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OPEN FORUM FOR SMALL-COMPANY ISSUES

Moderator: ROBERT H. DREYER
Panelists: KEVIN A. MARTI
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Recorder: ROBERT H. DREYER

Possible topics of discussion:

- Cash-flow testing
- Second-to-die policies
- Need for a small-company section

MR. ROBERT H. DREYER: Our first speaker is John M. O'Sullivan, vice president and chief actuary of Fidelity Investments Life Insurance in Boston. Some small-company actuaries can convince their top management that a small company has no business getting chewed up by the big boys in the markets that trade heavily in investments and tax-oriented products. Obviously, John does not have that luxury. So he is going to share with us some of the unique perspectives from his kind of real-world financial insurance market.

MR. JOHN M. O'SULLIVAN: When I was approached about talking at this forum, I wondered whether I really belonged to the group, since I have spent most of my career working for large organizations. Then it occurred to me that I must be working for a small company; if more than one of us attends a Society meeting, there is nobody back home!

There are some strong bonds that the panelists have in common, despite our diversity. First, we all tend to operate in specialty markets and/or have specialty products. In my case, we offer a variable annuity that uses Fidelity mutual funds and is sold to the Fidelity customer base through the Fidelity distribution channel. Another characteristic of the group is that we tend to out-source work in order to gain economies of scale. In our case, we plug our variable annuity into a Fidelity mutual fund that is used by about a dozen outside insurance companies -- aptly called the Variable Insurance Product Funds. Our general account is managed by Fidelity bond managers who manage pools of money, some of which are from independent insurance companies. We also are in a transition period of moving our servicing in-house from an outside service bureau.

Another thing that we have in common is more exposure to life and death issues. One brush with death was the Bush tax proposal on annuities earlier this year. In a different vein, smaller-company actuaries, as a group, are probably more sensitive to the issue of ratings. In our case, we are a relatively new company, and do not yet qualify for a rating from A. M. Best. However, we are blessed with the Fidelity name and can offer the separate account "wall-off."

Last, we have limited capacity -- more work than resources. This has not been a kind year for us. The pace of regulatory change has been extremely fast, as evidenced by: the implementation of the valuation actua y concept, the introduction of risk-based capital standards, the replacement of the mandatory security valuation reserve

(MSVR) with the asset valuation reserve (AVR) and the interest maintenance reserve (IMR), increased scrutiny of reinsurance, and the accountants' pressure for market-value accounting. The natural reaction to all this is: How am I ever going to get it done? But in the typical small company fashion, we separate the "must haves" from that which can be pushed off into the future, and we promise ourselves that some-day we will find the time to get back to it later.

In the area of cash-flow testing, I have lots of work to squeeze in between now and year-end. I am not an expert on cash-flow testing, but I have the general hang of it. I am having mild attacks of anxiety and discussions with the investment folks, probably like the rest of you. I expect that my anxiety level will increase a bit more before I am done with it.

There are two ways to look at cash-flow testing: the mechanical way and the broader view. All of us have to look at the mechanics to get the job done. There are a lot of assumptions to make: looking at the current assets; putting in the strategy for investment, reinvestment and uninvestment; determining the product characteristics; modeling policyholder behavior; putting in the crediting strategy; getting the expenses in the model; constructing future investment scenarios, etc. After all this, and killing a small forest, we have a mountain of paper to sift through and lots of judgment to exercise in determining what, if any, additional reserves to set up.

In arriving at a conclusion, we are caught between a rock and a hard place. On the one hand, we need to be aware of potential legal liability; I don't think we want to leave the impression that risk has been effectively removed, because you cannot really predict policyholder behavior in all scenarios. On the other hand, if we are overly conservative, we are probably going to lose sales and profits.

The other way of looking at cash-flow testing is to take the broad view, which is illustrated by questions such as, are we being realistic in what we are promising our customers, given what we are investing in and what we need to cover our expenses? Another way to frame the question is, are we setting realistic expectations for our customers and producing a satisfied customer? My hypothesis is that as we stumble along with this process for a few years, we are going to learn more about the financial security systems of the next century – the topic of this annual meeting.

I am going to look at the broad view of cash-flow testing. I like to think of it as looking through the other end of the telescope (as opposed to the microscopic view of the mechanics), and I will be coming at it from the perspective of a variable annuity actuary.

