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CURRENT TOPICS IN FINANCIAL REPORTING

Moderator: DONALD F. BEHAN
Panelists: ROBERT J. CALLAHAN
HAROLD G. INGRAHAM, JR.
LEW H. NATHAN
Recorder: DONALD J. MARTINEAU

- o The session will discuss recent activities of:
  - -- National Association of Insurance Commissioners
  - -- FASB
  - -- Actuarial Standards Board
  - -- American Academy of Actuaries
  - -- American Institute of Certified Public Accountants
  - -- Federal Government

MR. DONALD F. BEHAN: In this session our prepared remarks will include financial reporting issues that are arising from activities of the National Association of Insurance Commissioners (NAIC), the Financial Accounting Standards Board (FASB), the Actuarial Standards Board (ASB), the AAA, the American Institute of Certified Public Accountants (AICPA), and various arms of the Federal Government.

We're fortunate to have on the panel three actuaries who have an important involvement in the emerging issues. Bob Callahan is Chief Life Actuary of the New York Insurance Department and is very active with the NAIC. Harold Ingraham is Chairman of the Life Committee of the ASB. Lew Nathan is a member of the Committee on Life Insurance Financial Reporting of the AAA. The recorder for our session is Don Martineau.

Our first panelist is Robert J. Callahan. As I mentioned, Bob is Chief Life Actuary at the New York Insurance Department. He is chief of its valuation bureau. He has served on and chaired many department task forces on reserves and nonforfeiture for both life and annuity products. He has worked with advisory groups leading to both the legislation pertaining to actuarial opinions and memoranda and to Regulation 126. He's a member of the NAIC Life and Health Actuarial Task Force. He has been active in discussions leading to the proposed changes in the NAIC nonforfeiture law and proposed new regulations to implement changes in the law that require actuarial opinions and reports to management. He has also been a participant or an interested party on many other NAIC task forces and on working groups such as sale of future revenue, risk-based capital, high-yield bonds, Mandatory Securities Valuation Reserve (MSVR), and accelerated death benefits.

MR. ROBERT J. CALLAHAN: The agenda item assigned to me is the National Association of Insurance Commissioners, known as the NAIC. I have had the privilege of serving as a regular member of the NAIC Life and Health Actuarial Task Force since 1984. However, I have had sporadic contact with the NAIC since 1976, and I have known both John Montgomery from California and Ted Becker from Texas from the beginning of the NAIC Nonforfeiture Value and Policy Reserve Valuation Task Force appointed in December 1973. Many very important matters have passed through the Task Force pertaining to new and revised model laws, regulations, and guidelines on both new and existing products. One of the milestones was the drastic changes in 1980 in the valuation and nonforfeiture laws which incorporate a dynamic interest rate and a provision to adopt new mortality tables by regulation rather than by statute, and a provision for dealing with new products not otherwise covered. However, the valuation procedures were still based on formula rather than on the actuary choosing the most realistic assumptions and including direct considerations of expenses and lapses which statutory formula reserves ignored.

After John Montgomery's heart attack a little over two years ago, John has had to cut back from his 16-hour workdays to 8-hour workdays. He works four hours at the office in the morning, then he goes home and rests for a few hours, and gets up and works four more hours at home. He has also had to curtail his travel, but he has a very able assistant in Sheldon Summers who does the traveling for him and has served on many of the committees outside of California. John has had to restrict his travel to approximately four times a year, and just recently he was down here in Florida at the NAIC Blanks Committee meeting. John is looking better than ever and plans to continue to work. Matter of fact, he's already set next year's Life and Health Actuarial Task Force meeting for Los Angeles. At a recent social gathering at John's house, he and I were having a little discussion on which one of us flunked the more exams. John said that while working in the valuation of liabilities area for an insurance company he flunked the SOA exam on valuation five times. John said he answered the questions the way valuations should be done rather than the way that the book said legal reserves were calculated. Finally, he answered the exams by the book and got his fellowship. Then after becoming Chief Actuary of the California Insurance Department in 1973, he set about changing the valuation requirements. He became the first chair of the NAIC Nonforfeiture Value and Policy Reserve Valuation task force appointed in December 1973.

In his first report to the NAIC in June 1974, John reported, "There are three aspects of the present statutory reserve valuation as it relates to solvency and equity which appear to be causing some difficulties." His second aspect is as follows: "2. In other situations, although the reserves carried appear adequate and equitable, the asset values matching and supporting the policy liabilities either have become of questionable quality or do not match the liabilities they support as to interest earnings and values required by those liabilities to maintain their progress." Does this not sound like the valuation actuary of today?

The December 1980, changes in statutory formula reserves reduced the reserves on some blocks of business to such low levels that we have become concerned about asset/liability matching. In developing changes for the valuation actuary, John has been very patient and a good politician who brought individuals with differing views to compromise and reach agreement. We fully expect that the changes to the Standard Valuation Law requiring the actuarial opinion and memorandum will be adopted this December. The regulation will likely not be adopted until December 1991, although many are still hoping for adoption next June. (The NAIC model laws can only be adopted in either June or December when the commissioners meet in the plenary session.)

The currently proposed changes in the law are not perfect. The requirements for an actuarial opinion and memorandum by a valuation actuary do not replace, but are in addition to, the current statutory valuation requirements. Further, the requirements pertain only to in-force business and not to new business. They deal only with the adequacy of the reserves and not with the surplus. New business can cause statutory strain on surplus. Low surplus can adversely affect an insurer's ability to write new business both from a statutory standpoint and a public perception standpoint. Inclusion or exclusion of new business affects cash flows. Nevertheless, the proposed changes are an improvement, and a step forward in the evolutionary process of statutory valuation.

At the SOA's regional meeting in Hartford on May 1, 1990, I reported on seven unresolved or unfinished items. Some have since been resolved through changes in the proposed law or the proposed regulation. Let me briefly touch on these seven items.

1. The C-1 risk and use of MSVR assets. The regulation requires the actuary to consider the risk of default and allows a proportionate use of the MSVR assets to cover the C-1 risk of default and the risk of asset depreciation in case of premature sale of assets which sounds in part like a portion of the C-3 risk.

