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MISCELLANEOUS APPOINTED ACTUARY ISSUES/PRACTICAL SOLUTIONS

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As the years pass, many of the practical issues an appointed actuary faces are addressed, but more questions seem to emerge. This session will address some of these, as yet, unanswered questions. The panelists will address questions such as:

- Should stockholder dividends be included in the appointed actuary's reserve/asset adequacy analysis?
- How are appointed actuaries handling Section 7 Opinions in states that have not yet adopted the model regulations?
- How are appointed actuaries addressing the aggregate requirement in the state of filing?
- What about retroactive/extraterritorial reserve requirements?
- Are appointed actuaries addressing the going concern issues for undercapitalized companies? Should they?

MR. BRADLEY M. SMITH: We have two excellent panelists who will address questions.

A top ten list! Why would anyone want to become a valuation actuary? Number ten: You can impress your friends with acronyms. As a matter of fact, when I was walking in just now, I heard somebody say, actuary to actuary, "Have you heard that both the National Association of Insurance Commissioners (NAIC) and Financial Accounting Standards Board (FASB) are reviewing the methodologies used to account for collateralized mortgage obligation (CMOs), emphasizing interest only (IOs) and principles only (POs), deferred acquisition cost (DAC), present value of profits (PVP) and deferred federal income tax (FIT)?" Number nine: What other profession would allow you to become intimate friends with John Montgomery, Larry Gorski and Bob Callahan? Number eight: You never again have to talk to a life insurance agent. Number seven: You don't have to learn option-adjusted pricing. Number six: By the time anyone finds out you made a mistake you'll be dead. Number five: Your work gets checked only once every three years. Number four: The person checking your work does not have a clue. Number three: Software vendors become your friends. Number two: You can ignore the details of Hillary's health plan unlike our health brethren. And number one: You get to go to exotic locations and hear guys like Doug Knowling, Craig Likkel and Brad Smith speak.

The first question has been discussed at valuation actuary symposiums the last three years: should shareholder dividends be included in the analysis of reserve asset adequacy?

MR. DOUGLAS J. KNOWLING: Those of you who read actuarial publications know that Brad has a definite opinion on this. So I'm going to play the devil's advocate and tell why I think they should be included in certain circumstances. Clearly, you get a situation where a parent company expects a dividend paid to them on a regular basis.

If, in your projection, you had significant profits early on, and the losses came later, it's likely that those profits would not be left to accumulate to cover deficiencies later on in the projection.

MR. SMITH: You know, I'm a big basketball fan, and there are times when I wish I was Shaq O'Neil. When I'm answering this question, I really feel like I'm going in for a dunk on Mugsy Boogs. I really don't see that there is any situation in which you'd include shareholder dividends in a reserve asset adequacy test. The opinion required by the standard valuation law, the actuarial opinion and memorandum regulation, has to do with the adequacy of the assets supporting reserves established to pay contractual obligations and related expenses. Shareholder dividend payments are neither contractual obligations, nor related expenses of the company; therefore, they should not be included in the projection of the adequacy of the level of policyholder reserves.

The typical argument that I think we hear made is that the parent expects them. We're going to make them, so we need to account for them. Well, the same argument could be made for issuing new business. We know we're going to issue new business. We know we're going to have a drain on new business. Should we set up a reserve for the drain due to new business? Clearly not. From a practical standpoint, it's fine to include shareholder dividends in your analysis if you have a great deal of margin in your reserves, and if you're not worried about adequacy. However, what happens when you've got a situation where reserving for shareholder dividends results in a larger reserve? Are you actually going to go to your Board of Directors and say, we have to set up additional reserves for shareholder dividend payments? It's ridiculous. You'd get laughed out of the boardroom and your credibility would be lost. Does anybody else have any comments on this? I mean particularly the pro argument.

MR. CRAIG F. LIKKEL: I have a couple of comments to maybe help Doug out a little bit. There's possibly a situation that would concern me, where you could foresee that the suspension of shareholder dividends would create a fairly negative atmosphere of bad publicity or crisis of confidence in your distribution system, such that it might cause you to be concerned about your other assumptions. In projecting your liability cash flows, you make assumptions that the company is a going concern, and that some of the environment other than interest rates, the environment of being in a going concern with a reasonably solid company with a solid reputation, maybe some of those assumptions would be in doubt if you suspend the dividends. So, I think there's some rationale for at least looking at possibly the sensitivity test. But overall, I tend to agree with you that when you're testing reserves, shareholder dividends are not "related expenses of the company."