In preparing for this session, I reviewed the report of the Industry Committee on Risk-Based Capital (RBC). Toward the back of the report, there is an interesting table that shows the distribution of risk-based capital by risk category for all companies with assets of at least $50 million. The distribution shows that about 67% is needed to cover the asset default risk, 18% for the mortality and morbidity risk, 11% for the C-3 or interest rate risk, and a mere 4% for the general business risk. This demonstrates just how much of our capital is committed to guaranteeing principal and interest.

Historically, lower-rated investment grade securities have produced the best return relative to risk. For example, over the last 20 years, the spread relative to AAA intermediate bonds was about 30 basis points for AA, 60 basis points for A, and 130 basis points for BBB. The same risk/return message would be seen if a total return perspective, rather than a yield perspective, were taken.

Now, let's take a look at the other side of the coin, namely RBC requirements. For a smaller company, you would need a spread of about 20 basis points over Treasuries to cover the cost of capital on the top three investment grades, but a spread of about 50 basis points for BBB. The conclusion seems to be that the traditional role of the insurer in absorbing the investment risk is using up a significant portion (about a third) of the advantage of investing in BBB bonds. You could extend this argument to other classes. This suggests that the customer may be better off in a separate account where he is bearing the market risk.

Variable annuities have another neat feature: you automatically get your spread, but it is visible and the dollar amount is tied to the market value of your assets. This is great when everything is going well, but more than a bit unnerving when there is a significant market correction. This cyclical nature is dampened a bit by the diversification of assets among the various investment options. At the end of last year, the distribution of assets in the mutual funds used by variable products was slightly over 50% in common stock and about 25% in managed accounts where the investment advisor chooses the mix. About half of the remainder (12% of the total) was in money market instruments. High yield (that is, junk) bonds were only 3%.

At this point, you may be asking yourself why isn't everybody buying the product if it is so great? There are several drawbacks. First, it may be better, but it is not as readily accepted by customers. This is graphically shown by the experience that variable annuity products have had with their guaranteed account (under which the insurer guarantees both principal and interest) in Table 1. It is amazing how much this option gets used and the variation by company:

TABLE 1

	High	Average	Low
EOY 1990	90%	51%	1%
EOY 1991	88	36	1
MID 1992	86	26	1

This should not be surprising, because it parallels the experience of the Guaranteed Investment Contract (GIC) in 401(k) markets. It is analogous to my kids on Christmas Eve wanting to know what is wrapped up in the packages. The customer passion for knowing the return in advance is very strong. Hence, even with the variable annuity, you may be getting a lot of people choosing guaranteed principal and interest options.

Another nasty side of variable annuities is that they are cash intensive. You need to fully fund the separate account on a back-end-loaded product, while at the same time paying a front-end distribution cost. Last, there is the dual regulation of the variable annuity as both a security and an insurance product.

There are some reasons why things may be changing:

1. Customers are looking for higher returns.
2. Increased life expectancy means you cannot afford to leave money in a low-risk, low-return strategy.
3. Besides the life insurance industry, banks and savings and loans (S&Ls) also have historically guaranteed principal and interest. This is not good company for us to be in right now!
4. There is a growing awareness of the credit risk in buying an insurance product, and the advantages of the "wall-off" of the separate account from the problems of the rest of the insurance company.
5. The growing number of fund choices makes diversification easy and allows customers to adjust their mix, with changing needs and risk-tolerance levels.

Here are my thoughts about the financial systems of the next century. It will be more of an era of financial self-responsibility (as evidenced by the move away from both defined-benefit plans and postretirement health plans). Even within the defined-contribution area, there is a concerted effort to wean employees away from the GIC option.

There should be more of an acceptance for an appropriate level of short-term risk if there is a likely pay-off. As America grays, there will be the need for a more careful husbanding of resources so that they can last over a more extended lifetime. This suggests that customers may be more open to taking those risks that they can afford.

The industry will go back to its basics of serving as a risk-pooling device along with an investment function, but the framework is going to change to meet customer needs. The industry will survive nicely, but the role for small companies has yet to be assured. This will be a challenge, both professionally and personally for us as actuaries. This is where the Small Insurance Company Section can help. Let me share with you my thoughts on this new Section.

I would like to see the section meet the special needs of actuaries at small companies, but be useful to actuaries at most companies. Even in the largest companies, many actuaries function in a "small company" environment. For example, think about an actuary at a large company, who has just been assigned to a new profit center, trying a direct mail method of distribution.

One promising area would be to work with other sections of the Society to focus on issues that are of particular importance to smaller companies. For example, with the Reinsurance Section, we could suggest some work on the most appropriate type of retention limit for life and annuity products, and also some work on mortality experience when outside underwriting resources are used.

