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REGULATORY ISSUES WHICH IMPACT INVESTMENT STRATEGY

Moderator: JOSEPH H. TAN
Panelists: ROBERT J. CALLAHAN
THOMAS W. GENRICH*
WILLIAM HAROLD PHILLIPS
Recorder: EDWIN R. REOLIQUIO

- Overview of regulatory framework for investments
- Emerging issues for new investment vehicles
- Valuation actuary update, New York Regulation 126 and 128
- Regulatory attitude toward asset securitization, junk bonds and hedging
- Regulatory developments related to the valuation of private placement, mortgages, real estate, and other securities
- Developments related to MSVR and capital requirements

MR. JOSEPH H. TAN: It used to be that the job of an actuary was simpler. The valuation actuary followed a set of regulatory guidelines on reserve methodology and assumptions for establishing the reserves. The pricing actuary priced the product based on level investment yield and assumed that the assets were available to meet benefit payments. With volatile interest and economic environments, intense competition among insurance companies and with other financial institutions, and changing regulatory attitudes, the job of the actuary has become more complex.

Part of the complexity relates to the requirement that nowadays actuaries are required to understand not just the liability side of the company financial statement, but also the asset side. The actuary needs to work closely with the investment department in setting the interest yield assumptions, in determining the appropriate and optimal asset mix, and in projecting how the investment cash flows may affect the company's financial condition and product profitability.

All these responsibilities require that the actuary understand the risk underlying the company's assets as they relate to the company liabilities and be familiar with the accounting conventions used in establishing those assets and liabilities, and with the values, emerging issues, and developments related to investment and asset liability management.

In the recent past we have witnessed various significant financial events. We heard about the savings and loan (S&L) bailout, the FDIC insurance fund being depleted, the recession that we're in, the collapse of the junk bond market, the depressed real estate and mortgage market, and all other things going on on the asset side.

These developments are also parallel with developments on the regulatory side. We are familiar with the revised bond classifications propagated by NAIC, the changes in

* Mr. Genrich, not a member of the sponsoring organizations, is Director of Price Waterhouse in Hartford, Connecticut.

the Mandatory Securities Valuation Reserve (MSVR) requirement, the regulatory attitude relating to surplus relief treaties, and the coming requirement on valuation actuary and the corresponding asset adequacy test. We also heard about the risk-based capital requirement that had been proposed by Minnesota and New York, and is currently under consideration by NAIC.

There's also an NAIC proposal to limit junk bond holdings and the various types and classes of bonds. There is a requirement for establishing a liability for those transactions related to securitization. There's a disallowance of the constant yield method of depreciation for real estate. There's also the proposed treatment considered by NAIC under surplus notes. All these and other issues together with what's occurring in the Federal area, as was mentioned earlier about Dingell's committee investigation and hearings.

Also, on the GAAP side, there are developments in the SEC, the FASB, and the AICPA.

All this relates to the investment side that we actuaries have come to understand and are beginning to understand. Our three panelists will help us understand some of these emerging issues.

The first two panelists will discuss the various developments in the NAIC and State Insurance Department area while the third panelist will address the issues related to SEC, the FASB, and the AICPA. The first two speakers, Bob Callahan and Harold Phillips, will discuss the statutory side relating to all the investment, asset and liability developments that we actuaries need to understand.

Our third panelist, Tom Genrich, will then talk about the issues related to GAAP financial statements. The fourth member of the group is Edwin Reoliquio, Vice President and Actuary of Sun America Corporation, who will be our recorder.

To start off, we're going to have Bob Callahan, who is the Chief Life Actuary of the New York Insurance Department. He has been with the department for 39 years. And over the years he has seen a lot of growth and failures of various insurance companies.

Next is Harold Phillips. Harold is gracious enough to take the place of Sheldon Summers, who unfortunately couldn't be here because he has to deal with other regulatory issues. Harold joined the California Insurance Department in 1988. Prior to that he was with large fraternals in Wisconsin where he was a product and valuation actuary.

The third panelist is Tom Genrich from Price Waterhouse. He is director of the insurance accounting and auditing areas of Price Waterhouse and has been with them for 18 years. He is a "watch dog" over all NAIC and SEC developments for Price Waterhouse.

My name is Joe Tan; I'm senior manager with Price Waterhouse. Knowing that some of us might have some burning questions on regulatory issues, I'll turn the podium now to Bob Callahan.

MR. ROBERT J. CALLAHAN: What comes first, the chicken or the egg? Does the investment policy follow the product? Or does the product follow the investments? Now, if there were no specific limitations on the types of investments that you could make in a general account, and generally I'm speaking about a general account, probably most insurers with guaranteed cash values would invest heavily in bonds, because bonds are usually considered as preservation of principal, rather than stocks.

If we did not have required guaranteed cash values, as I understand is the case in some countries, then you could have all your investments in stock. And have the policyholders rely on the good graces of the insurance company to give them a fair cash out related to the value of the assets at the time the individual wants the cash out. However, in this country we don't have that. Because of the increasing interest rates during one period of time, we have seen in recent years that some individuals found it more convenient to cash out their policies and take out a new policy in another company that offered higher interest rates based on new money investments.

In the life insurance area, some of the remedies to this were variable policy loan and an increase in the policy loan rate. Also, there was an AAA Task Force on Nonforfeiture Benefits that released its report about 1.5 years ago. This recommended that in the U.S., companies should be allowed to provide policies without any guaranteed cash values. They would require nonforfeiture benefits, but they would not require guaranteed cash values.

However, if an insurer did provide cash values, according to their recommendation, then they would have to provide a minimum cash value. And in going from the value of the nonforfeiture benefit to the cash value, they recommended that an insurer be permitted to make an investment or asset adjustment, either one based on a formula or else a flat 10% charge off the value of the nonforfeiture benefits.