2. The small company accommodation. While some express personal opinions that every insurance company, regardless of size, should be required to have an actuarial opinion based on asset adequacy analysis, compromises have been reached to require a less strict opinion based on statutory formula reserves and on a finding of no red lights flashing in cases of small companies, and a more extensive opinion based on asset adequacy analysis for all other insurers. The proposed changes in the law have been amended to reflect these two types of opinion. The criteria for exemption have been incorporated into the latest version of the proposed regulation. Companies are divided into four categories by size of admitted assets. A company in one of the first two categories, that's the lower size, need not submit the more extensive opinion if it does not fail certain tests. The tests are:

    - The ratio of capital and surplus to the sum of cash and invested assets.

    - The ratio of annuity and deposit liabilities to the total of all liabilities less the MSVR.

    - The ratio of noninvestment grade bonds to the sum of capital and surplus.

    - The NAIC examiner team designation.

A company in the third category must submit the more extensive opinion every three years and more often if it fails one of the four tests. A company in the fourth category must submit the more extensive report every year. The proposed law with the most recent changes will be distributed to the commissioners at least 30 days before they act this December. The proposed regulation with the changes incorporated is being exposed for comment and will be included in the task force mailings. Most likely, both the revised proposed law and the proposed regulations will also be distributed by the trade associations.

3. Standards. As of this date we are still awaiting the promulgation of standards by the ASB. It is generally conceded that the ASB standards are general and that it is up to the regulators to be more specific. Before we can complete the addition of supplemental requirements, we first need to see the standards. The proposed regulation already has some supplements. For example, where cash flow testing is required, the proposed regulation requires the testing of seven specified interest rate scenarios. Even where cash flow testing is not required, it may be necessary to consider these seven scenarios.

4. Appropriate versus good and sufficient. While I have preferred the "good and sufficient" language and have objected to the use of the word "appropriate," compromise has been reached on the use of the word "adequate," that is, that the reserves and the related actuarial items, when considered in the light of the assets, make adequate provision for the company's obligations.

5. Accountability. I am not satisfied with the section on accountability. It states: "Except in cases of fraud or willful misconduct, 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 actuary's opinion." However, I will not oppose the adoption of the amendments based on this provision, but, I warn you, despite that provision, you're still in danger of being sued, and you might consider getting some liability insurance.

6. Discipline. The proposed law refers to discipline as defined in a regulation. The proposed regulation has been expanded to include language as to any prior violations or demonstration of incompetency.

7. Confidentiality. At the Hartford meeting, I blasted confidentiality, but I said I would not oppose the adoption of the amendments to the NAIC law based on the proposed provisions of confidentiality. I've changed my mind since that time. At the most recent meeting in Los Angeles in September, because I was perturbed about various published references to a particular actuarial report which had been held confidential, I proposed that the language of the law be amended, and we worked out, during the meeting, the following language:

   "Once any portion of such confidential memorandum is cited by the company in its marketing or is cited before any governmental agency other than a state insurance department or is released by the company to the news media, all portions of such confidential memorandum shall be no longer confidential." There was no one at that meeting who opposed that. No dissent from that. That will be shown in the revised proposed regulation about to be distributed.

The time is ripe for the adoption of the valuation actuary requirements. The Dingell Committee report put pressure on the regulators to beef up the monitoring of solvency and noted the importance of actuarial analysis and opinion. The NAIC solvency bulletin policing agenda for 1990 has among numerous items: "Consider mandating cash flow evaluation for life insurers to assess ability of insurer to meet liquidity requirements given their investment portfolio." The changes in the model law and model regulation are intended to do just this. So much for my seven points.

A few years ago there was discussion of reserves covering reasonable deviations and of surplus covering the difference between plausible deviations and reasonable deviations. Some companies have opposed any regulation of surplus. In 1986, the American Council of Life Insurance did not want the regulators to be any more involved in the oversight of company surplus levels than they were at that time. At that time, and still so today, the minimum capital and surplus levels were, and are, very low, with maintenance requirements for life insurers being $2 million or less, depending on the state and date of organization. However, today regulators are looking at variable capital and surplus. Another one of those items on the NAIC solvency agenda reads: "Evaluate the need for a model law which would provide for a variable capital and surplus requirement based on the nature and volatility of business underwritten and other factors. (Currently, insurance company capital requirements are not based on statutory requirements that are risk-based. Most state laws require only an invariable minimum amount of capital and surplus, which applies to both new and established companies.)"

At the June 1990 meeting of the NAIC, a working group was appointed to study risk-based capital. At the September 1990 meeting, the group was subdivided into one for property and casualty headed by Vinnie Laurenzano and into another for life insurance companies headed by Terry Lennon. They are the chief examiners of the New York State Insurance Department for these respective areas. In turn, volunteers of lawyers, accountants, and actuaries were requested for an advisory group. Currently, some rating agencies use target surplus based on a number of risk factors and block of business. Lew Roth, a Supervising Actuary (Life) of our department, looked at such factors, made some modifications, and proposed some factors for target surplus for life insurance companies. His proposal has been reviewed by other actuaries and examiners in our department and applied against New York licensed insurers. Such proposal is being released to the NAIC study group for an October 31, 1990, meeting in Kansas City. Ratios of actual to target surplus can be used for monitoring companies as well as the basis for any model legislation, including the limitation on writing new business or classes of business. One problem area with this is the treatment of the MSVR. MSVR is a statutory liability, but rating agencies generally add the MSVR to surplus. Should the regulators do likewise in comparing actual to target?

In the case of the valuation actuary, the treatment of the MSVR has also been controversial. Capital gains go into the MSVR. However, if higher-yielding assets are replaced by lower-yielding assets, then reserves may need to be increased. To avoid a double hit on surplus, a proposal has been made to revise the MSVR procedures to first use capital gains for reserve strengthening with the balance going into the MSVR. However, such proposal has been put on the back burner while more urgent changes in the MSVR have been considered.

At the March 1990 meeting, a working group was appointed, along with an advisory group, to consider the MSVR reserve classes, maximums, and accumulation factors. Working real hard with a large advisory group at the June 1990 meeting, a new classification system was established and with more classes, with maximums, MSVRs of 1, 2, 5, 10 and 20%, with the accumulation factors increased, with bonds rated by a recognized rating agency being assigned to a given class (where the rating agencies differ, the NAIC Securities Valuation Office may use the higher rating), and with private placements being rated by the Securities Valuation Office (SVO). While there is a transition period for use of the higher accumulation factors, the effect of the new factors may be to indirectly limit an insurer's ability to make new investments into high-yield, low investment grade securities known as junk bonds. Some insurers may even need to divest themselves of junk bonds to maintain a desirable level of statutory surplus.

