues and made assignments to different state members or groups of two or three state members to work on each of the outstanding items, and its goal here is to have an exposure draft that it agrees upon, that it agrees is worthy for exposure by December in hopes of adopting the package in 1991.

Two other smaller items. The NAIC has a working group that's been working for several months on requirements for loan securities. Outside of the life insurance industry, when securities are loaned there's a collateral requirement of 2%. The borrower must put up in cash or the equivalent 102% of the market value of the item loaned, and this is trued-up on a daily basis. The NAIC requirement is, on the one hand, more strict and, on the other hand, more loose. It's a 5% requirement, but it only applies on December 31. So, we're dealing with a world that keeps things at 2% every day and an NAIC that says once a year it's got to be 5% and doesn't have a standard for other times. So, the goal of a working group that's working with the NAIC is to put in place within the NAIC the kinds of regulations that exist elsewhere so that there would be a daily requirement, and it hopes that the NAIC will see fit then to change the requirement from 5% down to 2%. There's some pressure from the banking community to get this done this year because it doesn't like to go through December 31 maneuvers to get things from 2% up to 5%.

One more point, and then this will complete my report. The NAIC formed a working group to look at the management and discussion and analysis that's found in the SEC registrant's 10K's to see if there is any material in there that ought to be disclosed in the NAIC annual statement in the form of financial notes or in the form of interrogatories. This group is just in the formative stages, and I would not anticipate any results this year. In fact, I would anticipate that it might find very little. There would be severe problems if the NAIC attempted to put all of the same kind of information in its annual statement and have that done by the annual statement deadline. I wouldn't expect that the

regulators would want that much, but there may be some parts of that information that would be useful.

MR. ARNOLD A. DICKE: My topic is principles. As was mentioned in the introduction, a couple of years ago I was asked to form a committee on actuarial principles. The impetus to this came from Steve Radcliffe who was the Vice-President of the Society of Actuaries responsible for such matters. We formed a group and have done quite a bit of work. In fact you received a rather lengthy draft recently.

Let me talk about just four questions -- 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 a while back decided that it was in need of principles and appointed a committee. A somewhat longer answer is that, at the time that 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 is 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 AAA, SOA and CAS members in setting themselves apart . . ." from nonactuarial practitioners. That is, in fact, one of its purposes.

Another reason to have 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 have 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 it 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. We began to call principles at the most general level "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 you all received in the mail recently. 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 benefitted 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 take their comments and put them into the later drafts. We went through quite a number of drafts by the end of last summer.

In August, 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 you received in the mail recently. 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. After July 2, 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 CIA is also using it in Canada. The labelling of the draft as a "discussion draft" is intended to communicate that this is something we're just proposing to do. 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 the 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.

Finally, what responses has the committee had to date? Well, we've had a lot of different responses. There are people with all sorts of opinions about what we're doing. I'm going to quote from some of these letters, because I'm very impressed with the vividness of the prose, and I thought I should share the actual words, not merely the sentiments re-expressed in my less vivid language. So, if you hear your own words coming out here, it's because they're appreciated.

The first letter I will quote is very clear. This person says, "Fundamental principles and the associated material threatened in the discussion draft of March 1990 is worthless. There is no audience for the material that can make profitable use of it." Luckily, that sentiment was not echoed in too many of the responses that we received, but it was a very clear-cut response, and we thank the person who responded.

The second one heads in the opposite direction. This one says, "Overall, the paper seems quite carefully and thoroughly crafted." We like to hear things like that, but this letter goes on to make a very important point. It says, "It seems designed primarily to define our profession to ourselves, the members of the profession, rather than to the members of the outside group." And that's a pretty good idea of where we were really coming from. This person seemed to have seen the principles in the same light we did. In a lot of respects, we worried more about defining the profession to ourselves than communicating to other groups perhaps because we found it hard enough to do the first job.

The third response that I'm going to mention again talks about the purpose of the principles: "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 riskrelated matters." That's one of the ways I see the principles functioning. If you think this sort of thing would be useful, I again urge you to check if we did it right.

We had several responses from casualty actuaries. One Casualty Fellow wrote, "By stepping forward and calling actuarial science a profession, this discussion draft assists Society of Actuaries and Casualty Actuarial Society members in setting themselves apart form the 'practical' actuaries." The casualty people have had more of a problem with people who have set themselves up as experts and who have, in fact, convinced a number of jurisdictions to allow them to practice what we feel is actuarial science usually based on a general knowledge of statistics without other aspects of actuarial training. A number of respondents felt that if we got the principles right, it would be very useful in

trying to make clear what it is that we feel we do that goes beyond general statistical training.

The final set of comments involved language. Mr. Kingman Brewster, former President of Yale University, put it very clearly: "Incomprehensible jargon is the hallmark of a profession." Incomprehensible jargon -- that is what it looks like to some respondents. In fact, one respondent says, "I've been struggling with the discussion draft. I'm very frustrated and angry and upset. I think you need to start over, it's so bad." Luckily, this person also gave us 31 comments and so actually aided the job of starting over.