Well, the regulators did not like the aspect of permanent policies without guaranteed cash values. And the NAIC appointed a subgroup to study and make recommendations and that subgroup consisted of representatives of both the regulators and some insurance company people. And while we are proposing that cash values be required, we are at the same time proposing that an economic adjustment be permitted, either in formula form or flat 10%.

Now basically some people are afraid the formula form may make the product look like an investment product and subject to SEC. And the insurers generally want to avoid that in case of general account products, such that the formula was supposed to work independently of the assets. However, in general, the type of formula would reflect that company's investment policy, whether the company invests in generally long or generally short. But if the average investment was five years, then they would basically average out the investment rates according to an index for the five years preceding cash out. And take the investment rate at time of cash out and take that difference and apply it for roughly for three years to run.

If the investments were generally much longer term, say 10 years or more, perhaps then they may consider that the average of the portfolio was five years. That is still being worked on. But that would allow companies to be able to invest long term in their bonds without the danger of disintermediation.

Now there is a hybrid product: modified guaranteed cash value, based on an NAIC model regulation, and New York's regulation 136. We in New York allow the product either in a general account or in a separate account. But if it's in a separate account, the regulation generally presupposes that the investments will be primarily in bonds. As a matter of fact, New York's regulation requires that the bulk of the investments be in bonds and that the Macaulay duration of the investments be within a given point of the Macaulay duration of the liabilities. To date we have not received any submissions on the regulation 136.

In the case of single premium deferred annuities (SPDAs), the NAIC adopted a model nonforfeiture law and a model valuation law. They adopted a model nonforfeiture law in 1976. I believe they adopted the model valuation law at the same time. The intent under the nonforfeiture law was to provide for an accumulation formula which frankly was very, very liberal. And most companies generally guaranteed more than this minimum value. And if a company did guarantee more than the minimum value, then the regulation provided for a surrender charge that basically, if you look at age 70 as your normal retirement date, would allow approximately a 1% surrender charge for each year remaining through age 70, as long as you didn't fall below this rock bottom minimum.

The purpose of that was that companies could make long-term investments without the fear of asset depreciation when they had to liquidate assets to meet surrenders. Fine. But what did the commissioners annuity valuation reserve do? The commissioners annuity valuation reserve basically made the reserve equal to the cash value plus some small additional reserve in case there was any interest guaranteed in excess of the valuation rate, which went beyond year end.

Now what did this mean? It meant then since statement assets equal statement reserves there was no cushion now, in case of asset depreciation. Are we to know that's the way the nonforfeiture law is written on the NAIC level, with the surrender charges reducing to zero by age 70? Because one company in particular had a product that was selling, that had a 7% surrender charge at each and every duration including age 70 annuity commencement day. The NAIC came out with guideline III that said you could have one maturity value for annuitization purposes and another maturity value for cash value purposes. Today there are some nonactuaries on the NAIC level who are looking at that and said, that interpretation is wrong. And I agree, it's wrong. But we in New York did not follow the NAIC standard nonforfeiture law. In New York we explicitly allowed, the first time that we wrote it, 7% surrender charge for each and every duration, along with a front end charge.

Later in 1985 when we revised the law, we made the total of the front end charges and the rear end charges equal to 10%. And since most of the SPDAs were no front end load contracts, this meant that we were allowing up to 10% surrender charge.

Now initially in New York, we required that the reserve be equal to the accumulation value without any reduction for the surrender charge. We were different from the rest of the country. And we found that some insurers were able to get around our regulation through the use of surplus reinsurance agreements, wherein basically they reinsured the surrender charge for a little or no premium, and thought they reduced the reserves down to the net cash value.

In 1985, we revised our law and we strengthened our law for an actuarial opinion in memorandum as to the cash flow of the assets and all liability. And we then got in line with the rest of the country and said, you can reduce your reserves by the amount of the surrender charge to the extent justified by an actuarial opinion in memorandum. And practically every valuation actuary seems to have been able to justify that. There are some cases though where some actuaries do set up a reserve higher than the cash value. And even without the actuarial opinion in memorandum, some actuaries have set up full accumulation value.

But unless you have a difference between the reserve and the cash surrender value, you don't have the push for asset depreciation. And if you want to protect against it, that would mean basically investing short term. In 1985, we also revised our law to allow for modified cash value deferred annuities with a market value adjustment prior to the maturity date of a high-interest guarantee. This was based on an NAIC model. Again the assets were generally, primarily in bonds. And regulation 127 came before 136. But it basically required that the Macaulay duration of the assets and liabilities be very close: within one half year. Now that pretty much hamstrings a company.

In addition to that, though, our law deviated somewhat again from an interpretation of the NAIC law which required that it could provide a cash value at any time. In 1985 our law said, if you provide a cash surrender value, you've got to provide it at least once every 10 years. Then in our regulation 127 we say if you don't provide a high-interest guarantee, you've got to provide it at least at cash value if you provide it at all. You've got to provide it at least once every year. And if you don't provide a high-interest guarantee in any case longer than 10 years, you have to provide a cash value at the end of the interest guaranteed period of time.

This was to allow the companies to protect themselves against disintermediation. They could invest long and not worry about the disintermediation of assets being depressed in times of high interest rates. But very few companies have taken advantage of it. Furthermore, we were encouraging those companies that didn't want to go through a market value adjustment to use a nonfront end load contract, a flat 10% for a high-interest guarantee period of time, then waive the surrender charge, and then reimpose it.

Again we can't force the companies. Maybe we should. But we can't. And companies can protect themselves. But a lot of times they don't take advantage of it. But if they do go via the modified guaranteed cash route, they are hamstrung by our regulation as to the type of investments and the duration of the investments.

Now, we have in New York a regulation 128 on the market value of a separate account to fund guaranteed benefits. At the time the law was enacted to provide this, I envisioned that companies would put their guaranteed investment contracts, the traditional guaranteed investment contracts that pay a lump sum on maturity, into this market value separate account. I thought that they would be forced, because of the requirements of valuing assets and liabilities to market, to match the duration of the assets and liabilities very closely. Now that's what I envisioned.