Another opportunity is to give actuaries in smaller companies (where there are a limited number of actuaries) a network that they can use to bounce ideas off. This would not be a substitute for actuarial consultants, but more like a support group where people can talk over what worked for them and what did not. Obviously, we would need to keep far away from anything that could have antitrust implications. The basic thought here is to lessen any isolation.

We could set up workshops that may be more focused on smaller company types of problems – perhaps with some broader management type of subjects or even some very nitty-gritty type of questions, like organization of resources and choice of a programming language for actuarial departments.

I also would like to see this section help all Society members, especially those at smaller companies, to refine their skills as managers and business professionals. It is not that the SOA is ignoring these needs, but that the need to communicate well, delegate, follow up, and persuade in a gentle, persistent manner is much more pressing in a smaller company environment. If we are perceived as useful, and actually provide value to our organizations, the role for actuaries should expand. Otherwise, we are going to be looked upon as little more than a tool to be managed.

Lastly, we should agree that if the section does not fill a real need for our target population, then we need to fine-tune our role, and perhaps even consider a more radical change. In any case, this section will only be as good as the volunteers and the input of its members.

MR. DREYER: Our next speaker is John W. H. Taylor, executive vice president of London Pacific Life & Annuity in Sacramento. Jack and I go back a long way, having studied together in Philadelphia in the days when life insurance was not nearly so complicated. He has to relate to foreign ownership in his present position. This puts a different slant on many of the aspects of the business. Jack is going to talk about the pricing problems that account for many of his sleepless nights.

MR. JOHN W. H. TAYLOR: I would like to provide a little insight into the company I work for, because it does influence the way I approach some of the problems about which I will be speaking. Our parent is an international investment management firm, a small company with a worldwide staff of about 100 employees. It is 18 years old, and it is run by very strong-willed and very successful individuals, who built it from scratch. We have, worldwide, over $5 billion of funds under management. We also have some very nice office locations, including operations in London, the U.S., Singapore, Tokyo and other points around the world.

Three or four years ago, they were looking for a way of entering the retail investment market here in the United States. They had a group of people with quite a bit of experience in the life insurance business, who also had both marketing and operational skills. They purchased a shell that was widely licensed and developed a company, basically from scratch, in 1989.

That firm was London Pacific Life & Annuity. We have about 65 employees, depending on how you count our field personnel, and some part-time employees. London Pacific has over $600 million in assets, so it is not exactly small. We are servicing approximately 23,000 policies, and we issue about 10,000 new policies a year.

We use a separate marketing company, London Pacific Inc., because we are a small organization and cannot underwrite all the products we wish to sell through the distribution systems we have developed. Therefore, we created a marketing company to handle that relationship with the field.

Because we have an international parent, we report basically in the United Kingdom's format. The first year we had to report, we had a company of about 12 people. We had five cities represented in the actuarial consulting support group, and four other cities represented on the audit team. Having always been in situations where an audit was done only at the home office, I was faced with a new and interesting experience, involving nine cities worldwide. Somehow, it worked.

In a small company environment, the pricing actuary has to deal, not only with the pricing problems, but with the valuation responsibilities, including reserve adequacy and the cash-flow testing issues. We have to be concerned with the agents (who we see as our retail outlets), their policyholders and the stockholders. Another audience that we need to be concerned with is the regulators, in view of the difficult role they have. It is their duty to enforce the regulations and to make sure they are followed in spirit, as well as to the letter of the law. Those regulations seem to be getting more, shall we say, intrusive into the operations of companies, making the actuary's role more difficult.

Finally, I would add the Academy of Actuaries to this list. I have a feeling that there's a move within our profession (which hopefully we can address from a smaller company aspect in particular) to view actuaries as wearing some kind of capes of infallibility. The "Super Actuary" concept seems to have received a lot of attention. I sometimes wonder to what extent the Academy has given the regulators the impression that our ability to predict future events is greater and more reliable than it actually is.

Most of the material covered here applies whether you are a small company or a large company. However, some of the things have more impact on the smaller companies. For example, capital needs depend on your parent and its resources, but frequently, in a smaller company, your ability to access capital sources may be more limited. Certainly distribution capacity impacts what type of product you may consider. If your distribution system is too small, that limits your growth potential; if it is not trained in some subjects like taxes or investments, that limits the type of products you can sell. Similar concerns apply to your service capacity.