Another issue might be simply disclosure regardless of your position. You ought to carefully disclose and provide the rational for your assumption in your actuarial memorandum. At Milliman & Robertson (M&R) we always put in a statement that reads as follows: "It has been assumed in this analysis that the board of directors will pay shareholder dividends only if sufficient statutory surplus exists after allocating assets to support the reserves determined by the appointed actuary. Therefore, this analysis has not contemplated the payment of dividends to shareholders."

MR. SMITH: Don't get me wrong, I'm not saying that we should not make projections that take shareholder dividends into account to see where the operation would be if we paid shareholder dividends. I just don't believe that those are asset adequacy/reserve adequacy type projections. Those are capital adequacy type projections, as opposed to the reserve adequacy type projections. In conclusion, if you think that you have to reserve for shareholder dividends, the analogous argument is that if you were short, and you could get capital from the parent company, you would not have to set up an additional reserve. I don't think anybody would be willing to make that argument or sign an unqualified opinion based on that.

MR. DANIEL J. KUNESH: Brad, the analogy in your example to new business is invalid. If you considered new business, you very likely would pay less shareholder dividends and you would look better. I mean it goes in the other direction. And I don't think you should justify one ill with another. Cash-flow testing probably should consider new business. Many people have stated so. But the point is, you say reserves. What are reserves? Reserves are simply the present value of future benefits and expenses. And they're measured against the future stream of assets and returns on those assets. But those assets do not exist because you paid them in the form of shareholder dividends or policyholder dividends, or excess payments on policyholder dividends. You've got a problem. I think it's the actuary's responsibility to bring that problem to the attention of senior management. We're not necessarily saying that this is only a regulatory document, and therefore, we're done. We're talking about a document that should be, and can be made useful to management. And if management doesn't realize that they're overpaying shareholder dividends and that there will be a problem in the future, then I think it's the actuary's responsibility to bring it to management's attention.

MR. SMITH: I agree 100%. I just don't think that that's reserve/asset adequacy analysis. I think that that's capital adequacy analysis, and I think there's a big difference between the two. And I don't want to belabor the point, because we're in jeopardy of moving into a debate format. Let's move on to our next question.

How would you respond to the California law regarding exculpatory language included in the actuary's opinion? Does anybody want to take this? Let me give you some background first. I'm sure you've all looked at this. But basically the text of the proposed regulation, or part of the proposed regulation is as follows: "Liability of the actuary. The qualified actuary shall be liable for his or her negligence or other tortuous conduct. No language attempting to avoid this liability shall be included in any actuarial opinion submitted to satisfy this regulation." If exculpatory language is included, it is a violation of this regulation, a violation of the California Insurance Code, and the language is legally null and void.

We still live in the United States of America, right? If I make an opinion, and I put language in the opinion that says it's based on something or it relies upon something, the state can't say my opinion is the opinion without that language. I mean the state can go to the company and say, this opinion is no good. You must get another opinion from another actuary. But I find it very difficult to see how the state can sometime down the line, come back to me and say, that opinion was the opinion without the exculpatory language or without the reliance language.

I was told about three years ago, by a former commissioner of a major state, that the commissioners were looking for a scapegoat in case things went wrong. It's a panacea if you will, and that's what this regulation is attempting to get. They are saying, we aren't going to accept any reliance. We aren't going to accept any outs. We aren't going to accept an intelligent opinion; we just want somebody to sign on the bottom line. If California wants to come back and tell the companies, after I've issued an opinion with exculpatory language in it, that it's not acceptable in California, and they have to find somebody else, then the company has a decision to make. But I find it hard to believe that California can say," No, Mr. Smith, it's your opinion without this language in it." What does everybody else think or feel about this?

FROM THE FLOOR: The Academy is doing something about it. I can describe that briefly. When I read about this my initial reaction was I thought we fought this battle a year or two ago. You recall that the original version of the California standard valuation law removed the protection that the standard law provides the appointed actuary against liability. It took the provision that was offering protection and turned it around. It said that the appointed actuary shall be liable to any person for his or her negligence or conduct for any error or omission, etc. So that came out. The leaders of our profession were greatly opposed to it, and it was changed.