To date, however, I don't think I've seen one traditional product under regulation 128. Instead what we have seen has been fixed benefit payouts under terminated pension plans, wherein the assets and liabilities are valued at market and there are certain trigger points that if the value of the assets exceed, let's say, 104% of the value of liabilities, the contact holder can pull off the excess. (And if the value of the market value of the assets relates to the market value of the liabilities all blow another trigger point.) In some cases it would go from a separate account participating annuity over into a general account nonparticipating annuity, and in some of these cases, terminated pension plans. The contract holder is appointed as the investment advisor and as the custodian of the assets and in turn has to follow the guidelines put up by the insurance company as to investments. And if the investments fell below a certain trigger point, the company would take over actively managing the assets and would take over the physical custody of the assets.

In addition to that, we have seen a new type of GIC put into a market value separate account really with little or no guarantees. Basically the company is guaranteeing to the policyholder the principal; in some cases maybe a minimum rate of interest such as 3%; in some cases 0% and they allow plan benefit withdrawals at book. But if the contract holder wants to withdraw everything all at once, then it's either with a market value adjustment in a lump sum, or else it's in installments designed to roughly equate to the market value adjustment.

I think perhaps one of the primary reasons some insurers are using this type of account is because they identify the assets in a single contract holder separate account. And they insulate those assets from the obligations of the general account. And the type of investments here is more controlled by the contractual terms than it is by any regulation.

Now let's take an overview of the general account assets. I recently had some figures run off using the NAIC database, wherein we collected data from roughly 1,799 companies. And it indicated that the percentage breakdown of general account line 10A was roughly the same as what's printed in the ACLI fact book showing the 1989 breakdown of assets after you make an adjustment for the separate account assets.

By and large, the holdings of the industry as a whole are down around between 2-3% for stocks. This despite the fact that in New York we would allow 20% of admitted assets to be invested into stocks. Now one of the things we did is we pulled off the top 100 companies by percentage of their line 10A cash and invested assets that were into stock. And we found that we did not make any distinction by size of the company. Just by the percentage of assets, the 100th company had more than 30% of it's line 10A cash and investment assets in stock. The number one company had almost 100%, and the second and third company with more than 99% of their assets in stocks had more than $1 billion of assets. Now I say, how can this be? I looked it up and found that it's an insurance company holding company with practically all of it's assets invested in the subsidiary insurance companies. And I say I don't know how this could be done in New York. But it certainly reflects the fact that the investment laws do vary by state.

The other thing is real estate. Perhaps the average for all companies may be down around 5%. In New York we allow 25% in real estate. Broken down roughly, 20%

for income-producing property, and 10% for home office. But the two combined 25%, and the average for the industry is down around 5%.

In the first 100 companies we find that the 100th company has 32%. The number one company has 77%. Obviously, again, the laws of different states do vary.

Now let me correct myself. Those figures were for real estate mortgages. The average of the industry on real estate mortgages is roughly 22%. But for real estate the 100th company had 7%. The number one company had 56%. Obviously there's any number of companies that exceed what would be the limitations in New York.

Now, junk bonds. Back in 1987 we had gotten out of regulation 126 the first edition of regulation 126 effective for the 1986 statement. That required that the actuary take into account the quality of the bonds. And they use a default assumption. We later allowed the companies to use their MSVR assets to the extent to cover the default assumptions. Back at that time I think we suggested 2.5% for junk bonds. Later we suggested using the MSVR normal reserve factors, which for up through 1989 violation would have been 2% for junk bonds.

This with both type of factors, the valuation actuary would generally assume a spread between treasuries and his junk bond gross rate such that after he subtracted that 2% or 2.5%, he was still netting out a return that was higher than that of investment grade bonds. Now what does that tell the valuation actuary? That says to the valuation actuary invest everything into junk bonds.

Our valuation actuary actuarial opinion and memorandum initially had little effect. The more direct effect was a regulation 130 that the department issued in 1987, which limited an insurer's investments in below investment grade bonds to 20% of its admitted assets for the prior year end. Twenty percent. However, the regulation did not require divestiture. Now how were below investment grade bonds defined at the time? Well let's define what an investment grade bond was. An investment grade bond being anything that was in one of the top four generic categories by one of the major national rating agencies, or which was given a yes designation by the NAIC.

What followed over the next couple of years was that a good number of investment houses went to the NAIC's security evaluation office, gave them additional data, and said, these bonds which are rated below investment grade but in the top category or below investment grade by these national rating agencies should be given an investment grade classification by the NAIC.

With the result then, that bonds rated double B, the top of the investment grade and that some insurers then invested heavily into them because they were not subject to the 20% limitation.

Now what happened a year ago? The NAIC came out with new classifications for the MSVR. Whereas before they had maximum reserve categories of 2% for investment grade, 10% for higher quality below investment grade, and 20% for lower quality below investment grade. They have come out with new reserve classifications: 1% for the better above investment grade, 5% for the top of the below investment grade, the so-called class three.

Then 10% and 20% categories, depending on the grade of the below investment grade. In addition to that, the NAIC was given new instructions. Do not rate anything higher than the highest rating assigned by any nationally recognized rating agency.

The effect of that has been, as reported in the newspapers and magazines, that the percentage of junk bonds in some companies increased in 1990 over what it had in 1989. That was a major reason for a good amount of the entries.

In addition to going to six classes, the NAIC also adopted new annual reserve accumulation factors. And for the lower grade, below investment grade, the annual accumulation factor went from 2% wherein the ultimate rate by 1995 will be 5%. Now what is the effect of this?

The effect of this is that unless a company has sufficient statutory surplus, its ability to invest into below investment grade bonds is restricted by the amount of surplus that it can afford to transfer to the MSVR which is a liability above the line.

And frankly I believe that that was the intent behind the framework of these higher reserve accumulations to discourage companies from investing in a below investment grade bond. This indirect control sometimes is effective. Sometimes it's not. Now, in New York we had to change the regulation because now there was no longer any yes classification by the NAIC. So initially there was talk perhaps of liberalizing the 20-25%, to allow for these double B bonds, which were now put into a class three.

