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MANAGING STATUTORY PERFORMANCE

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Recorder: DAVID E. NEVE

- Factors influencing statutory surplus
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MR. DAVID E. NEVE: The title of this session is "Managing Statutory Performance." This is a very important topic that is getting a lot of interest these days. The purpose of this session is to discuss specifically how a company can manage and improve its financial performance as measured by the statutory financial statement. Now, as we all know, statutory accounting does have limitations, and it does not always capture the true performance of a company. There are a variety of other management-based approaches that attempt to measure true economic performance (e.g., GAAP, value added), but this session is designed to focus primarily on the statutory process and statutory accounting results. However, this session is not intended to be a critique of statutory accounting. We all know there are limitations, but our focus will be to deal with the reality of the statutory blank that we must file and how a company can best manage its financial affairs to improve performance. Our focus will be how the outside world perceives our companies' performance, rather than discussing internal management-based approaches, which many companies use for internal purposes.

In the past, many companies have used the statutory blank as their primary way of measuring financial performance. There are companies, such as my company (The Principal Financial Group), where there has not been much emphasis on statutory results in the past. For example, at my company we have our own internal "management-based" system that we focused on. We have been following these

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results for a number of decades to measure financial performance, and statutory results were somewhat incidental. We had to complete a statutory blank, of course, but we didn't really manage around it. In recent years, as we are all aware, there have been fundamental changes in the industry. The financial stability of the industry has come under great scrutiny, and so we, like other companies, have shifted our focus to deal with the reality that the outside world looks primarily to our statutory blank to measure performance. Even if we can convince ourselves from a risk basis or from our own internal analysis that we have plenty of capital and plenty of earning power, if the outside world doesn't think so, we'll be out of business. So, at our company, we have accelerated our focus and our attention on statutory results. I'm sure many of the other companies represented here have done the same thing.

One thing I'd like to emphasize before we get started is the difference between what I'll call real performance and cosmetic performance. There are things that you can do on your statutory statement that will give the appearance of improved performance that don't necessarily reflect real economic improvement. How does management deal with this when evaluating performance?

A final comment I'd like to make in this introduction has to do with the fact that most of us are actuaries. We have training in risk and financial matters that relate to the financial condition of an insurance company. However, I think we are being called upon to take a more active role in working with our own managements to empower them with knowledge so that they understand the various aspects of how to improve performance. It's not enough to just be an expert and to develop an expert analysis. If it isn't integrated in a comprehensive way throughout the management of a company, it doesn't really do a lot of good.

Patricia Guinn is a vice president and principal at Tillinghast. She's a manager of the life insurance and consulting practice in New York. Her principal areas of practice are management and financial reporting, mergers and acquisitions, and annuity product management.

Bob Ozenbaugh is vice president and actuary with Mutual and United of Omaha. Bob's current responsibilities include corporate modeling, experience studies, compensation analysis, in-force and new business reporting and interest-sensitive credited rate management. Bob added the Chartered Financial Analyst (CFA) to his FSA designation in 1990.

Finally, Terry Lennon is an assistant deputy superintendent and chief examiner for the New York Insurance Department. He's been with the department for 30 years and recently chaired three very important NAIC study groups, the Asset Valuation Reserve and Interest Maintenance Reserve group, the life Risk-Based Capital group, and the group that overhauled the Standard Valuation Office (SVO) procedures.

I'm Dave Neve and I am a second vice president at The Principal Financial Group. I head up the financial management area of our company and my responsibilities include capital management, financial reporting, rating agency relationships, expense management, asset segmentation, and coordinating our corporate planning process.

We have a great diversity of expertise, experience, and perspectives on our panel. We're going to begin with Bob giving us the basic framework and background of those forces, both internal and external, that affect financial performance.

MR. ROBERT OZENBAUGH: As Dave mentioned, we're talking about statutory performance, and there are a lot of things that impact it. I tried to separate the elements between those that I believe are under management's control and those that are somewhat outside of management's control. When I did that, I found that a lot of the items that you might think are within management's control may not be. So let's talk about them. Corporate structure has a big impact on how you raise capital and how you perform your jobs. Over time, even though you can outwardly change your corporate structure, there is something that I call corporate infrastructure that is difficult to change. These changes don't happen overnight and limit what management can really do, even with a change in corporate structure.

Risk tolerance is a second element that is obvious, but I think it, again, becomes part of the corporate infrastructure in the sense that new opportunities within the organization (such as brokerage, banks, manufacturing, or variable products) may not be encouraged. Is a "guaranteed return" type product encouraged over one that might be more risky, but potentially more profitable? Are statutory results, as we're talking about here, more important than adding value? I think the answers to these questions affect not only profitability and surplus in your company, but affect the risk tolerance your company is willing to take on. How your corporation addresses that tolerance is quite important. Making it become part of the infrastructure is difficult to accomplish as our environment changes around us.

Another area affecting performance is the type of investment strategy selected. Are new investments sought out? Are things like a total return portfolio or foreign opportunities considered? Does the investment division avoid credit risk at all cost because the risk or the suffering caused by one default is more than it's worth to them to take that risk? Or is investment performance measured against the risk class expectations that allows them to measure risk return characteristics of many different opportunities? Again, stagnation of changes in that environment can lead to an infrastructure that is unacceptable.

Dealing with this risk/return trade-off is an area that we as actuaries can relate to very directly and one that can really impact the profitability of our companies. This is probably the one area that management can control. I think the problem with it is that the decisions that need to be made are often made before we have all the input necessary to make the right decision in a lot of cases. I guess it's like my favorite multiple choice question when I was taking exams, where the possible answers are: all but 1, all but 2, all but 3, all but 4, and all of the above. I knew three of the four answers, but I didn't know that fourth one. I should have a 75% chance of getting that question right, yet when I went and looked at the answers I only had a 50% chance of getting that question right. Not only that, but I wouldn't know for several months whether I ever answered the question right. You can almost relate that to how we have to go about our business in the sense that you have to make decisions before you maybe have all the information available to you, but it may be all the information you're ever going to have. You may not know that it was the right decision until further down the road when you find out whether you failed or passed.