Also, an NAIC working group, chaired by Terry Lennon, is considering a model law or regulation placing direct limits on the percentage of low investment grade bonds as related to total admitted assets, somewhat along the line of New York's Regulation 130. The current thinking is to not require that an insurer divest itself of any junk bonds in-force but to prohibit the insurer from acquiring any new junk bonds unless it can meet the limitations. Even with the limits on new investments, an insurer's percentage of bonds could increase if its total admitted assets were to decrease and the company liquidated investment grade bonds and retained noninvestment grade bonds.

Such new MSVR classifications and both indirect and direct limits on investment into junk bonds affect the investment assumptions which the valuation actuary may use in projecting cash flows of assets and of liabilities in the case of positive cash flow and may influence the assumption as to whether to borrow or to liquidate assets in the case of negative cash flows. Obviously, the assumptions as to the spread from Treasuries and the provision for default will affect the net cash flow assumptions from junk bonds.

Lest anyone think that junk bonds are being unfairly picked on, an NAIC working group is also looking into an investment reserve for both mortgages and real estate, particularly in the case where an insurer uses the constant yield method of depreciation for real estate.

Actuaries have also been involved in proposals for enhancing surplus through securitization of assets using bank loans based on the loadings in gross premiums, that is, the excess of gross over the net valuation premiums, but not requiring payment unless the business is in-force. The proponents argue that since no paybacks are required unless business is in-force, no liability need be set up. However, the NAIC concluded otherwise and said that an appropriate liability should be set up.

Another proposal to enhance surplus was a levelization of commissions by setting up a third party, somewhat like a general agent, to receive level commissions from the insurer, borrowing money from the bank to pay high first-year commissions to the soliciting agency, and then paying the bank back based on renewal commissions received from the insurer. However, renewal commissions stopped when the loan was repaid in full. The NAIC working group has also concluded that there should be no surplus relief and that there should be a liability established in the full amount of the unpaid principal and accrued interest.

The proponents of surplus relief through such arrangements have proposed that any such relief be retained to the extent that it can be demonstrated that the assets can support all the liabilities, including the payback of such loans. The valuation actuary should be aware of such agreements and how they affect cash flows. The valuation actuary may be called on at some future date to express an opinion as to the quality and adequacy of surplus. If the better assets are all chosen to support reserves, and if surplus is encumbered by contingent loans for which no liability has been set up, the actuary should be aware of this. Before the NAIC took a position, some states permitted the surplus relief. In outlawing the surplus relief, though, the NAIC proposed to grandfather prior approvals for business already issued. In another presentation on surplus management, I'll go into more details.

In some of the areas mentioned above, the actuary has primary responsibility; in others, he has joint responsibility; in others, tangential responsibility. It sounds like turf battles, doesn't it? Regardless, though, of who has primary responsibility, the actuary must be aware of what's happening in things which will affect liabilities, assets, or surplus. You've got a great challenge ahead of you.

MR. BEHAN: Next is Harold G. Ingraham. Harold Ingraham is President of the Hemisphere Group, an agent-owned reinsurance company. Prior to joining the Hemisphere Group, he was Senior Vice President and Chief Actuary of the New England and subsequently was with Tillinghast. He is a Past President of the SOA and is currently chairman of the Life Committee of the ASB. Harold will speak to us on current ASB developments.

MR. HAROLD G. INGRAHAM, JR.: Normally when I give some kind of presentation on the ASB, and I've done a few of these in the past two years before various actuarial forums, I make it rather general, and I talk about some of the standards that we have gotten adopted by the ASB in the past year or so and then some that are in the works, and to some extent I'm going to do that here. At least I'm going to talk about the ASB, but I also want to talk in particular about the status of one specific standard, and that's the standard which I'll call, colloquially, "Reserving for AIDS," because there have been some significant, late-breaking developments with respect to that standard that I think you need to be aware of.

On July 1 of this year, the ASB entered its third year of operation as the standard-setting body for actuaries for members of the AAA. Much has been accomplished, thanks largely to the solid foundation work of its predecessor organization, the Interim ASB. Recognition here should also be given to the AAA's planning and coordination of efforts and support. The SOA, the Casualty Society, and the Conference have also played important roles.

The ASB has adopted, exposed, or has under development actuarial standards of practice and actuarial compliance guidelines dealing with a broad array of topics. A review of the most recently distributed *Actuarial Standards of Practice Manual*, the ASB Box Score, and the articles appearing monthly in the *Actuarial Update* will attest to both the breadth and the degree of this involvement.

Particularly for those of you who have ongoing contact with the public, the regulators and the members of other professions, it's really important that you be familiar with and stay abreast of current developments in the standards area and also that you contribute to their development.

The ASB is committed to the concepts that the actuarial profession be proactive rather than reactive and that standards of practice not be structured so as to preclude the exercise of an actuary's professional judgment. It's also committed to the concept that the needs of practicing actuaries and their public be constantly monitored. To further these ends, the ASB has initiated the development of standards for emerging areas of actuarial practice. Examples of this include continuing-care retirement communities and long-term care benefits and facilities. The ASB is also providing concurrent standards of development for areas being addressed by regulators and other professions. Examples of this include how to do cash flow testing, when to do cash flow testing, loss reserving, and voluntary termination benefits and the setting of pension assumptions.

At the same time, the ASB is focusing attention on developing standards for previously unaddressed areas where there are clearly demonstrated needs. Examples here include appraisals of insurance companies and expert testimony by actuaries. To further this commitment and to help improve the quality and effectiveness of regulation and reporting requirements relating to financial security systems, the ASB is currently in the process of establishing or enhancing meaningful working liaisons with FASB, the Governmental Accounting Standards Board (GASB), the AICPA, the NAIC's actuarial task forces, and other organizations that rely on or utilize the work products of actuaries. At the same time, internal professional liaisons with the various actuarial organizations, their interface committees and their counterpart structures retain high priority in dealing with standards of practice, guides to professional conduct, qualification standards, and the discipline process.