If anything, the regulation was tightened. Twenty percent maximum for classes three through six. Ten percent maximum for classes four through six. And I think it was 5% maximum. Perhaps even 3% maximum for classes five and six.

In turn, the NAIC has a model regulation which it hopes to adopt this year which would be very close to that of New York.

Now I had thought New York's regulation 130 on junk bond limitations applied to all licensed companies. I checked with my office and found that it's directed to domestic life insurers. The NAIC model is directed toward domestic life insurers. I will say I'm not aware of any foreign domicile company licensed in New York that exceeds the regulation. I'm not aware of it, maybe there are. But normally I would think that licensed companies would be required to be in substantial compliance with it. But if the regulation of each state only applies to its domestic insurers and if all states don't adopt it, you have discrimination. Another thing perhaps that may affect the company's ability to invest in various types of investments, or into lower grade, is risk-based capital ratio. And there are a number of factors and part of target ratio takes into account the quality of the underlying assets. More surplus is required (targeted surplus) if you have lower-grade assets.

New York internally right now uses a set of guidelines. The NAIC has an advisory group that has been studying the question. They have looked at New York's regulation and guidelines. We expect a report in June at the NAIC meeting in Indianapolis. Now part of this report though is they're supposed to be coming up with guidelines or trigger points as to what to do. If a company's ratio fell below a given amount of the target surplus, then perhaps the company would be restricted in its writings. And then if it fell below another lower level, perhaps the insurance department would take it into conservatorship even though it had positive surplus.

I'm sure a lot of you have been reading the papers. To date neither California insurance department nor New York insurance department has declared either of the two companies that it has taken over as being insolvent. Not yet at least. Even though in California they are not paying certain classes of policyholders. And even though in California other classes of policyholders are being paid 70% on the dollar, they have not declared the company insolvent. And while IRS has put in a claim such that it's greater than the company's year-end statutory surplus, California still has not declared the company insolvent, and neither has New York.

And the idea of somebody's trigger points would be for regulators to take over a company before it deteriorates into insolvency, but to conserve the company.

One of the odd things, frankly, is there were no limitations in the law on the amount that a company could invest in real estate. I think the accounting rules would be such that it would restrict the company in general account investments in real estate. I'm baffled by the accounting for real estate. And here I must say I'm expressing my own personal views, because I may be deviating from the line of my department.

Normally real estate appreciates. But on a general account, companies depreciate the statement values.

Forty years is the period of depreciation. I recognize that during that period of time there are capital improvements which in turn you then got to depreciate. That lowers your statement value. Yet, if you had this hidden value there between the market value you could sell it for and the value you're carrying on your books, if you're in need of surplus, it says sell it off. Buy another one. That's what it says.

But even so, some companies, to relieve their surplus strains, switched from the straight line method of depreciation to the constant yield method of depreciation. And this gave higher statement values all the way throughout the period of depreciation. And one company not only switched from the straight line to the constant yield, but made it retroactive. Such that then it's surplus increased, because of this difference in the statement value.

The NAIC which was studying the question, "should they allow constant yield method of depreciation?" But then because of the depressed real estate values throughout the country, last December the NAIC basically said, you can continue with the constant yield on anything you're using it for. But you can't use the constant yield method of depreciation on any other piece of property. And that hence forth just the straight line method would be accepted.

But that has the effect of indirectly, because of the low statement value assigned, restricting a company's investments in real estate. How do you model real estate? A couple of years ago there was one insurer that assumed on the valuation date they immediately sold the building for its then market value and reinvested everything on the statement date into five-year bonds. They later changed their assumptions to wherein they planned the sale of their real estate over a period of time and they took into account the expected difference between market and book at those times.

One final thing is private placements. Irwin Vanderhoof has advised me that companies that make private placements get a good deal of information on the company that they loan to. And in turn they can feed in a lot of this detailed information to the NAIC securities valuation office which now has the responsibility of assigning a class to all the private placements. And there is a computer program that the NAIC securities valuation office uses. And he further tells me that the companies can buy this program from the consultant and that the companies can determine classes themselves before they send all the data into the NAIC.

MR. WILLIAM HAROLD PHILLIPS: Amendments to the standard valuation law (these have been under consideration for quite some time) were finally adopted in December 1990. There are new sections plus numerous housekeeping items. The major new ones are the Actuarial Analysis of Reserves, Assets Supporting Such Reserves and Ten Minimum Standards for Health Plans. The NAIC sent the states the official version of the standard valuation law with amendments. The main thrust is to incorporate the valuation actuary concept into the standard valuation law. This concept has been used in the U.K. and Canada and closely studied and monitored by the actuarial profession in the U.S. as well as by the Life Insurance Trade Associations. I will go through the new amendments to the law. I think they're very, very important.

Every life company, unless exempted (and if exempted then you fall back to the current type opinion, which you're all familiar with) shall annually submit the opinion of a qualified actuary that the reserves when considered in light of the assets held by the company, with respect to such reserves, earnings on such assets and considerations anticipated to be received and retained, make adequate provision for the company's obligations covering benefits and expenses, etc.

That's the heart of the amendment. This opinion applies to all business in force, including individual and group health insurance plans.

Now how the reserves are acquired by the cash-flow testing. There's a three-year grade-in period that the commissioner may authorize. The opinion must be based on the standards adopted by the Actuarial Standards Board (ASB), and such additional standards as the commissioner may require.

Then there's the reciprocity with other states. For purposes of this section, the qualified actuary is a member in good standing of the American Academy, who meets the requirements of the regulations. Except in cases of fraud or willful conduct, the qualified actuary shall not be liable for damages to any person other than the insurance company and the commissioner for any act, error, omission, decision, or conduct with respect to the opinion.

So in case of fraud or willful misconduct, anybody can sue you. But for lesser sins, only the insurance company and the commissioner can go after you.