Financial reinsurance and surplus relief reinsurance can have an impact on financial results. Some of these arrangements are good and maybe some of them aren't and I think most of those things get found out in the long run.

Growth rate is another obvious element that can impact performance. We need to be careful to conclude that it is okay that a line of business isn't making money because it's growing so fast. Often times the growth rate slowed and the profits didn't emerge. Then we often say, well, that line isn't making a profit because our assumptions were set so long ago.

But here's my favorite. This is the best one: accounting assumptions and methods. Let's say I can project statutory reserves within 0.1 of 1% and I can project corporate profits within 10%. I think those are good results. Then the accountants come along and decide to expense something, or amortize something, or they decide at the last minute to put some money in the pension plan and forgot to tell me. Accounting assumptions really affect the bottom line.

Let's go on to those things that are not within management's control. They're all obvious. Interest rate movements is a good one. For the last 10-12 years we've been very fortunate to have a nice gradual slide in interest rates. Investing long was really kind of a no brainer in the sense that if you did that, you might win even with short liabilities since interest rates fell. But when interest rates move in the other direction (and I'm not going to predict that they will, since I can't get my investment division to predict what they're going to do next month or tomorrow), then what's going to happen? I think that portfolios are probably a little bit longer than what we might have assumed in our assumptions. I think that means that if there are some rate guarantees being backed by those assets, we might have some problems in maintaining some of our current crediting rates. Even though that's outside of management's control, I think it's something that we obviously need to be very cognizant of.

Economic growth is going to have an impact on our surplus and performance. Consumer activism is another. Consumers want insurance companies to be more solvent and be more stable, but I'm not sure they want to pay for it. It is kind of how Ross Perot sees the nation, in the sense that he knows what we need to be, but he's not real convinced that we want to pay for it. We all need to buckle down and contribute to a solution. Consumer activism has driven the rating agencies and the way companies do business.

Another item is federal, state, and local tax policies. It used to be that taxes didn't change very fast. A law was passed and they kind of forgot about it for awhile and then down the road a piece, they pass something else. That isn't the case anymore. Taxes and policies are changing faster than we can keep up with.

Government regulation is another good one. I work for a health insurance company and we are a big player in the individual major medical market. One of my jobs right now is evaluating the impact of regulations passed by New York. That's a very big concern that has a very big impact on our financial performance. The ripple effect that New York has on all the other states that are looking at the same types of regulation is going to have a big impact on us. You throw that into the bucket with all of the other types of government regulation that come along whether it be rate regulation or whatever, and it adds up to a big impact on our business.

Guarantee fund assessments. Obviously, that's not a problem anymore. We're beyond all those kinds of problems. Here's a good one. War, hurricanes, acts of God -- does anybody else think these things are happening most recently now, or is that just me? I don't know. It just seems like every time you turn around there's a catastrophe happening somewhere that was bigger than had ever happened before. I don't care if California falls in the ocean, but we have to be aware of these events because they have a major impact on not only how we do business, but the profitability of the business that we've written. I can tell you that the idea of California falling into the ocean isn't that silly because my company specifically went out and analyzed the mortgages and the assets and the buildings that were sitting on that fault line and have pulled out from the area because of some concerns that there could be a major earthquake in the Los Angeles area. So, these are real things that affect us and the health of the insurance industry.

Finally, the impact of politics on our business is another major concern. AIDS and national health come to mind immediately. Being in the health insurance market, medical usage and how they get supplied is a big deal to our company. You can see that there are just a few items that might impact your statutory performance.

MR. NEVE: I think that the challenge that I have in my company and maybe you have in your company, too, is to really articulate the impact of these factors on performance in a very precise, understandable, and nontechnical way so that those who are in senior management and others who are making the decisions really understand their impact. Do any of the panelists want to comment on whether you think this is happening?

MR. TERENCE LENNON: It's happening selectively. It's not happening across the entire industry. I think that the industry through the 1980s spent a lot of money on data processing and most of it went into policyholder information systems. I think that the management information systems in many of the insurers are severely deficient. I think that the management structures tend to be a leftover from the prior 25 years. Those management structures really don't work anymore. The management structure of 20 years ago had autonomous functional units (e.g., marketing, actuarial, investment, valuation actuary separate from the pricing actuary, etc.) and the control was separate. They perhaps all met at the Christmas party or somewhere once or twice a year, but other than that, they put the thing on automatic pilot and it worked.

That doesn't work anymore. There has to be much greater dynamics between all the parts of the company. You can't say that you don't know what the investment people are going to do next because they had better be doing what's needed for the product portfolio of the company. That doesn't mean that they can't use all of the tools available to them to get risk reward returns that are appropriate to the products they have, but they have to understand what investment demands are made by different products, and then fashion their investments with that in mind. But I do think that this focus toward a more dynamic and aggressive management of the products is necessary now.

MR. NEVE: We could probably spend a session on almost anyone of these topics. Let's move on. The concept of risk is one of the fundamental concepts that we, as actuaries, are trained to be experts in. Patricia, why don't you give us a little bit of a background and then we'll have some discussion.

MS. PATRICIA L. GUINN: My secretary has a very nice dictionary and dictionaries are wonderful things. And the first definition of risk that I found in her list was "the possibility of suffering harm or loss." The second definition was "the danger of probability of loss to an insurer." As actuaries, we can probably get a little more specific or a little more technical about what that means. What we're talking about is the likelihood or the magnitude of adverse fluctuations and results around their expected result.

The task force of the Society has been studying risks and identifying risks for many years. As time goes on, I think that we learn more and understand more about what these risks mean. The first one is investment risk. As actuaries, we've been talking about this as C-1 and C-3 risks. C-1 being a default risk or quality risk and C-3 being interest rate risk. Let's stop and talk about each one of those for a second.

On a simple basis, asset quality means if I pay a $1,000 for a bond and it's supposed to give me an 8% coupon, what's the chance that I'm going to get my 8% coupon and get my $1,000 back when I want? In our modeling work we've probably assessed default costs using historical default rates. In real life, when we look at lower quality bonds the concept of default cost and default risk is a bit more complicated. Often times, these are more thinly traded issues. In addition to a loss of principal there will be a loss of the coupon. At the time of default, the market value of the bond may be significantly less than its salvage value or restructuring value so there becomes a liquidity question of whether you can hold on to the asset until you can receive optimal value from it. This deeper analysis of quality and default risk needs to be taken into account in our analysis as we go forward.