Capital needs have certainly been a subject of much discussion at the Society meetings in the last year. I have heard people who were chief financial officers of fair-sized firms say that their goal was redundant surplus. If I told that to my chairman, I would be looking for employment very quickly. I think our goal is optimum surplus, quite a different target.

RBC has been attacked as not being restrictive enough. Let us keep in mind that what we are talking about with RBC isn't optimum surplus. It is the minimum required for a corporation to, in effect, control its own destiny. It is really a liability of the company, not a surplus, and I think it must be considered in all of our pricing work. Certainly the question of the strain involved in new products, such as participating life or other interest-sensitive products, involves the capital needs of your firm.

A recent *Product Development News* had a particularly good article about the cost of putting up the additional amounts of surplus required. These issues are important because they influence our pricing decisions and influence our ability to compete with our peers in the insurance industry. This is particularly true if you are involved with a product that has investment orientation and is interest-sensitive. Because our parent is an investment management firm, most of our products are annuity or universal-lifetype policies. These issues are of utmost importance in providing a competitive product.

The IMR is a new concept. It certainly makes sense to us as actuaries, but it does not always seem to make sense to the people on the investment side of the house. It limits steps that can be taken to develop competitive products, and once again, probably requires more surplus.

Finally, the economy is something we, as actuaries, have been discussing for quite a while. What course it will take in the months and years ahead is important to our pricing decisions, and we all seem to have different opinions as to what that course might be.

Service capacity, I think, is also an issue. If you are an actuary in a small company, you must contribute to the conversation with marketing and the rest of your executive team, as to what your definition of service is. In the insurance industry in the past, that definition often was to give the agent whatever he or she wanted, a very costly definition of service. A firm that I was with once analyzed expenses in their underwriting and issue area and determined that 70% of their costs were exception-processing service requests. Obviously the cost that was passed on to those who did not require that special treatment was significant. Also, it contributed to a tremendous labor-intensive situation. It is important to develop, with your marketing and executive management team, a viable definition of service that will be applied as you develop new products. It is okay to consider a product that does not fit your definition, but only if you take into consideration the major cost implications of changing that definition.

The final item bearing on market/product decisions is your distribution capacity. If you have a very large field force, you have an opportunity to try many different products. If you are a smaller company with more limited distribution capacity, the question is, will you sell enough of a new product to justify what you're going to have to spend to develop it?

Second, you have to deal with the cost of your distribution system. It must be recognized that you cannot simply say it is too expensive and lower your commission structure. If the people in your distribution system were making too much money, you would have a lot more people out there wanting to sell for you. You need to evaluate their distribution costs carefully, because that may limit some of your options.

The third item deals with the recovery of additional costs. If it is going to cost you $75,000-100,000 more to develop a product, because of some new requirements, can you sell enough, under the changed circumstances, to justify even thinking about it?

Finally, you have to know your field force. Is it a captive field force? Is it a field force where competitiveness is not important? Or is it one where, in effect, they are selling your product as part of an overall marketing concept and are not dependent upon income streams from the products you are creating?

It used to be heresy to express the fact that you price on a marginal basis. I know when I first raised that issue some 20 years ago, I was considered to be, shall we say, on the lunatic fringe. The problem is that if you don't allocate all the expenses of the company to your products, you're not going to cover them in your sales. In a small company, in particular, I think it is very difficult to use the traditional pricing approach. I think you need to allow yourself freedom to develop what some refer to as the optimum price. What is the optimum per unit cost of your product, or per unit spread if it's a spread product.

I started into cash-flow testing because it concerns me. I think it is important that the industry has been moving rapidly into this area. I think this type of analysis is good, in itself, and we should be doing it, but many of us would not do it if it was not required. Yet to require the formality of cash-flow testing creates a significant problem for smaller company actuaries.

Cash-flow testing is the subject of Actuarial Standards of Practice (ASP) Number 7 and Number 14. Most discussions have been primarily about reserve adequacy, but section 5.1 of ASP Number 14 deals with pricing. It specifies, for example, that if you are thinking of changing the interest credits or mortality rates used in a universal life product, or any items of that nature, it is recommended that you perform cash-flow testing.

Section 5.4 may be the most important one from the point of view of the smaller company actuary, because it deals with the question of when cash-flow testing is not necessary. It says that if your product and your business is relatively insensitive to influences such as changes in economic conditions, you may not have to do it. Section 6.2 says that if you have not followed this, you have to tell why you did not, and the impact. I would like to know how you know that without doing it? It seems like our hands are being tied.