The disciplinary action shall be defined by regulation. The regulations supporting these amendments, the actuarial opinion, and memorandum regulation do not cover this point. So we don't know whether the NAIC will develop a model in this regard or whether the states will be encouraged to develop their own regulation.

A memorandum acceptable to the commissioner shall be prepared to support each opinion unless exempted. And if the insurance company fails to provide a supporting memorandum or it's not adequate, the commissioner may engage a qualified actuary at the expense of the company to review the opinion and prepare such supporting memorandum as is required by the commissioner. So the job has to be done well or another actuary will have to come in to do the job.

Confidentiality -- Any memorandum shall be kept confidential by the commissioner and shall not be made public, shall not be subject to subpoena other than for purposes of defending actions, seeking damages under it. However, it may be released by the commissioner with a written consent of the company or to the American Academy upon requesting that it's for purposes of professional disciplinary proceedings.

Once any portion of the confidential memorandum is cited by the insurer in its marketing or is cited before any governmental agency, other than a state insurance department, or is released by the insurer to the news media, all portions of the confidential memorandum shall no longer be confidential. So you just can't leak the good parts. It's all out.

This bill has been introduced in California to be effective at the end of 1992. So for the December 31, 1992 statement, we will need this new opinion and the memoranda supporting it.

In our memorandum to the legislature, we made the point that this step is an important one in strengthening the supervision of life companies as they fulfill their obligations to their clients. It seems to be quite in line with what Dr. Freund was talking about.

Already we've got two amendments as it goes to the political process. One concerns when the actuary is liable for damages: we're not sure, but we suspect the trial lawyers had something to do with this one. This is how it reads in California -- the qualified actuary shall be liable for damages to any person caused by his or her negligence or other tortious conduct.

The other has to do with confidentiality. Any memorandum shall be kept confidential; it's not to be made public. However, this material shall be subject to subpoena upon the commissioner's consent. Or after notice to the commissioner and all other interested parties, in a hearing in which the Superior Court determines that the privacy interest of the insurer actuary does not outweigh the need for compliance with the subpoena. And the public interest and any ongoing investigation by the commissioner would not be unnecessarily jeopardized by compliance with the subpoena. So it's been changed significantly.

Now the other amendment has to do with health reserves. For the first time the current standard valuation law is silent on the point. But this gives the commissioner authority to promulgate regulations covering health reserves. There is a model NAIC regulation, but I think it needs a little work.

The actuarial opinion and memorandum regulation that support that amendment to the standard valuation law are to be adopted in June of this year, if everything goes according to plan. And I'm reading from the May 1st draft. And I think there'll probably be a little more polishing as we go along. But that's the one I'm working with now.

The purpose is to prescribe guidelines and standards for the statements of actuarial opinion which are submitted in accordance with section three. That's the cash flow stuff. The guidelines and standards for statements of actuarial opinion which are to be submitted when a company is exempted from section three. This is our current opinion, when you don't do cash flow testing. So this has not been -- the only place this is covered is I can, as far as I can find, is in the NAIC instructions to the blank. Well here we're getting official statement through a regulation.

Scope applies to all life companies and fraternal benefit societies, and all companies that are authorized to reinsure life, annuities, and accident and health. Not withstanding the foregoing, the commissioner may require any company otherwise exempt to submit a statement of actuarial opinion and prepare a memorandum. So, even if you are exempt by the criteria, which I'll cover later, the commissioner may still ask you for the full load.

Accredited State -- This is a new concept in the law. It means a state which the insurance department or regulatory agency has qualified as meeting the minimum financial regulatory standards promulgated by the NAIC. To date only New York and Florida have been so qualified. Others are being reviewed. Requirements are outlined in the NAIC policy statement on financial regulatory standards starting on page 690 of the NAIC model law. This covers things like CPA audits, Guarantee funds, and participation in the IRS program.

Asset Adequacy Analysis -- That's the term that we finally struggled with and ended up with. It's kind of a generic thing. And it means an analysis that meets the standards and other requirements. It may take many forms including, but not limited to, cash flow testing, sensitivity testing, or applications of risk theory. So cash flow is one of the many possible ways to satisfy the requirements.

Qualified Actuary -- I think I can skip that. Appointed actuary is a qualified actuary who's appointed directly by the authority of the board of directors through an executive officer of the company. The company shall give the commissioner timely written notice of who this person is and shall state that such person meets the requirements set forth in the regulation. Once such notice is furnished, no further notice is required, provided the company will give the commissioner a written notice.

In the event the actuary ceases to be appointed or meet the requirements, you have to tell who the replacement is and the reasons for the replacement.

Standards for Asset Adequacy Analysis – They must conform to the ASB standards and based on such methods as deemed appropriate by the ASB. Liabilities to be covered include all of exhibits 8, 9, and 10, and the claim liabilities in exhibit 11, and equivalent items in separate accounts.

In the past it's been a little squish as to what is covered. We're trying to make it much more explicit so that it covers all the actuarial responsibilities. Not just parts of exhibit 8 and maybe 9 and maybe 10. The write up in the actuarial standards is about 11 years old. And I think that needs to be updated too.

If the actuary determines that an additional reserve is required, it shall be set up. But there's a grade-in period for three years. Additional reserves established under this are deemed not necessary in subsequent years. They may be released. Any amounts released must be disclosed in the memorandum. And the opinion. The release of such reserves would not be deemed as an adoption of a lower standard evaluation.

Section six covers the required opinions. And this varies by the size of the company. The key amounts are 20 million, under 20, between 20 and 100. Class C is 100-500. And over 500. As you probably noticed, the categories are not mathematically precise. But it would be a problem only if the company had exactly 20, 100, or 500 of admitted assets. D size companies (500 million or more) have to do it every year. C size companies have to do it every three years. A and B size companies are forever exempt, as long as they meet the criteria. The exemption eligibility test for A, B, and C is that the NAIC must not have designated the company as a first priority in either of the past two years or the second priority in both of the past two years.