As Don mentioned, I'm chairman of the ASB's Life Committee. One proposed standard that's consumed a great deal of this committee's time and energy over the past 18 months is the one entitled "Guidance on Estimating and Providing for the Cost of HIV-related Claims Covered Under Life and A&H Insurance Policies." This proposed standard was exposed for comments last winter and reexposed in revised form this past summer. The main reason for reexposure was to eliminate an inconsistency in the first exposure draft. One of its subsections had stated that reserves should be increased directly instead of making an allocation of surplus if reserve testing indicated that reserves should be increased. Another subsection, though, of this first exposure draft had indicated that any excess claims costs not covered by reserves could be provided for by an appropriation of surplus or by other adjustments.

To eliminate this inconsistency, both of these subsections were substantially rewritten. The second exposure draft of the proposed standard made clear that reserves should be increased directly to cover any estimated excess claim costs instead of alternatively making an appropriation of surplus. Now, unfortunately, the second exposure draft wasn't clear on a very significant point. And that was whether an additional reserve should be set up if any further HIV-related claims are anticipated. In other words, some respondents weren't really sure whether the second draft could be interpreted either (1) to allow part of the margin in existing reserves to be used for future HIV claims, or (2) to require that an additional reserve be set aside equal to the present value of all anticipated HIV claims.

Most respondents endorsed the first of these two interpretations. As stated by Mike Mateja of the Aetna in his comments on the second exposure draft of this proposed standard: "That's consistent with the purpose of reserve margins. It's also supportive of the valuation actuary concept. Essentially, the valuation actuary should be free to assess the adequacy of reserves, and if they're deemed adequate in light of HIV-related infections and other factors affecting the risk, then no additional reserves need be established."

After extensive discussion at its meeting on September 25, the ASB's Life Committee voted not to proceed further with this proposed standard. Instead, at its October 1990 meeting, the ASB received a recommendation from the Life Committee that the board clarify and amplify Recommendation 7 of the AAA's Financial Reporting Recommendations and Interpretations rather than promulgating an additional actuarial standard specific to the cost of HIV-related claims. The ASB accepted this recommendation, and, therefore, this exposure draft -- Guidance on Estimating and Providing for the Cost of HIV-Related Claims Covered Under Life and A&H Insurance Policies -- will not be promulgated.

The Life Committee received 25 responses to the request for comments on the second exposure draft. Several commentators argued that a special standard for the recognition of HIV claims was unnecessary and inappropriate, and of particular weight in the views of the Life Committee were comments like the following: First, the respondents believed that the principles applicable to the recognition of HIV claims in actuarial practice are identical to those applicable to all other causes of claim. Second, they believed that Recommendation 7 of the AAA's Financial Reporting Recommendations and Interpretations gives specific advice as to the practices that are to be followed by an actuary opining on the adequacy of statutory reserves. Third, they believed it would be inappropriate to imply that HIV claims should be treated differently than other causes of claims in order to develop an opinion on the adequacy of statutory reserves.

These three arguments persuaded the ASB that a special actuarial standard of practice here should not be adopted.

However, the ASB also expressed concern that all actuaries opining on the adequacy of reserves held in statutory financial statements on behalf of life and health insurance policies may not be following the requirements of Recommendation 7 with respect to HIV claims.

In this regard, the ASB has noted that the advice in Section 7 of that Recommendation 7 is quite pertinent to the evaluation of the adequacy of statutory reserves and is applicable to all causes of claim. In particular, this advice should be applied to recognize the consequences of claims resulting from HIV infection in such an evaluation. Let me be more specific. Here's what Recommendation 7 says in this regard: "It is important to note that the actuary is expressing an opinion on the adequacy in the aggregate of all the enumerated reserves and that possible deficiencies for individual components of the total reserves may be offset by margins in other items. In most circumstances the actuary may be able, by examination of the interest, mortality and morbidity assumptions and the company's prior experience under those assumptions, to form an opinion as to whether the conservative intent of the statutory provision has been met in the selection of valuation assumptions. In those instances wherein there is evidence that because of company experience or practices, inappropriate or inadequate statutory reserve standards, or extraordinary external events occurring prior to the Statement date, the statutory reserves might not make good and sufficient provision for unmatured obligations, then the actuary should make further tests (possibly by a gross premium valuation as described in general terms below) before expressing an opinion as to such policy reserves and other actuarial items."

It goes on to say: "A gross premium valuation may be made for an entire line of business or a major block of business. The results of such a gross premium valuation for a line or block of business are considered satisfactory for this purpose if the current reserve on the reserve basis being tested provides an appropriate margin over the excess of: (a) the present value of future benefits and anticipated expenses, (b) the then present value of future guaranteed gross premiums using interest, mortality, morbidity, lapse, expense and any other appropriate assumptions selected as of the valuation date reflecting actual and anticipated experience." And that's the end of that long quote. In this regard the ASB concluded that the HIV epidemic is an "extraordinary external event occurring prior to the statement date," an event for which statutory reserves might not make good and sufficient provision for unmatured obligations, and thus the actuary should make the further tests referred to in Recommendation 7 before expressing an opinion as to policy reserves and other actuarial items.

The ASB also believes that in performing the gross premium valuation or other tests deemed appropriate by the actuary, the implications of the HIV epidemic on anticipated claims should be taken into account, and additional reserves should be provided for if total reserves fail the gross premium test. Also, the ASB believes that the actuary is not precluded from establishing additional reserves or appropriating surplus if the extent of HIV-related claims is of sufficient magnitude so that in the actuary's judgment a specific and separate provision is warranted even though it is not required for total reserve adequacy.

So, the Life Committee, at the request of the ASB, has prepared an interpretation -- I guess we're going to call it 7D -- in order to provide guidance on how HIV-related claims should affect the testing for the adequacy of statutory reserves required by Recommendation 7. We have drafted this. Gary Corbett and I just signed off on copy and we sent it off to the AAA office, and it's going to be distributed in a special insert to the next issue of the *Actuarial Update* which probably will be -- well, it won't hit the streets until after Thanksgiving. The ASB is also in the process of reformatting and expanding Recommendation 7 as an ASB Actuarial Standard. This revision will incorporate appropriate guidance respecting HIV claims and other matters covered in the interpretations to Recommendation 7.

The ASB also believes that the advice contained in Recommendation 7 should be brought to the attention of all actuaries who expect to sign actuarial opinions for 1990 in subsequent statutory financial statements. In this context the current activities of the regulators should be noted. They are proposing that an additional paragraph be included with the instructions for actuarial opinions in Life and Fraternal Blanks. This paragraph, I understand, would describe how the insurer provided for the cost of HIV-related claims for life and health insurance, and it might include the amount of any additional reserves established.