For the C-3 risk, we're talking about the expected term of the investment and what happens to the cash flows over time. Do we receive principal and interest payments when we expect them? Are they faster? Are they slower? As assets become more complicated, the study of the C-3 risk also becomes more complicated.

Finally, liquidity risk is something that we have not been particularly familiar with or paid a lot of attention to, but the last couple of years the real estate market has pointed out that it's something that actuaries must pay attention to. And by the liquidity risk, I mean what is the likelihood that while you may have a good asset, you won't get cash for it when you expect it. You may have a nice mortgage and think that the property underlying it is great, but if you have a five-year mortgage on it and money's tight at the time when the five years are up, you may be refinancing that mortgage rather than taking in the cash.

Pricing risk (C-2 risk). Bob talked quite a bit about this. These are risks that we know and understand well. Mortality, morbidity, expenses, and persistency. To understand the mortality risk, we need to understand how the business is sold. For example, you may have a very sound product, but if you use limited underwriting and you get a hold of some bad agents who go out and visit hospitals and try to sign policies up for people in the intensive care ward, you're likely to have some adverse fluctuations around the expected results. Expenses and persistency are typically linked together in many products because products are designed to have margins over time that pay for those up-front expenses.

Other risks, the so called C-4 risk, are a lot of fun. We talked about some of these risks already. These include a change in environment such as the change in tax law (e.g., the change in company tax law or a policyholder tax law). Whether products are designed with flexibility to change the cost of insurance rates or expense loads in order to respond to some of these external factors is a big issue. As Bob mentioned, change in regulatory climate can have a big impact on statutory results. Things like national health or federal insurance regulation might have a big impact on the company. Often times, these general risks are related to investment risk. For example, say there was a small company who wrote supplementary products and had maybe $50 million of assets. Not a big company, but the company had been selling term insurance quite profitably. Let's say that somebody from Wall Street walks in and takes the chairman to lunch and tells him his asset portfolio two years ago was earning 9% and now it's earning only 7%. Let's say he convinces the chairman to take these assets and put them in higher-yielding assets. In a matter of 2-3 months this company could go from being a very healthy company to being a very insolvent company. Is this an interest rate risk or is this a mismanagement risk? It's hard to say.

Finally, another new risk that we've all become quite familiar with in the last year or two is loss of policyholder confidence. This also generally manifests itself in a liquidity crisis. On another level, it could manifest itself in an expense crisis as well because one impact of loss of policyholder confidence is that sales drop off dramatically. Since many of the expenses of a life company are fixed, with a loss in sales there can be a huge expense over-run build up in a short period of time. No one ever knows whether this drop-off in sales is temporary or permanent. If it's temporary, who's going to cut all of their staff and get rid of all of the infrastructure needed to gear back up in three months when life is wonderful again? It's very difficult to recover from a serious drop in policyholder confidence.

Since Bob talked about factors that influence statutory surplus, and I very briefly talked about risks, probably most actuaries are very comfortable with the concepts that we've been talking about. The challenge going forward, as Dave mentioned, is to communicate to senior management, and to people who don't have the same background in training and discipline as we have as to the implications of actions taken. One way to do this is to look at things in terms of risk reward trade-offs.

It's very difficult to be in the life insurance business today with a zero risk strategy. Practically any strategy that you embark upon is going to have some risk involved in it. The question, or challenge, is to find the right level of risk for the right level of return. When you go in to talk to senior management about risk and return, it's important to talk about those two things in ways that management can relate to. For example, we would be very comfortable talking about risk in terms of volatility, standard deviations, or variances. Up on the executive floor you might get puzzled looks talking about things like that. The key is to translate concepts like standard deviations and volatility in terms that senior management can understand, like the risk that you're going to need to increase reserves, or the chance that your risk-based capital ratio is going to fall below some threshold, or the chance that even though you expect a 12% return, it could end up below 6%. In a stock company it would be good to express these risks in terms of the risk that a shareholder's dividend might have to be cut, or for a mutual, the chance that you're going to have cut the policy-holder's dividends.

Typically we look at return in terms of expected profitability or expected results. For actuaries, terms we used may have been profit margin or profit as a percent of premium. New-style companies are probably more focused on return on equity (ROE) or rate of return on surplus. A lot of people understand and accept that, without outside capital, the rate of return on surplus determines the growth rate of the company. Other new ways of expressing return might be value added where you're looking at what value is being added to a company by selling this product or making this decision at a particular hurdle rate. And for some companies who are, say getting into a new line of business, frozen assets might be a valid measure of return, although probably one that I would not like to use as the sole measure of return.

The strategies under consideration in this session encompass different investment strategies, different product strategies, and different pricing strategies. It goes back to what Bob was saying that I found quite interesting: when you were talking about the infrastructure making it difficult to make changes in these strategies to improve performance, how do you cope with it?

MR. OZENBAUGH: Well, I can tell you how I cope with it. I cope with it by becoming a lot closer to my people in the investment division. As we moved through time, it was obvious that the products that we were writing were very dependent on the types of assets that we were acquiring to support them. Our corporation had what I thought was a very, very conservative infrastructure for a very, very long time. For example, the risk of default was just not acceptable, because default losses just never occurred historically. I think that we had to go with that and go through some explanations and get beyond that to where we can now be a little bit more realistic and a little bit more aggressive with our investment strategies. However, we still would never take the kinds of risks in our portfolio that I think our competitors might be taking because we can't quite keep our crediting rates up as high as some of them do. Prudence will hopefully win out in the end.

MR. NEVE: Do you think that management and the people who are making many of the fundamental decisions really understand this concept of risk when they make decisions? I know in my company this was pretty much in the realm of the actuarial department. I mean, we've been doing risk-based studies for a long time and I think we have had a good handle on it, but I'm not so sure we were doing that good a job of really articulating it to management, getting them up to speed. What's your experience as far as the degree to which management (outside the actuarial function) really understands risk and is managing to it?