For sizes A, B, and C the ratio of book value of noninvestment grade bonds to capital and surplus must be less than 50%. So not more than 50% of your capital and surplus can be invested in these. If they are, then you've got to submit the opinion.

The remaining two criteria vary by size of company. This is the ratio of capital and surplus to the sum of cash and invested assets (or your surplus ratio). For A size companies it's got to be over 10%, B over seven, C over 5%. And then the last criteria the ratio of reserves and liabilities for annuities and deposits, I guess that's exhibit 8B and exhibit 10, must not exceed or must be less than 40% and not greater than 50% for C.

In the interest of time I'm going to skip a lot of the details. There's a description of the opinion based on asset adequacy analysis. And there's a reliance paragraph. There'll be two possible areas for reliance. First the accuracy of listings and summaries supporting liabilities. You're familiar with this. If the actuary relies on another, that person must attest to the accuracy of the records.

Two, the opinion records also the procedures or assumptions involved in cash flows, and variation in cash flows according to various economic scenarios. This person relied on could be an officer of the company, an accounting firm, or a security analyst. This person must affirm the listing, summaries, and analysis in support of the asset-oriented aspects of the opinion.

There's recommended language. Aggregation of reserves and so on. The seven interest scenarios you're familiar with. New York, seven. Okay. Impact on investment strategy. Where there's little asset liability matching, the results of cash flow testing could create serious problems. Heavy additional reserves may be required or the actuary may not be able to offer an opinion with memorandum back up. These are extreme situations. However, if the valuation actuary requirements encourage or make necessary further asset liability matching, this then will be the impact on investment strategy.

Very brief comment on asset securitization and levelized commissions and surplus relief. The NAIC accounting manual now reads or soon will read the immediate recognition of proceeds from certain transaction characterized as the sale of future revenues, in income and or surplus. And the accounting treatment for certain transactions characterized as levelized commissions, which result in enhancement of surplus had been determined to be inappropriate for statutory accounting.

Accordingly, a liability should be established for the amount of the proceeds which have been given as proceeds are repaid. These plans are attempts to mitigate the effects of statutory accounting. Very stern task master indeed. It seems each time the NAIC group (which is called the sale of future revenues, securitization of non-admitted or unrecorded assets working group) considers such items, it has been reaching the same conclusion. No surplus or income enhancement contrary to statutory accounting principles. In California it is my sense that we are moving in this direction for surplus relief, from so-called reinsurance of existing blocks of in force business.

MR. THOMAS W. GENRICH: I'm going to cover some of the recent accounting projects and statements that have come out of the AICPA and the FASB that are related to investments, and that may be impacting investment strategies. Before I talk about some of the specific actions though, what I did want to do was very briefly go over the framework of standards setting and kind of where the authority comes from. Because by specifying how investments are accounted for, these bodies that set accounting rules can impact investment strategies.

For general purpose financial statements, those prepared in accordance with GAAP, the FASB is the primary body which sets accounting standards. The authority under which the FASB operates basically derives from two sources. First the AICPA has designated FASB as the body to establish GAAP and provides that an auditor can't give an unqualified opinion on a set of financial statements if those statements contain departures from a statement of the FASB.

And then second, the SEC is authorized by Congress to establish accounting principles for financial statements filed with it. And it has indicated that it won't accept financial statements where the auditor has qualified his opinion for departure from GAAP. The SEC has also directly recognized that the FASB establishes GAAP. A secondary source of GAAP is the AICPA itself, which issues statements of position on accounting matters. Those are not as authoritative as FASB statements. But generally members of the AICPA are expected to follow it.

Certainly the most visible activity in the accounting realm related to investments has been the issue of marking bond investments to the lower of cost or market. This treatment is often referred to as marked to market and that's the term I'll be using here. The issue of valuing bond investments is not a new issue. But in 1990 and continuing up to now, it has certainly had a much higher profile than it had in the past. The current consideration may well be traced to some comments made by Chairman Breeden of the SEC to Congress in testimony and in other statements. He proposed the financial institutions, primarily banks, but including insurance companies, should value bond investments at market value. Currently, of course, GAAP for insurance companies and other financial institutions provide that most bond investments are valued at amortized cost when the company has both the ability and the intent to hold the investment to maturity. Basically and probably to a large extent because of some of Chairman Breeden's comments, the AICPA undertook a project in 1990 to better define and limit the circumstances when bond investments could be reported at amortized cost.

The AICPA issued an exposure draft in May 1990 which would have allowed some bonds to continue to be carried at amortized cost, as is present, but would have required some other bonds which under the old rules could be carried at amortized cost, to be carried at the lower cost or market. In other words, some measure of marked to market accounting.

That proposal had a lot of press and was not well received by banks and insurance companies and others. And in the end, the AICPA decided it wasn't going to go as far as the proposal called for. The AICPA issued a statement of position in November, which was a little watered down and only required some more extensive disclosures of the differences between market and cost for bonds, gross amount of unrealized gains, gross amount of unrealized losses.

However, the AICPA and the SEC didn't want to give up on the issue, and so they both said that the FASB should look at it and maybe promulgate some new rules. The FASB has had a project on its books since 1986 on financial instruments to cover all aspects of accounting for financial instruments. And so as part of this project, the FASB was eventually going to be looking at the recognition and measurement of bond investments as well as other financial instruments. So the FASB agreed to accelerate that part of that project as it addresses accounting for debt instruments held as assets.

The FASB is still working on exactly how it's going to define the scope of this accelerated project. And that has not been settled yet. But some of the things that the FASB has been discussing have been perhaps requiring some bond investments or requiring a lot of bond investments to be marked to market, and then allowing or permitting some related liabilities to be valued on a market basis.