Also, the New York Insurance Department recently circulated a questionnaire -- I think Bob distributed it -- entitled "AIDS - Financial Implications Life and Accident and Health" to about 400 insurance companies to be completed and returned. A letter being released this week to all chief life actuaries of life companies operating in Illinois is also worth noting. This letter addresses the reserving-for-AIDS issue with respect to the actuarial opinion for the 1990 life annual statement.

The Illinois letter notes that the Actuarial Opinion does require an opinion as to whether reserves make a good and sufficient provision for all unmatured obligations of the company. It also states that in making this opinion, the actuary "should evaluate the actuarial assumptions used by comparison with plausible sets of adverse circumstances in relation to the time periods over which such circumstances can plausibly be expected to prevail." And it makes clear that the test is of the adequacy of reserves and not reserves plus allocated surplus.

The Illinois letter further states that just because the exposure draft and reserving for AIDS hasn't been adopted yet by the ASB -- they didn't know at the time they wrote this that we're not going to come out with a standard, per se -- that that shouldn't be used by the actuary as an excuse to overlook the impact of AIDS when signing the actuarial opinion for life insurance companies. And it concludes by stating that when signing a statement of actuarial opinion, the actuary should also be mindful of the professional conduct interpretation of Opinion 3. In particular, the actuary must comply with any documentation requirements.

I mentioned earlier that the ASB is now developing a meaningful working liaison for the NAIC's actuarial task forces. We recognize that there's a need for closer contact by the state regulatory actuaries in the ASB with respect to standards of practice, qualification standards, professional support for the regulatory discipline process, and guidelines for the use of standards.

To this end a working group is being organized to determine the proper form and content for future liaison meetings between these two groups. The ongoing ASB representation at these meetings would be the chairpersons of its Life, Health and Casualty Operating Committees. Our first such meeting is scheduled in conjunction with the December NAIC meeting in Louisville.

One critical priority for the ASB in 1991 will be the development of standards relating to the valuation actuary. On one extreme, some might believe that such standards should be very broad with no specificity whatsoever. On the other hand, some might believe that such standards should possess a level of specificity comparable to that of the New York Insurance Department's Regulation 126. The ASB recognizes that from the regulator's viewpoint a greater degree of specificity than currently contained in the standards dealing with cash flow testing may be desirable. At the same time, however, the ASB doesn't want to adopt a cookbook approach in developing standards because it recognizes the need for the exercise of professional judgment by the qualified actuary.

A word about enforcement. I believe that the creation of the ASB has provided a sound basis for the promulgation of actuarial standards of practice. However, the issue of enforcement of such standards, obviously important and significant, still requires serious further discussion and action. In the absence of any enforcement mechanism, our standards could become meaningless.

As was stated in an excellent article on this subject by Jim Murphy, the AAA's Executive Vice President, that appeared in the April 1990 *Actuarial Update*, enforcement of standards of practice requires a variety of steps: (1) the standards must be promulgated and publicized throughout the profession and among its many publics; (2) a method for verifying compliance with the standards by actuaries is necessary; (3) counseling and advisory services should be available to actuaries who are working within a particular standard for the first time; and (4) an equitable, yet effective, disciplinary mechanism must be in place to deal with those relatively few individuals who intentionally deviate from standards without justification or who engage in activities without any consideration of the applicable standards.

Now, the AAA believes that the biggest holes in the current system are compliance, verification, and monitoring. They believe, and rightly, I think, that the primary goal of enforcement ought to be to catch the problem at the beginning rather than at the end. In other words, counseling and advisory services should be available prior to the need for any disciplinary action. This is particularly true in cases of inadvertent failure to comply with standards.

One final comment. The ASB is able to operate only with the continued, active support and participation of the actuarial profession membership. Much of the ASB's work is carried on through its operating committees and the other ad hoc committees and task forces which have the responsibility for researching and drafting the standards.

Currently, there are close to 200 actuaries involved in the standards development and promulgation process. However, this significant effort will be expended in vain without the continuing support of the membership of the profession, and by this I mean the entire membership, not just consulting actuaries. There seems to be an erroneous belief that standards really apply more to consultants than insurance company actuaries, and that's definitely not true. This membership support requires giving, first, the time necessary to review the exposure drafts and to provide meaningful comments, and this support also requires the necessary commitment to professionalism to assure adherence to the promulgated standards.

MR. BEHAN: Our next speaker is Lew Nathan who will talk to us about U.S. federal government issues. Lew is Assistant Vice President and Actuary for CNA insurance. He's been with CNA for 16 years, and during the last eight years he has had valuation responsibility. He is now the valuation actuary for CNA in the areas of life, health, and annuities. Lew is a member of the Committee on Life Insurance Financial Reporting of the AAA and is a member of the Profitability Studies Committee of Life Office Management Association (LOMA).

MR. LEW H. NATHAN: I will be discussing several current life and health financial reporting topics at the federal level. In particular, I will be discussing several issues relating to tax, the Securities and Exchange Commission, and Congress. Due to the specialized nature of the pension field, I will not be discussing any pension-related topics.

The first area I will be discussing is taxes. The life insurance industry has debated the proper allocation of taxes between mutual and stock insurance companies for many years. This debate has led to a number of different tax law changes, including the current congressional budget deficit reduction discussions. As you know, the amortization of deferred acquisition costs is on the budget reduction table, but first let me quickly review the history of this probable tax law change.

There's an old saying, "What have you done for me lately?" This could be more appropriately restated as, "What have you done to me lately?"

The Deficit Reduction Act of 1984 substantially revised the federal income tax treatment of life insurance companies. One of these changes was Internal Revenue Code Section 809. As you recall, back in 1984 Congress had noted that the mutual companies' average return on equity, after dividends but before taxes, was below the return of stock companies. This difference was attributed to the distribution of earnings by mutual companies to their owner or policyholders. However, stockholder dividends are subject to personal income tax, but mutual company dividends are not. Congress enacted Section 809, which determines the taxable income amount based on an imputed earnings rate on mutual company equity. This tax is at the company level rather than at the policyholder level.

Congress also required a series of reports by the Treasury Department to monitor the amount of federal income tax paid.