MR. OZENBAUGH: I would hope that risk-based capital standards when adopted will give us a powerful tool to talk to our management because it will give them something very practical to focus on.

Let me go back to one thing Patricia said that I think has to be emphasized. It probably doesn't affect every company, but it really is what I think has propelled the entire environment that we're in now, and that is liquidity risk. It is also the risk that is most difficult to address. It's perhaps impossible to address, in any risk-based capital formula. You can address it in cash-flow testing. That's one of the things we're looking at now. I challenge all of you to go back to your companies and figure out how to address this risk. If you're going to do it just on the asset side you're going to turn the life insurance industry into a short-term investor, which you don't really want to do. You do it for the sake of the industry, its customers, or the country. So, the answer really lies on the liability side, the way you write contracts. I really believe that the primary response to liquidity is proper contract writing. We have to build in circuit breakers and the like so that a company has confidence that the institutional client from which most of these assets had been acquired understands that he's going to be there for a while until the cycle concludes itself. I just wanted to underline that particular aspect of risk management because I think it's, frankly, the central part of our problem today.

MR. NEVE: Well, the concept of risk and its role in assessing financial performance leads us to the next item, which is capital management. Obviously, they're linked together. Capital, at least as I view it, is the financial capacity to meet all obligations under adverse conditions and unexpected occurrences. If your product is designed to only perform and to provide adequate returns and to generate enough surplus to meet your obligations under good conditions only, it's a flawed product. We must bring in the concept of risk to determine how much capital you need.

I think this is a new concept that the insurance industry has not really dealt with before. In the old days the goal was to grow. The more we sold, the more successful we thought we were. Because of the environment we were in then (fairly fat margins, a passive consumer, and a relatively stable economic climate), that strategy seemed to work well. But those days are long gone. This concept of capital management is a key concept that I think is new for many of us. I think it's something that we need to educate our management about. In fact, capital levels are now becoming, in some customer's eyes, as important if not more important than the price they pay for the product. Are you going to be around to provide that benefit when I need to be paid? In reaction to this new environment, how are management and regulators responding? Do you think they're coming on board and getting up to speed and understanding this whole concept of capital management?

MR. OZENBAUGH: I think the rating agencies have somewhat forced the issue. I'm not sure that the risk-based capital requirements of the NAIC are going to force the issue because most companies are going to pass them. I think when the rating agencies come in and ask you those hard questions, and management obviously has to be a part of that discussion, it's very hard to avoid the fact that you have to have a plan for your capital. I think it brings regulators and companies almost together. Maybe that's one good thing about the rating agencies. It forces us to come together and have a discussion about where we're at and where we're going.

MS. GUINN: Just to add to that, I think that companies have gotten comfortable over the last couple of years with the fact that they're going to have to manage capital. And I think that a lot of companies understand a Moody's risk-based capital ratio and are in a better position to understand the NAIC approach. But many companies are concerned only about the end of this year. I think that people need to have a longer time horizon than next quarter or the end of this year. For example, if we continue writing $1 billion of single premium deferred annuity, are we going to be able to sustain that for 3-5 years? Or if we're thinking about getting into this new line of business, do I have enough distributable surplus that will fund not only the start-up costs, but also any ongoing costs? I think the challenge that we're now facing is extending that time horizon.

MR. LENNON: Well, I wouldn't want to disagree from the man from Omaha since he dropped the west coast into the ocean already. And I live on one of the two remaining coasts. The rating agencies really only address about 120 companies. I'm talking about the two major rating agencies, not A.M. Best. There are over 2,000 life insurers and so we certainly hope that the NAIC risk-based capital will focus them on capital management. I don't think anyone can manage to be just at the minimum level of 100%. I think companies will have to manage to maintain a considerable cushion above that. We've been working at the New York department with a risk-based capital formula now for about four years (a different formula as an in-house tool) and we found that it was a tremendous learning tool for the financial analyst who found a new way of looking at a company. We certainly hope that experience spreads throughout the industry as it becomes widely used.

MR. NEVE: We've been talking about performance, but we haven't really defined it. What do we mean by performance and what ways are companies trying to answer that question? Are we performing where we want to be? What goals have we set? How do we articulate them? How do we define goals and then monitor ourselves to see if we're making performance goals, whatever they are? Patricia, can you give us a little bit of background as to what companies are doing in this regard?

MS. GUINN: We were talking earlier about statutory performance goals. What are statutory performance goals? Well, I'm not sure that a whole lot of companies have very intricate statutory performance goals. Terry mentioned that he thinks people just look at their surplus every year end and say, well, do I have as much surplus as I did last year? Or did I keep up with the growth in my business? And that's probably as detailed as anybody's statutory performance goals have been for many years. I think that companies are looking at their statutory balance sheets in terms of capital, risk-based capital, and capital needs, moving in that direction. But that is as far as many companies go. Looking at performance or profitability in terms of statutory results probably takes a back seat to other measures.

Measuring performance in terms of statutory earnings has a couple of obvious problems. First, you might have a real profitable product, but if it has a typical profit pattern, high sales can mean statutory losses. Second, high withdrawals can mean statutory gains, which intuitively doesn't make a whole lot of sense. If I sell a lot of businesses which I expect to be profitable, why am I depleting my statutory surplus? Or second, if I have this business on the books and it's a nice profitable business, shouldn't I be losing money if my lapses are higher than I expected? These are the problems with statutory earnings looked at on a one-year-at-a-time basis, but they're real important.

However, statutory earnings are important for two reasons. One, the statutory balance sheet determines the solvency of the company. It determines whether the doors are going to stay open for another day or a week or decade. Second, from my perspective and my experience, I think that it is statutory results that drives value for a life insurance company. I think the price paid for blocks of business is driven more by statutory earnings than anything else. So, in that respect, statutory earnings are important.