Another comment states just the opposite. The writer didn't like the language either and said, "Somehow, though, I get the impression that this draft is written so that it might pass a Flesch test." Balancing these two responses is a little difficult. Luckily, there's a third one that says, "My congratulations. It is a very clear document."

But the most witty comment of all comes from a distinguished actuary, whose papers all of you have probably read. The writer quotes Plato: "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 yet the man with real knowledge will, in many instances, allow his activities to be dictated by his art and pay no regard to written prescription." And in his final paragraph, this person wrote, "Apparently the Committee of Actuarial Principles consists largely of bean-counting Aristotelians."

Well, that's what I mean. The responses are wonderful. This profession is great. The level of interest shown by its busiest and most distinguished members has been wonderful, and we appreciate it. July 2nd is the deadline for comments, and I hope we'll get more responses from you.

I have a question for Paul. You indicated several old standards were too "cookbooky." What is it that the Standards Board is trying to do in terms of changing this?

MR. KOLKMAN: There are some of us who feel that a standard in excess of five pages is excessive. The old Recommendation 1 on GAAP accounting where it talks about premium recognition and all kinds of minutia -- that's cookbooky.

MR. DICKE: How would FASB-type pronouncements be rated on a cookbooky scale?

MR. KOLKMAN: I think some of them go a little bit in, but most of them stay out.

MR. DICKE: That's where you want to be?

MR. KOLKMAN: Yes. I think if you look at the history that's behind some of the older and longer ones, the dividend one, for example, you will find that a lot of the stuff in that standard was put in there because they were issues of the moment. They were being discussed in the actuarial literature and there was a decision to sort of resolve it. So, the resolution was explained, and several years later the resolution is still necessary,

but you no longer have to go into that level of detail. And so far, most of the standards we've been able to write have stayed out of that but we may not always be able to.

MR. CARROLL: I have a follow-up question that was suggested to me by one of the phrases you used. You used the phrase "issue of the moment." During your presentation you mentioned developing the HIV reserve standard. Why do we need a specific standard to tell me that my reserves have to be good and sufficient or appropriate, and in doing this I might have to do cash flow testing, and in doing this, I should look at AIDS? Shouldn't I also look at Lyme disease or any other situation that's out there in my environment that might cause rampant future change in my experience? Why is AIDS so important and so different that it needs to be singled out? Shouldn't a more general standard tell us that, of course, you should look at AIDS? Is AIDS an issue of the moment that is getting into the standards?

MR. KOLKMAN: I think you can make a very strong case for that. AIDS is a little bit different from some of the other types of things of this nature that may become future issues of the moment in that it came along pretty suddenly. It's concentrated in certain segments of the population, and companies with certain underwriting practices probably have the biggest risk.

It may be reasonable to say that when you're doing work, valuation, pricing, or whatever, this is something that has to be taken into account. Think about it, and do the best you can, and then say what you've done. The case can be made that going beyond that and prescribing how you're supposed to deal with it, where you're supposed to put provision for it, is going to be out of date in several years and may be removed. But I would agree. There is a strong school of thought that says that this is an overreaction to something that's currently a hot topic and is very, very important to a small number of companies and not too important to a larger group of companies.

MR. DANIEL J. KUNESH: I've got two questions, one for Jim and one for Bill. You alluded to the AICPA's special project. What is the implication of market value accounting for NAIC purposes? Also, are we going to see this form of GAAP reporting and not have to go through the FASB process? And what implication might it have for operating results?

MR. WALLACE: With respect to the FASB issue, maybe the best way to put it is that the SOP does no more than clarify what current GAAP accounting already is. For the most part, with few exceptions, at least before 1989, most insurance companies carried their bonds at amortized cost. But I think an argument can be made that the literature provided for carrying bonds at market, if, in fact, they were being bought and held in a trading account capacity, and at the lower of cost or market if they were assets held for sale. So, I don't know that the FASB would have to get involved for this SOP to become effective. The SOP may just be clarification of what GAAP is. I don't know what the NAIC would do with this new set of rules. They apply only to GAAP financial statements. I suspect nothing, although I'm not aware of what they're doing with this area. It may not be the question you asked, but GAAP accounting provides for taking the change in market value of any of those trading assets held at market directly through equity. I don't think it is intended to affect operations. We are not aware of any current

movement to change the way actuaries do reserves. It seems obvious that if you begin marking assets to market, maybe there ought to be some impact on the GAAP reserves and the deferred acquisition cost assets that relate to those particular assets that are marked to market.

MR. CARROLL: Let me add to this. With regard to the NAIC it is true that the traditional arguments that have been made are the same, the ability to hold to maturity and the intent to hold, and those words perhaps are contained in the NAIC accounting manual. The NAIC has one other feature in place, and that's the MSVR, and its stated reason for existence includes, in part, to help support the philosophy of carrying bonds at amortized cost. I agree with our moderator. I don't think there's the slightest chance that the NAIC would move rapidly toward valuing things at market, as long as all of the life insurance companies on the Pacific rim remain solvent.