In addition, the House Ways and Means Committee requested the General Accounting Office, the GAO, to assess how Section 809 has affected the income tax split between stock and mutual company segments and examine alternative methods of taxing mutual life insurance companies.

In late 1989, both the GAO and the Treasury prepared reports on this subject. The GAO recommended that Section 809 be deleted from the tax code. Instead, Congress would designate the portion of dividends to be treated as distributed income to individual policyholders which would be similar in nature to stockholder dividends. However, to simplify computing and collecting these taxes, insurance companies would pay this tax as a proxy for the policyholders.

The Treasury report also proposed several changes to address this issue. Again, Section 809 would be repealed. In its place would be a tax on the net investment income of life insurance companies. Under this proposal, stock life insurance companies would be allowed a stockholder dividends paid credit against this new tax.

Representative Downey, a Democrat from New York, introduced a bill in the House in early 1990 that would also repeal Section 809, impose an excise tax of up to .66% on the equity of all life insurers, and require life insurance companies to capitalize and amortize certain acquisition costs such as commissions when computing taxable income.

Lobbying efforts by both the mutual and stock companies have been alive and well. The *Wall Street Journal* recently commented that during the recent budget talks, Democrats and Republicans agreed to target the industry for a tax increase of $10 billion over the next five years. Specific mention was made of the life insurance industry's overheated lobbying efforts and how many lawmakers are tired of hearing the "blinding, arcane details of the insurance dispute."

In early October, Congress introduced a version of the amortization of policy acquisition expenses in its current deficit reduction package while essentially leaving the current tax laws unaffected. This version would have raised $8 billion over the next five calendar years. In contrast, from 1984 through 1987, the GAO estimated that the life industry incurred over $13 billion in federal income taxes.

This entire deficit reduction package was defeated in the House on October 5. However, this insurance company tax proposal is still part of the current budget reduction talks. Both Democrats and Republicans are in favor of this tax.

There are two specific proposals that directly affect the life insurance industry.

First, deferred acquisition costs on life and accident and health will be taxed. As a proxy for using the actual deferred acquisition costs which will be difficult to measure, the tax proposal substitutes specified percentages of total premiums by line. These amounts, though calculated, would be deferred and deducted over a 10-year period on a straight line basis.

Recent information suggests that the Democrats may be revising this tax proposal. The percentages being discussed late last week could increase a bit, and a small company deduction would be added. After all, these percentages are somewhat arbitrary and are subject to change. Small companies would be allowed to deduct these acquisition costs perhaps over five years rather than 10 years. Revenue estimates from this proposal are assumed to be the same as those in last week's proposal.

The second proposal to affect life insurers relates to changes in Medicare deductibles and copayments. These changes will affect coverage provided under Medicare supplement policies.

As a result of these new proposals, it's probable that the life industry will pay more in taxes, and the method of reporting taxable income will change.

There are also several issues being reviewed by the SEC that could impact financial reporting in the future.

One issue relates to debt security accounting rules. The SEC, through its Office of the Chief Accountant, is responsible for improving accounting and auditing standards and maintaining high standards of professional conduct by independent accountants. The Chief Accountant consults with representatives of the accounting profession and the standard-setting bodies designated by the accounting profession regarding the promulgation of new or revised accounting and auditing standards.

This office is responsible for many other functions, including drafting rules and regulations, and prescribing requirements for financial statements. These requirements, along with the generally accepted accounting principles promulgated by the profession's standard-setting bodies and the opinions issued as accounting series releases, govern the form and content of most of the financial statements filed with the SEC.

Even though the SEC has statutory authority over accounting standards, it has generally allowed most of the rulemaking be conducted by industry bodies.

In September, the standards committee of the AICPA withdrew a proposal that would have forced banks, insurers, and other financial institutions to mark to market debt securities held in their portfolio. Currently, debt securities held as trading assets are marked to market, but those held as investments are marked at historical cost. Instead, the emphasis was shifted to full disclosure in the notes to the financial statements about the market value and amortized cost of the debt securities held for investment.

However, SEC chairman Richard Breeden is "determined that the financial statements of financial institutions have to reflect fair market values more than they do now." The SEC has requested that the AICPA reexamine this issue. If the AICPA agrees with the SEC, then a draft of this change would probably be available as early as this December for review.

If assets are marked to market, then the valuation of intermediate and long-term liabilities will also be brought into question. If the value of these liabilities is not revised, then the value of statutory and GAAP statements would be somewhat questionable.

The SEC is also reviewing high-yield bonds. In particular, the SEC is concerned with the risk to financial institutions of default in high-yield bonds and the lack of information about the high-yield bond holdings of insurance companies, banks, and securities firms.

The SEC's Division of Corporate Finance has the overall responsibility for ensuring that disclosure requirements are met by publicly held companies registered with the SEC.

This division works closely with the Office of the Chief Accountant in drafting rules and regulations which prescribe requirements for financial statements. This division is monitoring the management discussion and analysis disclosures of financial institutions, including insurance companies that have significant assets invested in noninvestment grade debt instruments. This monitoring will focus on the adequacy of risk disclosure and the extent to which the reporting company's income depends on such activities.

The staff will continue to gather data on the high-yield bond market in order to promote a full assessment of the need for legislative or regulatory changes and the likely policy implications of those changes.

The last topic I will be discussing relates to the recent congressional activity regarding the solvency of insurance companies. The House Committee on Energy and Commerce, through its subcommittee on oversight and investigations, both headed by John Dingell, a Democrat from Michigan, has been continuing its inquiry into the adequacy of solvency regulation for insurance companies that participate in the U.S. insurance market.

Although solvency regulation is presently handled by state governments, the subcommittee's objective is to evaluate how well the existing regulatory system is working and to determine whether federal legislation is necessary or desirable. Also ,this subcommittee is responsible for assuring that the publicly owned companies involved with insurance operate in compliance with the federal securities laws.

Previous subcommittee insurance inquiries and its earlier report, "Failed Promises: Insurance Company Insolvencies," have dealt primarily with the solvency problems of property and casualty companies. The subcommittee received many comments that it should also review the more than 2,000 life insurance companies since they control about $1.2 trillion of statutory assets. At the end of 1988 there were $85 billion in junk bonds owned by these companies. This level of junk bonds was estimated by the subcommittee to be 108% of the combined statutory net worth of life insurers and 7% of statutory assets.