As we become more aware of capital needs, statutory earnings need to be part of the evaluation process. But they need to be adjusted from straight statutory earnings to what I'll call distributable earnings, which makes an adjustment for the change in required surplus. So, in the first year when we write a policy we can get an even bigger loss than what shows up in the statutory earnings statement because we have to allocate some surplus to it, too. Similarly, in the renewal years or as time goes on, we get the statutory profits, but we also get some surplus back that we no longer need to back the business. Evaluating performance in terms of distributable earnings and looking at the expected value of the business that we have on the books is a step in the right direction. You can either look at that from a rate of return, a return on investment (ROI) standpoint, or if you have a particular hurdle rate, you can identify what your cost of capital is (or what your target growth rate is) compared with that hurdle rate.

So, integrating current year statutory results with a long-term projection of statutory earnings enables you to develop what I call a value-based or value-added performance measurement. I think that gives you some good information above and beyond statutory because it lets you focus on two major issues. One, is the new business I put on the books this year profitable? Second, I have this big off-balance sheet asset that's not recorded on my statutory statement. This is created by the in-force business. Am I managing the in-force business to achieve the profits that it should? By using this sort of approach, you can look at and identify variances between your pricing assumptions and your actual results to validate pricing assumptions over time. Also, look at cash flows discounted at the hurdle rate. That can give you an idea as to what your future dividend capacity might be. Including target surplus or required surplus into the process of capital management is going to be critical going forward.

MR. NEVE: In my company, as I said in the opening remarks, we have really taken this concept of a statutory goal very seriously in the last year or so. We've had some product lines that did have specific statutory targets, but, again, we were more driven by our internal management-based approach. But now we have established specific statement goals for each major line of business. Each line has to achieve a certain level of statement surplus, and pricing is designed to meet that statutory target. It's a change of thinking that we had to go through in our company, but I think it's the right direction to go. I don't know if other companies have done that. Bob, you've mentioned before that your company has always been driven by statutory results and now you're bringing in some of these other approaches like value-added. How do you see the two related to each other and which really drives your pricing and your evaluation?

MR. OZENBAUGH: Well, it depends on what question you're asking. If you're asking what drives my personal compensation, it's statutory profits because that's what the incentive compensation is tied to. Several years ago we moved over to value-added accounting, at least internally, from the sense of putting a value on our in-force business and trying to manage that value. And to be honest with you, we're still developing that concept because when you have a diversified company such as Mutual, where there are different types and lines of business, and where the company is expanding on them on almost a daily basis, as in Dave's company, it's really difficult to report value-added results on a level enough playing field. But I think that, yes, we were for a long, long time driven off the statutory accounting. We also have a kind of unique company in the sense that we're a mutual health company and the life side is a stock life company that is solely owned by the mutual health company that doesn't pay dividends. So, figure that out. We don't do GAAP accounting, so we really have to be careful about what our profit targets and goals are because there's nobody telling you exactly what you should be doing other than maybe a regulator once in a while. If you're a solvent company, you don't run into that problem. I think that we're moving to a mix of the two and we are aware of new opportunities that add value to the company, as well as the impact on statutory earnings at the same time.

I think it's rather new for regulators to even talk about profitability. Again, if you go back 25 years, profitability took care of itself and we didn't concern ourselves much with it. It's become apparent from the last decade that if a company doesn't take care of its profitability it eventually becomes stressed. So, we obviously have a concern now that whatever method is chosen, and there are a lot of methods, the performance measurement has to be understood by the company. You have to know where you are. You have to know what your products are returning. If you don't, you're eventually going to have problems. It's that simple. If I could develop regulations that require everybody to track the initial pricing assumptions year by year and monitor the results of each line of business, I would do it. I hope all the companies represented here have sense enough in this environment that they do this.

MR. NEVE: Let's shift the focus a little bit. Terry, could you comment on this concept of real versus cosmetic performance? I know we talked about how companies at year-end try to do some things to improve their earnings. Some of these techniques are planned in advance, but how does that fit into this whole evaluation of the performance process? Maybe you could describe some of the techniques, too.

MR. LENNON: Well, I'm sure everyone knows them. I don't have to describe them. I mean things like financial reinsurance, securitization and lease-back arrangements are things we've addressed recently. Surplus relief. There's some confusion and I know there are no exact terms, but surplus relief reinsurance, which built a lot of small companies, and which I still consider a legitimate form of reinsurance, kind of converted or evolved into financial reinsurance with the new products. Financial reinsurance is cosmetic. It's simply renting surplus or transferring liabilities without the associated risk. Those things are very harmful in our view. As a matter of fact, one of the key differences between Executive Life of New York and Executive Life of California was that Executive Life of New York had no financial reinsurance left in it when we took it. As a consequence, we're not going to have to tap any guaranty funds. The assets will run off. So, it wasn't the acquisition of extraordinarily large pools of junk bonds by itself that caused the company to go down. I think financial reinsurance did a lot toward masking what the company's real condition was.

Securitization of premiums. We went through that over a period of time and that was only, again, something that was just taking credit now for future cash flow. It was not even the future profits or the future earnings of this cash flow. It makes the company look good now and is just hypothecating the future.

Lease-back arrangements. Again, we're talking about cosmetic performance. Again, we will focus on people taking real steps.

Surplus relief on traditional business and to the extent that it can be constructed on the new business is something that's worth looking at, but it is a joint venture. It's giving up future profitability and it's sharing the risk on a segment of your business so that you can get that reinsurance commission to help you grow. That is still legitimate. The other things, obviously we've done all we can to cut them off.

MR. NEVE: Kind of related to this is the concept of hidden surplus items. These are not necessarily cosmetic items, but there can be redundancies in reserves that you choose to maintain for a particular reason. Doesn't the existence of these kinds of "hidden surplus" make it more difficult for management to really understand what's going on when you decide to release some of these "hidden" items?

MR. LENNON: Yes, but there's less of this now. At one time, particularly in mutual companies, liabilities were dripping with surplus. Not so much anymore, particularly for new business. We've seen the growth of annuities, the growth of pension business, and much of this type of business is reserved using much more realistic liabilities. The old traditional life business still tends to have redundancy in it, but how much of that is left on books? And pretty soon, not that much of it will be left at all. So, what one might call the quality of surplus has changed considerably over the years. Before, we knew that surplus had a cushion in the liabilities, but there isn't a lot of that left anymore.