But this obviously opens up a bigger question as far as what are the market values of life insurance reserves for bank deposits of banks that are not going to be redeemed? And that's part of the problem, I think, the FASB is having as far as just trying to define the scope of the project, because if the FASB has to set out rules and a whole new framework for measuring market value of things that aren't presently traded in an active secondary market, any project it ends up with isn't going to be able to be completed on an accelerated basis. But you should be aware that the FASB does have this item moving on to it's agenda to be calling for some market value accounting and GAAP financial statements for debt instruments.

As I mentioned, the FASB has an entire financial instruments project on it's books. This was just one piece of it. And I wanted to talk briefly about some of the other things that are happening in that project, because those will also affect most of the asset side and possibly most of the liability side of life insurance companies. Because basically everything life insurance companies do as far as the FASB is concerned is trade in financial instruments. All investments except for real estate investments are financial instruments. And most all insurance contracts and related liabilities are financial instruments, as far as the FASB is concerned.

As I've said, the project has been under way since 1986. In has resulted in one final statement which is a Statement of Financial Accounting Standards number 105, which is disclosure of information about financial instruments with off balance sheet risk and financial instruments with concentrations of credit risk. This statement is only a disclosure type statement. And it was effective for the 1990 financial statements. So your companies have generally already implemented that in last year's annual reports to shareholders.

Also issued as a result of this project is an exposure draft of a proposed statement, which is disclosures about market value of financial instruments. The agenda calls for a final statement on the disclosures to be issued by you in 1991 and to be effective for 1991 financial statements. As described in the exposure draft's summary, the proposed statement would extend existing market value disclosure practices by requiring all entities to disclose the market value of all financial instruments, both assets and liabilities on and off balance sheet, for which it is practicable to estimate market value. If estimating market value is not practicable, the proposed statement requires descriptive information pertinent to estimating the value of financial instrument.

Although the proposed statement would probably include all assets of insurance companies, it is important to note that they specifically excluded life or insurance contracts other than financial guarantees and investment contracts from the requirement. They still consider them financial instruments, but they excluded them from the disclosure requirements. So at least for 1991, your accounting departments are not going to come to the actuaries and ask them for the market value of the life reserves. That probably won't happen until 1992. Other phases of the financial instrument project that had not yet resulted in exposure drafts are distinguishing between liability and equity instruments, recognition, and measurement. Accounting by creditors for impairment of a loan, accounting for investments with prepayment risk, offsetting of amounts related to swaps, forwards, and similar contracts, and finally pension plan accounting for guaranteed investment contracts. For two of those projects, the FASB has reached tentative decisions. The rest are still in formulative stages with discussion memoranda being issued. The two phases with some tentative decisions are in the offsetting related to swaps and similar contracts. And basically there the FASB has tentatively decided that it's going to issue interpretation that would prohibit offsetting of amounts, recognized for swaps, forwards, and similar contracts unless a write off exists. In other words, you can't net gains and losses and present one number in the financial statements. You're going to have to disclose gross gains and gross losses separately.

However, the FASB also tentatively decided that market values of multiple swap forward or similar contracts with a single counter party executed under master netting arrangements could be presented in net amount. Any proposal here would be expected to be effective for 1992 financial statements.

And then the other phase where they have some tentative decisions is for investments with prepayment risks. This is obviously mortgage loans and then securities backed by mortgage loans primarily. Basically the FASB has tentatively concluded that for investments carried at amortized cost, whose cash flow may vary significantly because of prepayments, the recorded investment should be reduced and a loss recognized to the extent that the carrying amount exceeds undiscounted future cash flows. No conclusions have been reached on other issues. This would also probably be a 1992 effective statement.

Basically what I'd like you to walk away with from here is the understanding that the FASB does have, in a sense, a massive project on it's agenda looking at financial instruments. And there is certainly a reasonably high probability that eventually and not next year, but probably talking in a five-year time frame, there's going to be some rule changes on how for GAAP purposes and reporting to the SEC you're going to be presenting your investment balances in the financial statement. And that's something maybe to keep in mind when you're making some investment decisions.

FROM THE FLOOR: I'd like to ask a question about mortgage pass throughs, in particular, Ginnie Maes on the one hand, and either Freddie Macs or Fanny Mays on the other. And the question is, that in at least four states I've seen some indication toward limiting the amount of investments in the Freddie or Fanny area to perhaps in the best case 10% of assets, the largest case. I've seen 3%. As though it were a commercial credit of anywhere from triple A to B double A. Whereas a Ginnie on the other hand because it has the full faith in credit of the Federal Government, has an exemption from the diversification laws. My question then is, has anybody seen and can anybody explain the logic then of why Freddy Macs on the one hand should be limited to something like 10% of assets, when each pool of bonds is collateralized by a separate pool of residential or commercial mortgages on the one hand and have 100% in Ginnie Maes?

MR. TAN: Does anyone on our panel have any comment on that?

FROM THE FLOOR: I'm not drafting anything like that, and I can't say why those people who are drafting it are reaching those conclusions. But of course, there is a distinction in the protection afforded on the Ginnie Maes type versus the Fanny Mae or the Freddie Macs. Whether it's a practical difference, whether you really have more default risk, credit risk in the instruments that are not backed by the full faith of credit, but certainly there's some implied promise, that I can't tell you. But I mean if you look at the legal documents, the underlying mortgages that are packaged into

Ginnie Mae pools, are backed by the full faith in credit as is the past year's certificate. The other agencies don't have that protection.

MR. CALLAHAN: I'd like to just note that in case of the class one type of assets on the MSVR, some of those class one assets, which are backed by the full faith and taxing power of the government are exempt from any MSVR reserve.

FROM THE FLOOR: If Executive Life was not insolvent, why was it taken over?