We also need to consider the costs involved. We know what the Academy, and the insurance commissioners expect us to do, but the cost of doing it may be prohibitive for some companies. I have seen estimates of $50,000-75,000, and even more, to do it in accordance with the required provisions. I think a lot of smaller companies could have trouble selling enough extra business to justify that amount.

RBC and reserve adequacy also are issues. For example, are we taking into consideration the impact of reserve adequacy on the reserves we hold? Are we pricing properly if we are not reflecting the impact of a potential spike in interest rates on our reserves? We are looking at things today in a very rosy environment. Interest rates have fallen for a number of years, but what if that changes?

MR. DREYER: Our final speaker is Kevin A. Marti, assistant vice president and chief life actuary of Westfield Life Insurance Company in Westfield, Ohio. Kevin's talk is going to deal with the problems a small company runs into when required to do cash-flow testing. Kevin and I have a lot in common. We both work for small property/casualty affiliates which few of you have heard about, and we both came to our present companies from Milliman & Robertson, Inc. We also both have to deal with the upset caused by asset/liability matching. Now, we both are learning to spell relief, A-S-A plus P-T-S.

MR. KEVIN A. MARTI: I want to start by telling you a little bit about my company, because it is not very well known. Westfield Life has about $225 million in assets and about $32 million in surplus. It is an A+ rated life affiliate of an A++ regional property and casualty group. When I came to Westfield Life in early 1989, I was the chief, and only, actuary. My first job was to find an actuarial student, because I could see what was going to happen if I did not get some help. I was successful in recruiting a student, and he has become an ASA. We also have a "para-actuary," a woman who has worked in the department for 8-10 years, doing some of the monthly statutory report compilation work.

We have sold universal life (UL) and annuities since about 1983. We have between $70-80 million of reserve liabilities in each of those lines of business. We have a corporate investment philosophy that precludes owning junk bonds or mortgages, so I do not have to deal with a lot of the nuances that some of the other companies have to deal with in cash-flow testing. (We do have some CMOs that create some "opportunities.") Mostly we have investment grade corporate bonds, so the asset side of cash-flow testing is not nearly as difficult for me as it is for a lot of people.

Last July, I concluded, based on my interpretations of the Actuarial Standards of Practice and with the assistance (or maybe a better word would be insistence) of our outside auditors, that cash-flow testing was required for Westfield Life at year-end 1991, not 1992. Many of you reached a different conclusion, but we chose to do the cash-flow testing last year-end.

How to get it done was, of course, the big question. If any of you think that President Bush is having trouble building a coalition for reelection, you can imagine my problem trying to convince senior management that cash-flow testing had to be done, even though it wasn't legally required, and that further down the line we would need to spend $50,000-100,000 to purchase software so that we could bring all these things in-house. (As an aside, I would need the help of the outside auditors, the investment department, the accounting department, and several of our data processing people in order to get the job done). Also, an additional actuarial student might be required. This was really a hard sell.

We had been working on a source-of-earnings financial reporting model at the time we decided to do cash-flow testing, so we already had begun the process of building our liability model. We ended up with approximately 150 cells, representing different issue years and issue ages and so on. About 60% of these were UL cells, maybe a third of them were traditional, which consisted mostly of term insurance, and the rest were the annuity plans.

We began the process of truing up the model to reflect the actual past year-end in-force values from 1983-91, to prove the validity of our model and to gain the benefit of past experience in setting future assumptions in several different areas. One was the premium persistency of the UL and flexible premium deferred annuities. Actual versus "price war" mortality was another area, as were persistency and actual versus expected expenses. As a side note, I would encourage you to think about the other possible uses and benefits of cash-flow testing. Since most of you wear several different hats, depending on which way the wind is blowing on any particular day, you might want to consider what side benefits you can get when you go through this exercise.

Those of you who already have begun the cash-flow testing work will be able to empathize with the remainder of my story. I worked, essentially, every day for about three months to keep all the balls in the air in my job as chief actuary. My ASA was tied up at the time on a life administrative system conversion from Life 70 to CAPSIL. (He was having a good time, also.) Product development had to be put on hold, much to the chagrin of the marketing department. Also, in order to meet our time constraints, we had to make a number of compromises.

First of all, since we had no asset/liability cash-flow testing software in-house, and it did not look like I could get such a purchase approved in short order, we had to engage some outside help to get the projections run. This was done by our outside auditors. It turned out to be a seriatim list; we were able to include all the assets because of the size of our portfolio.