MS. GUINN: Just to expand on what Terry said, I think it's very difficult for companies to write new business and create redundant reserves as they did in the past. Certainly, if you put up reserves more than the statutory minimum, those won't be tax-deductible reserves. It's very expensive to set up reserves without tax dollars. If you're pricing on an ROI basis, the incidence of profits is very important. And if you set up redundant reserves, you're pushing profits back into the out years, which makes it very difficult to achieve a satisfactory ROI.

MR. LENNON: Yes. And I think there's also maybe a disincentive to be conservative in those situations because you don't get the credit like you used to. If you set up conservative reserves before, well, that was a prudent thing to do and you were applauded. Now, you kind of get hurt for that because it lowers surplus. You hope rating agencies and others recognize that, but you wonder how much credit you really get for it.

MS. GUINN: You probably don't get dollar-for-dollar credit and you probably get zero credit unless you tell them about it because they're probably not going to figure it out themselves.

MR. NEVE: I guess that maybe moves us along to discuss how some of these outside rating agencies have impacted the way companies look at themselves. Bob, do you want to lead us through this discussion, giving us some preliminary thoughts on rating agencies and customers?

MR. OZENBAUGH: Rating agencies have become a bigger part of how my management views our business. I think the only way to avoid or evade the wrath of the rating agencies, or any outside evaluators, is maybe to be very small and fall between the cracks, or really be nonexistent in the financial marketplace. I just don't think that's probably the strategy of choice for most of us.

My company's involvement in the group pension arena really sparked our desire to seek a rating. At first, one rating seemed okay. But then as we expanded into bank annuity and life distribution markets and things of that nature, we now sport all three ratings and we're very happy to have them. To be honest with you, I think rating agencies do a good job. I think comparing companies using only public information is like, you know, comparing breakfast cereals by looking at the box. But I think the actuarial profession has spent a lot more time evaluating solvency concerns as a result of rating agencies' concerns.

I also think the rating agencies have done a little fine tuning on their own. I know my management team spent several hours with each rating agency discussing investment philosophy and performance, market strategies, profitability issues, as well as strategic goals. This due diligence process went far beyond the statutory blank that some lesser known rating services might use. I think they ask the right questions. I think they listened to our unique situation and then they went off into some closed room somewhere and came up with a rating.

But the problem I have with the rating agencies is the aloofness of their methods. Let me give you an example. I don't think that we should be making the wrong decision for our company just because it has some negative impact on how it might be perceived by rating agencies. Let's assume that there is a company that has about a $50 million block of major medical business and let's assume that you can't manage it very well. You're willing to sell it for almost nothing. Let's assume my company has an expertise in managing this type of business and that we would be willing to buy it from you. Let's assume that the purchase price plus the risk-based capital requirements that would be needed would drive my company's surplus levels below where some other companies are, so that our rating agency would not be supportive, and perhaps might lower our rating. Should I go ahead with that transaction? I think so. If any of you have that particular situation, come see me. So I think the point is that let's not let the tail wag the dog.

I think prudent risk-based capital and target surplus management is important, but it's not the primary ingredient to a business decision. I believe that there's a risk reward to any opportunity that we take. Maybe they're not always determinable, but I think it's there. I think it is my job to evaluate those risks and rewards and make them compatible with my corporate structure, infrastructure, whatever you want to call it. I can reduce my risk in a couple of ways. I can change the pricing or I can change the product. I can change my investment strategy or I can capitalize the product a little more heavily through reserving or other methods. I think all of those should have a negative impact on my expected return, but hopefully a positive impact on my variance. But once I'm comfortable with that marriage, then should I proceed or not? Again, the elusive rating agency may decide that I need more capital for that particular opportunity. Can I afford more? No. I can't. I can't make my product work unless I'm willing to accept a lower return. I have a hard enough time going to management and explaining to them the risks and rewards that I've determined. To then proceed to tell them okay, we're going to get a lower return is really a hard sell. So, I guess I'm hoping that when the rating agencies go in this dark room and make these decisions about our ratings and our solvency and our strength, that they consider a lot more than just the results of their surplus formulas. In the end, we have to run our business the way it needs to be run and the rating agencies are there as a service, not as the driver, I hope.

MR. NEVE: So, you see them not so much as a partner in helping manage performance, but maybe more as just a necessary evil? Maybe the others have a comment, too, as to what role rating agencies play in really being partners with us and helping improve our performance.

MR. LENNON: Let me just say two things about rating agencies. All of those that I've talked to know the business. I agree with Bob. They get good data. They ask the right questions. Two observations. One is that right now they're filtering that data through a sensitized filter, one that's been sensitized by their own performance over the last 3-4 years by rating rather highly some companies that perhaps didn't deserve that high rating. I think that's reflected in everything they do.

And the second observation I'd make is that there are something like seven or nine investment grade ratings. Now, both of the major rating agencies agree that any of the seven or nine investment grade ratings means the company is fundamentally sound and fundamentally secure. They have seven or nine investment grade ratings which implies a degree of precision which can't possibly exist. And what's happened is the focus comes on the movement between these ratings rather than the underlying meaning of what these ratings mean. Yes, they're doing a good job. They're doing the right thing, but for whatever reason the focus comes on movement between what they would describe as fundamentally sound, fundamentally secure positions. But the environment is not treating it as that.

MS. GUINN: Bob, you gave an example of a business situation where you thought it was the right thing to do to buy this block of business, but the rating agencies wouldn't like the immediate implications. I think that when we run up against situations like that, the power of the rating agency needs to be taken into account whether to buy the block of business or let it pass by. Rating agencies are particularly powerful right now. Institutional investors and the bank annuity market in particular would swear by those ratings and to lose a rating can trigger a loss of policyholder confidence. I think that happens. Maybe it's not likely to happen again any time soon, but the sort of liquidity crisis that can result from a two-grade down-tick in ratings can be a severe price to pay.

MR. LENNON: The problems with the 1980s have prompted a whole host of changes. Some of them have already been completed. Some are proposed and some are still in the working stage. Let me go through them rapidly first and then maybe give a word or two on each one.