The first step in this subcommittee's inquiry regarding the life insurance industry was the examination of First Executive Corporation.

The subcommittee's purpose was to determine whether the regulatory system is properly addressing the increasing use of junk bonds as security for insurance companies. In particular, the subcommittee mentioned that insurance companies should not face the risk of insolvency due to a significant concentration of junk bonds.

Mr. Carr, the chairman and chief executive officer of First Executive Corporation, as you may recall, testified before the subcommittee. He stated that Executive Life was solvent and financially sound. He also noted that mortgage loans and real estate portfolios have risk and that a high-yield bond portfolio can be made less risky by broadly diversifying by geographical area and industry segment.

The subcommittee will probably continue these hearings on solvency issues during the next session of Congress.

The NAIC has addressed these and other issues in its recent report, "State Actions to Improve Insurance Solvency Regulation." The NAIC believes that solvency goals can best be accomplished with the existing framework of state regulation. This activity will undoubtedly result in changes to the current financial reporting requirements.

Our next speaker is Don Behan who will speak on current activities of the AICPA. Don is in charge of insurance consulting in the actuarial group of Deloitte & Touche. He was a member of the AAA's Committee on Life Insurance Financial Reporting for five years and is currently a member of the Life Committee of the ASB.

MR. BEHAN: I would like to discuss activities of two bodies within the AICPA, the Insurance Companies Committee and the Accounting Standards Executive Committee (ASEC).

The Insurance Companies Committee has a great many projects underway. Most of them would not be of direct concern to us in our role as actuaries for life insurance companies, as such. For example, an audit guide for property and liability companies was issued during the last two months, and an accounting and reporting guide for agents and brokers is going to be exposed for comment in the near future.

Of more direct concern to us is a paper on transfer of risk, under discussion by the ASEC. This is on the agenda for the November meeting of ASEC. The purpose of this paper is to provide guidance on distinguishing reinsurance that is, in substance, financing from other forms of reinsurance. This is a very difficult area because of the great variety of reinsurance arrangements, and the fact that some of the important criteria, such as the amount of risk transferred, are matters of degree that range over a spectrum, and many of the treaties in force are somewhere in the middle. Because of the difficulty of these issues, I don't believe that a specific schedule for release of this paper can be given at this time.

Before the end of 1990 we can expect the Insurance Companies Committee to issue a paper on critical audit issues for life insurance companies. Work on this has not yet begun, but I think we can anticipate that asset quality will be one of the key issues that will be mentioned in that paper.

There are two items I'd like to discuss in more detail, representations of auditors to actuaries and the practice bulletin on Statement of Financial Accounting Standards Number 97.

At least one national consulting firm in the U.S. has auditors to provide a letter on data used to compute reserves at the end of 1989. There is a proposal in Canada to require that actuaries get a representation from auditors on the underlying data used to determine reserves.

I believe this is a difficult issue. There are some fundamental questions that we as actuaries need to resolve before we can define the kind of representation that we need.

Clearly, the actuary should decide what data to use in establishing reserves. The selection of information that's relevant to the reserving process is one of our important professional responsibilities. I don't think we would want to ask an auditor to make this decision for us. For this reason the actuary will need to tell the auditor what information to review.

A second issue is the degree of testing or confidence level for each data element. Typically, an auditor deals with a simple relationship between data elements and financial statements, that is, each element is significant in relation to the degree of its true monetary amount to its stated monetary amount. On the other hand, in the case of reserving, an item can have importance beyond its monetary amount. For example, a claim with an incorrect incurred date can have an effect on claim liabilities far beyond its amount. In addition, some of the important information, such as age and sex of an insured, or policy type, is not of a monetary nature. An audit doesn't normally give absolute assurance that the information audited is correct. Rather, a level of confidence is established that any errors that may exist are within specific bounds. We will need to have an understanding of the bounds and the level of confidence. The actuary cannot expect that the auditor will perform the work necessary to provide assurance on the reserve data, unless we get involved in planning the work. Especially since some of the information is of a nonmonetary nature, our guidance in directing the auditor to the relevant items will be necessary at the outset.

It seems to me that these issues make it clear that communications between actuaries and auditors will need to be carefully thought out. We can't expect to write a letter for the auditor to sign without giving the auditor an understanding of what our needs are.

I'd like to now move on to another topic which is the forthcoming release of a practice bulletin on Statement of Financial Accounting Standards Number 97. That's the statement "Accounting and Reporting by Insurance Enterprises for Certain Long Duration Contracts."

The practice bulletin is a paper in the form of 15 questions and answers. It's been under development by the ASEC for more than two years.

We just received word that the Financial Accounting Standards Board has agreed to the release of the latest draft of this practice bulletin. I believe it will be issued before the end of this month.

There were two earlier drafts of the practice bulletin that were widely discussed. The first appeared in October 1988. The second appeared in December 1989. There were some very major changes between those two drafts, including the reversal of the position on certain questions. In other words, some questions that had previously been answered "yes" were changed to an answer of "no" for the same question. The final draft, however, is very similar to the December 1989 draft. There are some minor and relatively subtle changes. For example (and this is one of the more major changes, actually, between those two), in the 1989 draft the question was asked whether there should be loss recognition on contracts that are treated as investment type contracts, and at that time the answer was that loss recognition is not required. The final draft says loss recognition is not permitted, and that's really about the most major difference between the 1989 and the 1990 draft. The final draft clearly states that the statement, FAS 97, covers limited payment participating and nonguaranteed contracts. This was stated in the earlier draft but not quite in as clear a form. The reason that is given now is that such contracts are not conventional forms of participating or nonguaranteed premium contracts, and that issue, whether they are conventional forms or not conventional forms, determines whether they fall under the purview of Statement 97.

In view of the fact that this practice bulletin will appear in a short time, I will not review its content, which will be self-explanatory.

What is the standing of this bulletin? It's not of the same standing as an FASB statement in establishing GAAP. It will, however, have weight in establishing preferable methods of accounting. The significance of this is that whenever a company makes a material change in a method of accounting, the SEC will require that the company's auditors conclude that the new method of accounting is preferable to the old method of accounting. Presumably, the methods described in the bulletin are preferable to methods that are inconsistent with the bulletin. Therefore, companies can expect to be permitted to change to methods that are described in the bulletin, but if you're currently using a method that's described in the bulletin, you can expect that you will not be permitted to change to another method.