Our investment people were heavily involved in determining the input for the asset model -- that is something I encourage all of you to do. We built a liability model, as I said, as part of the source-of-earnings project. Then a bridge program was written to convert the data from that system over to the cash-flow testing software, PTS, which was also being used by our auditors at the time.

We decided, due to the time constraints on us and our auditors, that we would run the projections as of September 30, 1991. This is an area that causes some controversy in the industry. For us, it was really the only feasible date. It took me through the end of October to finish the liability models. The asset model and the projections were completed by mid-December, which gave me until the middle of February to finish the cash-flow testing report.

We chose to run only the "New York 7" interest scenarios, because of time constraints and our belief that our asset quality and duration was such that Westfield Life assets and liabilities were fairly well matched. I think the results of our cash-flow testing on those scenarios bore out that impression.

We also chose not to model some of the less material lines. We had a closed block of deposit administration business that amounted to roughly 5% of total reserves. We also had single-premium immediate annuities and structured settlements which were a small, but growing portion of our business, amounting to about 3% of our reserves. None of these were modeled. Also, we chose not to cash-flow test our traditional business, because it was mostly term insurance and the assets were not segmented for that business. The point that I would like to make is that cash-flow testing, of necessity, may have to be an evolutionary process at your company. You may not get the perfect answer or the perfect model the first year that you do it. You may have to cut some corners, but hopefully that will not affect your ability to interpret the results and sign the opinion.

The biggest problem with choosing September 30 as the date to run our test was that the interest rate environment began to shift rather dramatically during the fourth quarter of 1991. I have to admit that by the time the end of the year came around, I had some real concerns about the projections being run as of September 30, rather than December 31. Our projections had provided for a minimum yield of 2% for short term, 2.5% for intermediate term, and 3% for long-term investments. I felt that we were sufficiently exposed, in those few downward interest rate scenarios among the New York 7, that our judgments and conclusions were not invalidated.

What did I learn from all this experience? I learned I made a big mistake deciding to do it in 1991. I learned that you need to involve, as early as possible, the other parties who must contribute to the project. This includes your investment people, your accounting people, your data processing people, and anyone else you need to get the necessary data. The assets and asset models were not something that came naturally to me, so I welcomed the help from our investment people. They set up the specifications and gathered the various assumptions needed for the investment projections.

Initially, you may have to take some shortcuts that are less than aesthetically pleasing to get your cash-flow testing done. There are a plethora of input variables you have to deal with in most systems. You can drive yourself crazy trying to look at all the different possibilities and all the different options you have.

You should make a large commitment to validating your models and to documentation. This is especially true with respect to nontested lines of business. We had something on the order of 25 pages of text and appendixes when we got done with our cash-flow testing memorandum.

For 1992 year-end cash-flow testing, we have purchased software that will allow us to perform this job in-house. This is, as you might imagine, a good news/bad news situation. We now have the software, but I question whether we have the manpower to be able to pull it off. Because of the drop in the maximum valuation rate from 5.5 to 5%, we have a major product development project that we have to complete as soon as possible.

My best advice to all of you would be to get as much help as you can from whatever resources you can, get started as early as possible, and try to make the best of what is obviously a difficult situation for us, as smaller company actuaries.

MR. DREYER: Are there any questions for the panelists on their presentations.

MR. LAWRENCE A. SELLER: A question for Kevin. What kind of priority did you give to asset segmentation in your cash-flow testing, and what shortcuts did you take with regard to investment or reinvestment assumptions?

MR. MARTI: We have our assets segmented for both the UL and annuity lines of business, so it was not a question of deciding which assets went with which liabilities. The assets are segmented up-front. As far as the shortcuts in the modeling, as I said, we did a seriatim model so there was no shortcut involved. We have every asset that is invested in either of those two lines of business in the program. That is something you are going to have to decide based on how many assets and how much time you have.

MR. JAMES N. VAN ELSEN: I want to suggest another responsibility for this new section: that is the monitoring of some of the new regulations, and how they affect the smaller companies. As you are making your changes for valuation interest rates, and asset/liability matching, it is sometimes hard to keep track of all the pounds of paper that come through your office.

In that vein, I want to bring attention to a bill that is being considered that I think will have a major impact on smaller companies. I cannot remember the exact wording, but it is a new valuation regulation for life insurance with nonlevel premiums. It includes a provision that allows companies that can demonstrate experience based on 100,000 life years to benefit from a lower valuation standard. We do not have that kind of exposure, and this regulation would put my company at a severe competitive disadvantage in term and universal life.