On the completed side, we have the asset valuation reserve (AVR) and the interest maintenance reserve (IMR) which will be required for the first time in the December 31, 1992 statements. We have the overhaul of the SVO procedures. We have a requirement for cash-flow testing at the NAIC level and in New York since 1986. We have the model regulation for below-investment-grade bonds. And in the proposed and new adoption stage, you have both life risk-based capital and the model life reinsurance regulation, which is really addressing financial reinsurance. In process, you have a whole lot of other things. Let me name three that I think you could focus on: the model investment law, the recodification of statutory accounting, and the various initiatives to address the liquidity issues which we discussed a little bit already.

These changes are all necessary to take care of the shift from profitable long-term security-driven products to more lean margin investment products with more volatile persistency. I think all of them in one way or another address that. Let me go back just quickly and give a word or two because I think all of these are being addressed in other sessions here, so we don't want to go into much detail. But let me mention the AVR and IMR.

As you all know, the Mandatory Securities Valuation Reserve (MSVR) had existed for some time. It basically addressed bonds and stocks. The new structure of the AVR addresses the default and volatility aspects of all asset types. The IMR recognizes the relationship of capital gains or losses that are merely a result of interest rate changes that most times are not a real economic change in the company.

The overhaul of the SVO was necessary just because of how crazy things got in the 1980s. I think it was a matter of modernizing the classifications from the old limit here. Remember it was "yes," "no," and the "no's" were broken up by asterisks. It was a bit arcane so we went to a more simplified 1-6. This is one of the major delegations that regulators give to the NAIC. In fact, at this time, it's probably the only major delegation that has been given to the NAIC. So we were concerned that there would be a consistent and consistently conservative regimen applied to these valuations, which is why that overhaul was done.

The requirement for cash-flow testing began in the early 1980s in New York. I think our statute was dated 1986 and now the NAIC has adopted them. I'm sure this subject is being taken care of in other sessions, so I won't go into it.

The NAIC asked us to chair a group to create a model regulation for below-investment-grade securities for the NAIC and we did. Since then, we've also amended the New York version. I think the life risk-based capital is a good start for that project. It's being set up much the same way that the annual statement is. In other words, there will be a continuing task force which will meet every year to monitor and make whatever adjustments are necessary, either because of changes in the blanks (which will actually propel most of the changes) or their pure reference changes. Since the risk-based capital formula uses so much of the annual statement, changes in the annual statement will have to be reflected in that formula. So, we had to set it up in that way. But it will also give us an opportunity to monitor the dynamics of the business and make whatever changes are necessary.

Regarding the model life reinsurance regulation and the financial reinsurance regulation, as you know, New York was probably the only one that had one for a long time. There might have been a few other states, but we've had one since about 1985. This one has been modernized, I guess. It's a lot longer than ours. It has a lot more words in it and it will only take a month or two to figure out how to get around those words.

In process is the model investment law. I think it got off to kind of a shaky start. For the most part, the advisory group is staffed by investment people who very understandably want the most complete pallet they can have in terms of investing. I think it's not wise to look at the experience of the last decade when fashioning a model investment law. Some of those problems have to be addressed. Things like bullet loans, underwriting standards, and some sort of limitations have to be brought up some places, either in the investment law or some other law because we can't get into the same situation. We're fools if we repeat our mistakes. At this point, I don't see clearly how we can put into place things that will prevent us from doing that.

Recodification of statutory accounting is extremely important. As you know, statutory accounting has a great deal of leeway for the local commissioner. It's one of the things that the accounting profession, the Securities and Exchange Commission (SEC) in some respects, and the federal government has found fault with. There is not really a standard. Recodification is extremely important and is intended to come up with something that's much tighter and more like what the accounting profession works with.

And then finally, there are various initiatives, as I said, to address the liquidity issues. We put together a group of ACLI and industry advisors earlier this year. They have just recently gotten back to us with some suggestions. We know what happened in a number of companies, most notably Mutual Benefit, with respect to liquidity, with respect to large institutional clients, not with respect to people who could take out little thimbles-full of assets and who would have to line up around the building for several blocks to do any real damage. We're talking about people who could take out whole buckets full of assets at a time and who could seriously damage the company in perhaps a few days. These are very, very different times, and very different problems. We are working on several fronts to try and address that. That's kind of a shorthand of what's going on.

MR. NEVE: Did you want to discuss the concept of the appointed actuary in England? I know the concept is broader than what we use here in the U.S.

MR. LENNON: It's been brought up a lot and suggested a lot here. Let me make it clear what I said in other public statements that I don't think there is another profession that's as important to the restoring of health or continuing health, depending on your perspective of the industry, than the actuarial profession. I think for the most part it's the only group that understands virtually all aspects of the company's operations and can bring together the various disciplines necessary to bear on the health of the industry. However, to say that we're going to go to a single actuary who will sign off that a company's surplus is adequate to its needs misunderstands the British system, in what it addresses and how it works and what its traditions are. For one thing, the British do not have book-value guarantees for the most part. They have made it a lot easier, I think, than what would be faced here.

The other thing is their tradition. There is a relationship between the appointed actuary and the board of directors and the regulators that is somehow, and I don't fully understand how, embedded in both the statute and the ethics of the profession. The tradition is that the appointed actuary has a great deal of autonomy in a company. I don't think that the cultural climate in our companies supports that yet. I think that the valuation actuary will have a period of time to, in fact, grow and demonstrate that kind of autonomy can be achieved. We'll see. I think that we're still preliminary on the valuation actuary and that it's way too preliminary to talk about appointed actuaries.

MR. NEVE: Let me conclude our discussion by referring to specific strategies to improve performance. I won't go through these items in detail. Obviously, many of them are things that you're working on or you're very aware of.

Strategies to Improve Performance

1. Improve understanding and measurement of risks you have taken on.

2. Develop a comprehensive, financial management strategy, which coordinates pricing, asset management, capital management, and financial reporting into a single coordinated process.