MR. CALLAHAN: You should read the press release of the Commissioner, which said hazardous conditions. And then you have to balance that with all the other statements he has since made including -- his stop payment on certain classes of policyholders, as well as reduction in payments on certain classes of policyholders. But it puts it into a different type of situation if you declare the company insolvent and turn it into liquidation rather than if you try to put it into conservatorship. Perhaps I shouldn't be answering that question. Maybe I should let Hal Phillips answer the question. But there has been a tremendous amount in the press. And all I've said is that to date, neither commissioner has declared either company insolvent. You've read in the newspapers, *The Wall Street Journal* of April 5, that the New York Department required the setting up of an additional $125 million of reserves which reduced the company's surplus from $185 million to $60 million. This $125 million may not be proper figure. We are having continual discussions as to what the proper figure may be. But to date, the New York Department had only required an additional $125 million, which meant then the statutory surplus at the time they were taken over was roughly $60 million.

MR. PHILLIPS: I think it's a legal question. Every state has a statute or a number statutes that cover various stages and steps of a conservatorship, liquidation, rehabilitation. And these are defined in each state's statutes. And they could vary considerably. And we have to follow them and this is the step that was taken as we felt was appropriate as to what we could do under this statute.

MR. ALLEN J. ROUTHENSTEIN: I head the insurance strategies group at Merrill Lynch, Capital Services Inc. And I have a question for both Mr. Callahan and Mr. Phillips. I'd like to hear your opinions as far as Dr. Freund's comment with regard to a revision of the way insurance companies are regulated, whether you think there's a need, and if so how you would suggest going about it? That's number one. And number two would have to do with regard to risk, extending risk-based capital requirements more into the actuarial profession of having risk-based reserve requirements? I don't know whether this is something that has been explored. But for example I'm not trying to create any problems for insurance companies. But instead of having a minimum reserve and insurance companies having to demonstrate that that's adequate, based on their investment strategy, have actuaries designate or assessing reserves based on their perception of the risk. And if they can't demonstrate it, have a significantly higher reserve to ensure that there's not a solvency problem.

MR. CALLAHAN: Where is regulation going? I think that you've seen enough in the newspapers and periodicals to draw the conclusion that there's a good force out there that wants to make the regulation more uniform. And about the only way you can do that is to have a central source -- whether that will be the Federal Government or whether the Federal Government will designate an association of insurance companies or designate an association of state insurance departments. Now I think what a lot of people don't realize is that in the last five years the NAIC central office in Kansas City has been built up tremendously, hardwarewise, softwarewise, number of personnel and expertise. That if you wanted to have a central unit, the NAIC, if it can clean up the rest of its act, would be a good starting point. Now if this association went from being primarily an association you might say that accommodated the state insurance departments, and that was you might say primarily social with only a handful of people in the central office. Wherein it now has good professionals, good software, good hardware. I indicated before that we extracted some of the data off the NAIC database from that time 1,799 life insurance companies. In the ACLI fact book, you'll find that in mid-1989 there were roughly 2,300 life insurance companies in the U.S.: over 700 in the state of Arizona, where a slew of them are just reinsurers with very little capital and surplus. But the 1,799 represent the vast, vast bulk of really viable insurance companies. And when they get all the companies on their database that have to report, it may be somewhere around 1,900. But the NAIC currently now is setting standards. Now whether this will be sufficient or not I don't know. But I think everybody recognizes that if there is going to be a continuation of state regulation, the state regulators are going to have to beef up their act. Now I frankly would be very surprised if 40 states could qualify according to the NAIC standards within a few years. I'm not sure whether they said within three or four years. But that's the figure that I've heard quoted. I might also say that if 40 states qualified I would think maybe the standards are too low. But if you have only a handful of states that are accredited, do those handful of states then examine companies domiciled in every other state? Or do they pull their license? Regulation is changing. Go to the panel. Insurance Regulation -- Envolution or Revolution? Go to that panel; I intend to go to it. One of the panelists is the chief of our life bureau, Terry Lennon. But regulations are changing. And even though in a recent testimony before Congress on May 7, our superintendent noted everything that New York did to beef up regulations, New York cannot force the other states to adopt those same standards. But we'll have to wait and see whether it is an evolution or revolution for the change. But you are in the midst of a change.

MR. IRWIN T. VANDERHOOF: I view regulation of the insurance companies by the states as reasonably adequate. There have been a number of problems which we've all heard about. And there have been losses to policyholders. On the other hand, the movement in terms of the valuation actuary is most satisfactory. And most of the serious investment and management problems of the companies are being addressed. It should eventually lead to a good system for the regulation of all financial intermediaries. On the other hand, the record of the Federal Government in the management of it's financial intermediaries banks and savings and loans is beneath contempt. That applies to the regulators, the banks, the SEC, and the Congress in particular. It seems to me that the proper direction is to find a way to produce the valuation actuary doing the same services for the banks that they are developing an expertise in for the insurance companies. Do you have any ideas as to how that could be accomplished? Of course, if you agree with me that it should be accomplished.

MR. CALLAHAN: Irwin, I've said I feel that the regulation of banks is even stranger than that of the regulation of insurance companies, where you have both state banks and national banks. But even your national banks are restricted to doing business in one state. And the banks can switch from being regulated by a state government, to being regulated by a Federal Government. And switch back and forth to whichever method of regulation best benefits the bank. And both state and federal banks are in the Federal Insurance Deposit Corporation. Now that's strange.

MR. VANDERHOOF: Yes, but a valuation actuary for the banks could prevent a lot of the problems. The new stuff coming out of Europe on the capital risk based capital is silly and trivial, as compared to what you're doing.

MR. CALLAHAN: Why shouldn't the S&Ls fail, when you had an industry that was primarily one product with fixed long-term mortgages out there. And then interest rates shot sky high. There was no way that the S&L industry could withstand that type of mismatch. With cash on demand deposits and long-term asset. No way. Somebody's got to put discipline into them.

MR. VANDERHOOF: That's what I'm saying.

FROM THE FLOOR: I have a question on a specific investment regulatory issue that the panel did not address. I direct it to Bob Callahan but really leave it open to any of you. And I'm only looking for a brief answer. Could you comment please on the current position of the New York Department and/or the New York state legislature on attempts to override the provisions of the secondary mortgage market enhancement act?

MR. CALLAHAN: No I'm not prepared to comment on that one.