For each company to have to keep track of every piece of legislation, and how it varies from state to state, is an enormous task. I do not think any of us at smaller companies is in a position to put staff on that function, and I wonder if this group or the Academy could do it?

MR. MARTI: Perhaps this is the kind of thing we can cover in our *Small Talk* newsletter.

MR. GREGORY J. CARNEY: There is one thing I would like to point out, having been involved in some of the sections before. The startup of a new section requires an awful lot of work. The more people that you can involve, the better and the easier it is going to be. The sections are bottom-up type of organizations. However, by definition, the members of this section are too busy to do anything, because they don't have anybody to help back at the office. If some of you can volunteer to help, I know Bob would appreciate it, and I think you would get an awful lot out of it.

MR. DREYER: We seem to be getting into talking about the section as much as the topic. I am sure each one of these topics could have had an entire session devoted to it. This is what we would like to get the section doing in future meetings. For the rest of the time period, let us talk a little about the section.

MR. ROBERT J. JOHANSEN: I think that the formation of a Small Insurance Company Section is a great idea. I am sure, over the years, it is going to fill a need that no one here is really appreciative of right now. In trying to keep up with what is happening in the regulatory area, the Life and Health Actuarial Task Force publishes, about monthly, a compendium of correspondence to and from that group. It costs about $200 a year. I think it would be a good idea for the section to monitor what is going on. I also suggest that the section have a liaison with the ACLI statement group.

MR. LAWRENCE SILKES: Do you feel that in your other areas, such as marketing and investment, you are being adequately notified or have early warning systems? You are discussing regulations, but what about the other dimensions?

MR. TAYLOR: It seems to me that on the investment side, tools are available that are accessible as quickly as those data get on the street. Marketing information depends on the quality of your marketing officer and his or her lieutenants. You have vibes coming back from other companies. It seems, in my experience, those two sides are close to what's happening.

FROM THE FLOOR: What about working with reinsurers?

MR. TAYLOR: I think they try to do the best job they can. I know we get a lot from our reinsurers and some of the consultants we work with on a routine basis.

MR. O'SULLIVAN: There is an interesting model we might follow. I believe it is from the Life and Health Compliance Association, which takes care of a lot of the regulatory initiatives, for example, how much interest is credited on death claims state by state. They form committees that are organized by subject and parcel out assignments to monitor regulatory information sources. That way it is not too much work for any one individual, and all the material gets shared among the whole group. If we can tag these things, we can use the NAIC subscription service, and perhaps work with the ACLI and the NAIC to make the material more user friendly. It would be more of a summary document, and we could make it available for those section members who need it.

MS. DONNA R. CLAIRE: Related to the fact that the valuation actuary has to comply with all states, you are not the only ones having that problem; even the big companies don't want to read all the different proposals. The ACLI has recently said they were willing to take on the responsibility of compiling a list of the variations in state requirements.

MR. MARTI: Last year when I filed my actuarial memorandum, I prepared it based on the cash-flow testing language that I had seen in various sources. I was given rejections from a couple of states that did not like the new format. They had not adopted the cash-flow testing format and said I would have to furnish the old type of actuarial opinion. You are probably going to get caught in that sort of thing at this year-end, too, because there are about 10 states that have adopted the changes in the Standard Valuation Law, but others have not.

I would like to ask for some discussion about what I perceive to be an apparent conflict between the Actuarial Standards of Practice and the new Standard Valuation Laws, which exempt some small companies on a periodic basis. Is it O.K. to do cash-flow testing every three years, or do you feel the Actuarial Standards of Practice require it annually?

MS. CLAIRE: In effect, what you do have is the Academy trying to come up with what they think is right, without a lot of thought to practicality. Even within the current standards, there is something about consideration of time and money constraints. To change ASP 14 to try to reflect more exactly what the law says does not seem practical. It is more likely that they will come up with a compliance guideline for the smaller companies, so that you do not have your profession telling you one thing, and the law telling you something else.

MR. JOHN W. MCKEE, III: Kevin, you have me worried. My company does not need to do cash-flow testing, but the law says that we should once every three years. I have not even thought about doing it annually. We do not need too. We are going to prove that we do not need to this year. I was not aware that this was an issue for some of us.

MR. MARTI: I think you can make an argument for testing just by reading the Standards of Practice as they exist today. I went through it last year, and I decided that it had to be done at last year-end, even though the law did not require it. I felt the Professional Guidelines really did not leave a lot of latitude.