3. Develop sound, conservative product-pricing strategies.

4. Design products to lower the magnitude of adverse effects of such things as surrenders and withdrawals.

5. Improve asset/liability matching techniques.

6. Downsizing and expense controls.

7. Tighten underwriting standards.

8. Modify investment strategy.

9. Improve management and operating controls.

10. Incentive compensation programs.

11. Tax-planning strategies to minimize tax costs.

To summarize this discussion, I think it behooves us as actuaries to, first of all, understand the technical aspects of the business (understand the risks we're taking on, measure them properly, assess them properly). Second, to have the courage, the discipline to do the right thing, and to make decisions to fundamentally improve performance (but not just cosmetic things to give the appearance of performance). I hope we've all been challenged to be more articulate in the way we empower our managements, and to explain to them all of the forces that impact performance.

FROM THE FLOOR: You've presented a rather traditional sort of discussion regarding risk and return and the need to balance them. I'd like to make a couple of comments on that. One element of risk that I did not hear addressed, that I think is quite important, is the risk of having an incorrect expectation. Your definition talked about variance from the expectation, adverse deviation. That's one kind of risk. The other kind of risk is simply having the wrong expectation in the first place.

And on the subject of return, the definition of return is a critical element of management control that will lead to widely divergent results. To perhaps exaggerate a little bit, is your definition of return an increased likelihood that you will be able to meet your obligations 20 years in the future or that you will be able to report higher profits two years in the future? I'm trying to differentiate between a fiduciary concept, which has a long-term time frame, and the normal profit-making concept, which has a short-term time frame.

Finally, any good businessperson must be an optimist; otherwise he wouldn't be taking on risks. Any company selling business, except under extremely extraordinary circumstances, has in its own mind the belief that the business will be profitable. We have an adherent bias, however, that if you are showing poorer performance than you want, then the solution, if you are convinced your new business is profitable, is to sell more business. If in fact your business is not profitable, then what you are doing over the long run is making the situation worse and worse and worse. Statutory accounting for all its faults does have one very good quality: it directly recognizes that selling new business with the kinds of cost structures that we have immediately reduces your ability to pay claims and meet your obligations in the current year regardless of whether your long-term expectations for profitability are met or are not met.

MR. OZENBAUGH: Let me respond to your first point. It is assumed that your assumptions are wrong when you start. They always are. If you had a real belief that your expectations that you put in a deterministic model are ever going to come close to being right, then I think I need to talk to you after this meeting because that isn't going to happen.

FROM THE FLOOR: I was not saying that your expectations were wrong. My point was that your expectations not only are wrong, but of necessity, biased.

MR. BRIAN L. HIRST: Has there been thought of an ongoing formal dialogue between the regulators and the rating agencies in terms of the inherent inconsistencies between the different risk-based capital formulas? Under the current formulas, one business decision drives one formula one way and another formula another way. Maybe the easiest example is the different way bonds and mortgages are treated in these formulas. Given current spreads, the NAIC formula encourages you to get into mortgages in terms of return, but certainly the rating agencies are kind of looking askance at getting into mortgages. So is there thought about a formal dialogue or at least some analysis or studies that can be done to try to get more consistency?

MR. LENNON: I don't know that there's a plan for any formal dialogue. The New York Department talks with some regularity to the major rating agencies about general conditions in the industry and initiatives undertaken. So, these kinds of things do come up. I don't know whether we have the NAIC formula for mortgages right yet because it's brand new and we're going to have to wait and see. The rating agencies' formulas are largely subjective. Actually, the view of the two major rating agencies is different with respect to real estate. One of them has a much bleaker outlook than the other and I don't know that either is related to hard numbers. But we do talk to them about general conditions on at least an annual basis.

MR. STEVEN P. MILLER: I work mostly on the asset side of the balance sheet and I have noticed a merging between certain items of GAAP accounting and statutory accounting on that side of the balance sheet. GAAP accounting is moving toward a market-value based accounting on the asset side of the balance sheet plus parts of the liability side of the balance sheet. Can you comment on the appropriateness of market-value based accounting on a statutory basis?

MR. LENNON: Anything can be done. All these new suggestions are different ways of representing the numbers. You'd have to do it on the liability side if you're going to do it on the asset side. I think this would tend to drive the industry to be short-term investors. I don't think that's good for the country. The life insurance industry is about a $1.4 trillion investing machine, and this has helped the country because of the industry's long time horizon. Statutory accounting grew up around the realization that life insurers were not traders. They were viewed as long-term business people who could ride cycles, so the value of their assets was not necessarily determined by what they could get for them today, but what they would deliver in the long run. I think that is healthy for the industry. I think it's healthy for the country. I don't think everyone is focused on this today. If we can, again, get focused on this long-term view, and make the appropriate changes to contractual language, I think staying where we are is a better solution than going to market value. The life industry generally has long liabilities that give them the kind of patience to be able to sit with assets. In the current environment, we're losing sight of that, I think.

MR. LARWENCE M. AGIN: With respect to the risk-based capital formula, I think many are using it in a rating sense, similar to the rating agencies. You made the comment that the rating agencies consider their investment-grade rating levels all to be strong and solid ratings. If the NAIC risk-based capital ratio is over 100%, is the impression that this indicates an adequate, strong company? How would you avoid ranking companies who fall between say 110-150%?

MR. LENNON: Well, I hope just being over 100% isn't viewed as being strong because a 100% level is the minimum. It's the threshold level. If you fall below 100%, by definition you're in need of regulatory attention. One of the things that we did at the onset was to not try and come up with a target surplus formula, but rather a threshold surplus formula. The reason for that is really quite simple. In order to make all the subtle distinctions you would have to make to come up with a target surplus that works for everybody, you would have a formula that would be so complex and so large that it would be essentially unmanageable.

Consequently, it does not differentiate between adequately capitalized companies. It has never been tested and was not designed to differentiate well between adequately capitalized companies. For instance, if you took the 400th and the 450th company on a ranking over the 100% level, I couldn't tell you that they shouldn't be reversed because we've never introduced the subtle distinctions necessary to make that kind of differentiation.

So, we've repeatedly made public statements that state the formula is not intended to be a ranking formula. It was not designed to be, and was not tested to be, and will not be. With that said, everybody's going to want to produce a table, unfortunately. The truth remains that the formula was not intended to rank companies, and I would at least hope that they print that on the top of the table.