MR. KUNESH: I don't believe you explained how bonds get classified in that third category.

MR. WALLACE: Assets held for sale really is a default category. Those securities that you have the ability and intent to hold to maturity, with ability being the one-year period I spoke about as the foreseeable future, are held at amortized cost. The SOP is very murky on what exactly constitutes a trading security, but generally a trading security is one that is bought for the purposes of actively trading, a security that you get in and out of frequently. If you don't fall in one of those two categories, you have, by default, an asset held for sale. Those are carried at the lower of cost or market.

MR. KUNESH: Bill, do you wish to comment on the findings of the working group on levelized commissions?

MR. CARROLL: There are two aspects of the levelized commission. One is the one that came up last year. I'll call that securitization. We have some off-balance-sheet assets, and we'd like to take account of them. So one thing we could do is get some money from some folks in exchange for these things. There were those who would have wished to put that through as an increase in surplus, and the NAIC thought of certain traditional principles, unarticulated principles, statutory accounting, and New York, California, and the NAIC all said no. That was last year.

The issue that came up this year was the Milico-type transaction, the levelized commission transaction, where you establish a third party and the insurance company contracts to pay level amounts to the third party. The third party makes a contract with agents to pay traditional high-low commissions. A source of funds loans money to the third party but not the insurance company. The insurance company doesn't borrow money. The source of the funds doesn't look to the insurance company for payment on the debt, and it argues that the insurance company has escaped the surplus strain. The regulators have been discussing this for two or three meetings, once every four months, and I think it's quite correct to characterize the majority as they don't like it, and they are not precisely sure what words they can use to condemn it. If Terry Lennon of New York were answering this, he would talk about the safety net, and he would say more eloquently than I, they are chipping away at the safety net, and that's the part that he doesn't like.

So he wouldn't like it for that reason. Then he would search for reasons to find fault with it. First of all, they did it in executive sessions, and I do not know what they did. I don't have a written statement of what they did. What I got is conversations with two or three of the members and they're perfectly entitled to say what happened in the executive sessions without breaking any confidences, but the kinds of things that they seem to have said is that they don't like it, and they'll study it. I'm not prepared to say precisely what they did with it other than to say that their action is leaning against it, but they haven't slammed the door shut, and they promised to make some more studies. Do you have any more information? Does anybody have any more information?

MR. KUNESH: The only thing I heard was that the task force voted very heavily no for new transactions.

MR. CARROLL: Now you're refreshing my memory. They have decided to make a negative statement. They have in their minds the nature of the statement, but they don't have it out in a paper, and the nature of the statement is that for the future, new contracts will be disallowed. For existing contracts the question came up, "What about new funding under existing contracts?" That is, I have the contract in place, and it provides for future issues under the contract, and I think they came down on the stricter side of that thing. But there was also an agreement to continue to study, which, whenever you see that, suggests that in the working group there's at least another position that is arguing in the opposite direction, and this is the consensus of opinion. Massachusetts spoke in favor of relaxing the rule, and he was supported by, I believe, Illinois, and that's important because Illinois is the state that had approved securitization last year. To sum up, I think that they're coming down against it, but they haven't slammed the door.

MR. DICKE: I have trouble seeing precisely what they're coming down against. In the case of securitization it was very clear. They simply said you had to draw up a liability. That's that easy answer. So, you can do this but it doesn't create surplus. In this case, it's a lot trickier. You can see them objecting. Most of the arrangements that actually are in place involve some kind of relationship between the special purpose corporation and the originating company, some kind of experience refund or something.

MR. CARROLL: They have pinpointed the reasons why they don't like it. At the previous meeting we discussed the payment from the life insurance company to the special purpose corporation. While it's called a commission, nevertheless, it has more of the characteristic of a loan in that there's an amount that you could keep an account on, and you would credit interest to it, and as you make payments, you would reduce it, and when you got to zero you would stop. He's never seen commissions that work like this. So, I think if he was going to go to court on this kind of thing, he would say that's an item in the nature of a loan.

MR. WALLACE: If the insurance company had all their policies lapse but still had the ability to pay what you refer to as a loan, but no obligation to pay once the policies lapse, its liability is gone. There may not be any obligation to pay back the loan even under these circumstances. What about those arrangements?

MR. CARROLL: That's an appropriate response, and, again, I work for the American Council of Life Insurance, not for any of the state governments, and this kind of a panel might be better if we did have a representative from a state, but, since we don't, I'll answer your question. I think the Terry Lennon answer would be that, yes, it is true that if all the policies lapse, there's going to be a loss on the part of the third party, the special corporation. However, the arrangement has been made, and a prominent actuarial consulting firm has been consulted with, and they've set this thing up so that it is extremely unlikely that that's what's going to happen. It's much more likely that the loan will be paid off well before all of the sources for payment have expired.