It was changed, it wasn't removed completely, but it was changed and toned down to be effectively equivalent to common law. I don't have the exact language, but now I think it simply reads that the appointed actuary shall be liable for his or her negligence or tortuous conduct. It doesn't mention errors omissions, or third parties. So when that language was amended it was a victory of sorts. Now the department is coming back and saying, in the regulation that they're proposing, you can't dodge your liability.

The Academy wrote a twelve-page letter in response to this proposal. I have a copy; obviously it's rather lengthy and makes numerous legal and logical arguments against the proposal. I'll read the conclusion because I thought it was very good. The conclusion of this letter from the Academy to the department is, "The proposed regulation is contrary to the interests of the appointed actuary and the public. It represents a content-based prior restraint on the appointed actuary's freedom of expression. It declines to provide the appointed actuary with reasonable notice of what language will be deemed a violation. For these reasons, the Academy urges the department to reject the proposed regulation."

So the Academy has taken the lead in opposition to this proposal. We don't know the status. It's under the consideration of the department as far as I can tell.

MR. SMITH: I urge everybody who is actually signing as an appointed actuary for a company to not be intimidated by this law and take out language that they feel is appropriate. Include it and let them come back and tell you that they want another opinion. I'm clearly not an attorney. I think they're going to rely on this opinion as if the reliance language wasn't there. And I just have a hard time seeing how they could possibly do that.

MR. HOWARD M. PHILLIPS: I have been involved in much of the stuff going on; there is a great deal of discussion. We received many letters. What we're trying to do is let the actuary be in the same position as he is under California precedents. There is a case that's very analogous to what an actuary does. It involves an accountant. The first law went through at a lower level in the courts, and the accountant lost. The issue was, can a third party rely on an accountant's statement? A guy invested in it, it went down, so he's suing everybody including the accountant. The company asked, how could you mislead me in a such a terrible way? The lower court agreed that this accountant is indeed liable. That decision has been reversed by the way. The court said, no, he's working for regulators and for the company. He's only liable to the company and the regulators. We think that actuaries are probably in the same position under that case. There's a lot of heat in this thing. I'm going to speak on why we're unhappy with the burgeoning exculpatory language. The model opinion doesn't have any of it by the way. It's very simple and straightforward. Most accountants' opinions don't have any exculpatory language. This is my opinion. The books look fine. They haven't been cooked.

There are a number of items that we're quite unhappy with. "This opinion can only be read and understood with the help of an actuary." That's totally preposterous. It's a public document. It's filed with the annual statement and everybody in the country has access to it. To say that you can't read this without another actuary is really stretching it. The other wording talks in terms of this being issued or prepared only for company management and the regulators. I disclaim any responsibility for anybody looking at it. We think that's contrary to the law. It says, the actuary is responsible for any negligence and tortuous conduct. Under California common law, we think he's in good shape. Under this particular case.

MR. LIKKEL: Is that the Bily case (California Supreme Court, *Bily versus Arthur Young*, 1992)?

MR. PHILLIPS: Yes. That's the one. I've developed some compromise language. I don't know where it will go. This opinion is primarily prepared for the company and regulators. Not only do I take the disclaimer responsibility, but I think the courts are going to tell you if you're responsible or not. If this case is reversed in the Supreme Court, for example, accountants are liable to anyone that reads their report. It's a public document. Why shouldn't they be liable. Somebody relies on an actuary in good faith, and he's intelligent, and he doesn't get an actuary to interpret it. A court is going to tell you what your responsibility is. We don't think you can disclaim it in your opinion.

One other item. There are about three of the four items about which you can have a very interesting discussion. I think the language is very inflammatory. It was written by an attorney. So I'm working on a compromise, but I don't think it's as bleak as you paint it. We're trying to live with our common law. We're trying to live with the attorneys that we deal with. You know, we have to work with them. We have many of them in the California Department and they have many interesting opinions on what goes into our laws and regulations. We're working with them and I hope we can come up with a reasonable compromise that our attorneys can live with and you can be comfortable with. I hope that's helpful.

MR. SMITH: It was very helpful. I guess my only comment pertains to you referring to the complications. Will the accountant say that everything was rosy and great with this company? I've never seen any accountant's opinion that said, "Everything is fine with this company." That's part of the problem. People aren't reading the opinion, they're just reading the signature and presuming that everything is fine with a company. I think we, as actuaries, have to communicate what we've done, what we're qualified to do, and put qualifications in the opinion. I would say that if California doesn't like the opinion, or if I need to qualify the opinion of a company to California, then California needs to come back to the company and say, well this isn't acceptable. We need an unqualified opinion, as opposed to trying to eliminate language in the opinion.