MR. WILLIAM CARROLL: First I'd like to congratulate the panel on the very informative and very current presentation of valuable information. Second, I'd like to congratulate the ASB for two things, for listening to the comments that it heard from many of its commentators who said that a specific standard regarding AIDS was not necessary, and for deciding to remind actuaries that their responsibilities already included taking account of AIDS. And if I may, I'd like to report on activities of the NAIC Blanks Task Force on this subject last week. Harold made some brief reference in his report to the fact that it was under consideration and still is under consideration that the NAIC require a specific paragraph in the actuarial opinion referring to the fact that the actuary had taken account of or considered AIDS in forming his opinion, and if he had chosen to provide an additional reserve, to state the amount of that reserve in the language of the opinion itself. As Harold indicated, action on this was deferred until December, but I think it's important for people to know that John Montgomery from California, who is the proponent of this, is very strong in his desire that this be included. On the other hand, I, representing the American Council of Life Insurance Committee on Financial Reporting, and Jim Murphy of the AAA office, were prepared to oppose that action.

Fortunately, we did not have to publicly speak against this, and we're grateful for that because both of our organizations support the valuation actuary movement and do not wish to appear to be opposing it in public. Larry Gorski from the Illinois Department, the state actuary, presented his alternative, namely, the letter that Harold referred to which Illinois plans to send later this month to all companies operating in Illinois which will state pretty unequivocally that Illinois believes that actuaries are currently required to take account of AIDS. On hearing each side of this presentation, the chairman of the committee decided not to continue the discussion and to defer it until December. An important element of this is the fact that the ASB plans to put out a communication to actuaries, and we hope that this communication will be available for the NAIC consideration in December.

MR. INGRAHAM: Let me just respond to that last point. Indeed, we're very sensitive to the need of getting the announcement of our action, that's going to go in the *Actuarial Update*, to the regulators as soon as possible. We're not going to wait until the *Actuarial Update* is published, but, rather, we'll have this in their hands before the end of October.

MR. CARROLL: I think that's very important because I think it's going to be necessary that they see that the actuarial profession is taking some action; otherwise they will certainly feel it's their duty to take action themselves in this regard. The other point I have, if I may, is a question for Bob Callahan. You mentioned that New York is considering a revision in Regulation 130 and that the NAIC has a group that is planning to develop similar limitations on the amounts of securities that a company may purchase or perhaps hold. I wonder if you can give us any details about the progress either in New York or at the NAIC.

MR. CALLAHAN: Sometimes the actuaries have a tangential responsibility like I mentioned, and this is one of the areas. Primary responsibility for the assets lies with our Life Bureau in our New York City office. However, I have been an interested party and have been kept abreast of what's going on. Now, I don't think I said in my prepared remarks here that New York was changing its Regulation 130. However, I have said that in private conversation. One of the reasons for this is that Regulation 130 considers an investment grade bond, any bond that is rated in one of the top four rating categories by either Moody's or S&P or one that is given a "yes" designation by the NAIC Securities Valuation Office. Now, what happened after Regulation 130 was issued is that a certain investment house visited the NAIC Securities Valuation Office in New York City, and they convinced the people that certain bonds, BB bonds, which is the top of the non-investment grade category, should be given a "yes" designation. Now, that then fell outside the limit of New York's Regulation 130. Mention of this did appear in particular companies' actuarial opinion in memorandum, and, frankly, they had a considerable amount of such bonds which were not given an investment grade rating by either of the rating agencies but were given a "yes" classification. Now, one of the things that this NAIC group did is they wanted individuals to be able to identify in the MSVR maximum reserve categories those bonds which were rated investment grade by one of the rating agencies, and, in turn, they gave new instructions to the NAIC Securities Valuations Office that they could give a bond a lower rating than what the rating agencies gave it but that they could not increase the rating that was given, but, basically, all the investment grade bonds would fall into either the 1 or 2% maximum reserve categories, and the noninvestment grade bonds would fall into the 5, 10, and 20% categories. The BB bonds would fall into the 5% categories. But there wouldn't be this mixture of investment grade and noninvestment grade by certain rating agencies in any given reserve classification unless it happened to be a case where the SVO office downgraded. Now, as I say, with no change in Regulation 130, this immediately places all those bonds which had been rated -- or given a "yes" classification in 89 statements -- it immediately places them into the noninvestment grade category.

MR. BEHAN: We have time for a couple more questions.

MR. RICHARD V. MINCK: I wanted to make one observation on Lew Nathan's excellent presentation on taxes. The question of amortization is one that has been addressed by Congress earlier. Property and casualty companies were required to amortize, and the method used there was dealing with a question of either advance premium reserves or unearned premium reserves, and that was carried over into the proposals that are currently before both the House and Senate as it applies to group health insurance, one line that's written by both types of companies. Another area was the alternate minimum tax. For some time, and particularly in 1990, companies were required to amortize acquisition costs. The relief currently being considered in the Senate for small companies would exempt them from the 1990 requirements. That is not true on the House side as yet. The other areas that are being considered for relief, I believe, are for companies' foreign business, in some cases, and possibly a carry-on beyond 1990 for small companies, but, again, there are two different forms, one on the House side and one on the Senate side, and I think the best thing you can say of the congressional situation at the moment is that it's very unclear as to how it will proceed.

MR. NATHAN: I agree with all that you said, and one other potential item is that the Colonial American amortization requirement may be overridden by this new tax law which would then create more of an equal playing field. Right now it would seem, if you reinsured a block business, and the Colonial American decision applied, that the government stepped in and basically became a player and took some of the profit out of that type of transaction.

MR. BEHAN: We have time for one more question.

MR. J. TYLER LEE: I'm aware that Joe Belth is looking at this situation, but are there any actuarial or accounting bodies looking in the area of assumption reinsurance -- currently, that is?

MR. NATHAN: Other than the transfer of risk paper which is really more financial reinsurance, I'm not aware of anything going on in the accounting side. I don't know if anyone else can comment.

MR. CALLAHAN: Of course, you are aware, Tyler, that New York issued a Regulation 102 back in 1985 which would require risk transfer to get any reserve credit, and, in turn, the NAIC adopted a model regulation along a similar line. There is a working group that is looking further into financial reinsurance, even though some people would prefer that we move on to other topics. Sheldon Summers has written to the chairman of that working group, Leon Hank, with some of his views on financial reinsurance.