MR. MCKEE: This is an area where you have to be comfortable with your personal situation and your company's. We have 10-15% of our assets in interest-sensitive areas.

MR. MARTI: We are very heavily into the interest-sensitive area, so that was certainly a factor for me.

MR. MCKEE: I have some comments on things that the Section might do. First, we could provide a means for small company actuaries to identify various sources of information they may need. Another thing we might do is help provide information for the small company actuary to determine what it takes to be successful in that role. There are certain things you do; how you manage your time, etc. My final suggestion is to have an open discussion where we could share our experiences on certain tasks or projects such as: When have outside consulting firms been used? What systems are available? What worked and didn't work for you?

MR. DREYER: Kevin, I would like to make a comment with regard to the question you raised. While I have discussed this issue at length as a member of the Academy's Committee on Professional Responsibility, I am speaking now for myself. I do not view the Standards of Practice as a straitjacket. I do not see anything there that prohibits you from doing anything that, in your professional judgment, you feel you can justify. As long as you are comfortable, and can document it appropriately, I feel you have acted responsibly, and within the guidelines of your profession. I offer this point of view as another possibility.

MR. JAY M. JAFFE: I like the idea of the section, but would prefer a name such as "actuaries who work with smaller companies," which would embrace the consultants. I have been involved in a couple of other sections, but your division by size of company is somewhat unique. That presents both a danger and an opportunity. I hope we will be proactive and make our voice heard, not simply sit back and be an information source. I think that has to be done with delicacy, and I would be curious as to what the organization intends to do in that respect.

MR. DREYER: I certainly have it in my mind that I would like to see this group become proactive. As Greg warns however, we are all very busy. If each smaller company actuary, or actuary related to smaller companies, were to give a small part of his time to committee work, to the structure of the programs and the activities, I am sure you would get benefits back many fold. This is what we are trying to encourage here. I strongly urge all of you to keep this in mind as we go through the formative stages of this section.

MR. TAYLOR: I also have a comment on an earlier question. The Standards of Practice, I think, have been drafted with tremendous flexibility. Bob's comment that it is not a straitjacket is obviously the intent. One concern that came up at the Chief Actuary Forum this year is that it is not only our interpretation that counts. It is nice to think we have the independence to make judgment calls on when we can avoid the recommendations of the standards. However, we will not be deciding whether we made a mistake or not, it will be somebody else. Hopefully, it will be just our management. Hopefully, it will not be the insurance commissioner, or worse, some jury hearing a lawsuit raised in the State of California.

MR. DREYER: I knew you were going to get that in somehow.

MR. TAYLOR: I think you just have to be sensitive to the fact that for the first time, actuaries are being asked to opine to something in a fully legal sense. As I tried to point out, somewhat in jest, we are basically putting ourselves in a position that the regulators definitely desire us to be in. There is an impression that we can do things, we have the tools to be able to do those things, and I think we have to keep that in mind. It is not just what we write and what we do; it is not enough to comply with our best and most conscientious beliefs of what is professional. We will be viewed by people who do not have the foggiest idea of whether we did this with full professionalism or not.

MR. PAUL A. HEKMAN: We work with quite a number of you. Our experience has been in both large and small companies. I once worked for a company that had 65 employees and all the demands made of a smaller company actuary. With regard to cash-flow testing, if the only reason you are doing it, or even looking at doing it, is to comply with the opinion requirements, it is a waste of your money. It has a much broader application than that. It can be used to check for surprises in your reserve patterns. It also can become an integral part of your budgeting process.

MR. JAMES W. PILGRIM: Relative to the 10 or 11 states that have passed the Standard Valuation Law, it is my recollection that only Oregon has passed the memorandum regulation. That may put some companies in a difficult position, because without the regulations, there is no basis for claiming a Section 7 exemption. I would encourage people that are licensed in the states that have not gotten around to passing the regulation, to get the states to do so for 1992.

MR. DREYER: I would like to make one personal observation with reference to Jay's request that our section embrace consultants. Years ago, each Society meeting had a Smaller Company Workshop. For a while, it was a very effective way of meeting the concerns some of you have expressed. The workshops were discontinued when the Program Committee realized that they had been reduced to workshops for consultants; I know, because I was a consultant at the time. When consultants and/or reinsurance actuaries and/or vendors are faced with smaller company problems, they should be encouraged to participate on that basis. We appreciate those who do and will participate in that spirit, however, this Section is not intended to be, and should not be used as a means for promoting their business.