MR. PHILLIPS: I would be thrilled with a qualified opinion. I haven't seen one yet. I've looked at thousands of them. That would be fantastic. The other point I recalled had to do with the reference to the memorandum. There's a reference that says that you can't read this opinion; it doesn't make any sense at all. You've got to read the memorandum in conjunction with it. You can't say that. It makes the memorandum a public document. It's a confidential document. We take that very seriously. It's written primarily for management. Somebody said, "Hey, that's written for management to help them manage their business better. We have an oversight responsibility as regulators to look over your shoulder and review how you're doing things in relation to the new standard valuation law, which was developed over the course of ten years with the help of the profession and the NAIC and so on."

So we have an oversight. That's the position we take. If you say, you can't read this except with the memorandum, you have just declared the memorandum to be public. That's the logic that we go through. So, we say you can't put that in the language. You're going to put it all in there anyway. I'm having trouble with that. But that's the third point I was going to make. The reference to the memorandum. We don't think you should do that.

MR. SMITH: OK, lets move on to the next issue that Doug is going to address. How do you determine if a scenario passes, and how is the amount of additional reserve determined?

MR. KNOWLING: We said we weren't going to get too technical here, so I think I'm going to talk in generalities. Certainly, if the book value and market value of surplus were positive throughout the projection, I think everyone would agree that it should pass. Try to look for guidance. The American Academy of Actuaries' practice notes say there's no specific rule. It's up to the actuary's judgment.

I tend to look closely at the market value of surplus at the end of the projection, with the idea that that's sort of a liquidation value of remaining cash flow. But you also want to keep an eye on the book-value surplus throughout the projection. Just because you may be solvent or the reserves are adequate at the end of the projection, that doesn't do any good if, in fact, the company went under during the projection on a book basis.

As far as criteria, again, that's up to your own judgment. I think there's no cut and dry way. Much of that depends on the comfort you have in various assumptions. We tend to look at realistic assumptions. Then we will sensitivity test assumptions that we are not as comfortable with or assumptions that might clearly have a stronger effect. We might want a little more leeway on those assumptions or on those tests.

The kinds of things we might sensitivity test of course, include lapses, prepayments and defaults. And again, that will vary from company to company and depend on what kinds of things are unusual or different about that company. So again, I didn't say exactly how you set the initial reserve; but I'm just giving you an idea of the kinds of things to think about.

Once you have decided what your criteria is, there is generally one decisive scenario that you must pass. The up scenario, scenario three. It seems that if you pass that one, the criteria that you selected allows you to pass the other tests. So when you set the initial reserves, you need to have additional reserves to make that positive in that one decisive scenario. The way to determine those additional assets could just simply be trial and error. Throw some assets in and see how it comes out.

One little short-cut method that we've used is to take the present value of the cash shortfall and discount it back at the earnings rate after federal income tax. That will put you close to what surplus is beginning to accumulate out at the end. It may not be exact, but it puts you very close to that starting point.

MR. SMITH: Yes, the only reason it wouldn't be exact is if your investment earnings rate changes, because you have additional assets.

MR. KNOWLING: Yes, exactly.

MR. LIKKEL: Doug, do you actually go back to your allocation of assets and find actual assets to add to the model?

MR. KNOWLING: We generally put cash in.

MR. TODD H. ERKIS: How many scenarios do you have to pass? You know, not all companies pass all seven. Does that mean you have to set up reserves if you pass six out of the seven? What do the people think?

MR. SMITH: We've taken the stand that it's a function of the company and a function of the situation. It is conceptually possible that reserves would be considered adequate by passing six out of seven or five out of seven tests. In fact, that would, to a certain extent determine the number of additional scenarios you'd have to do. What additional scenarios do you look at? In the Dallas office of M&R, we looked at the seven required scenarios. Additionally, we looked at moving to an inverted curve and a movement to a less-steep yield curve. When doing this in the first year, we moved to a less-steep yield curve. Then we performed the seven required scenarios with the less-steep yield curve. Those 15 scenarios were discussed with some regulators, and they were acceptable to them a priori. Logically, if you passed all 15 of those scenarios, no additional reserves would be required. To answer your question directly, the fact that you failed one of the required seven scenarios doesn't, in my mind, require you to set up additional reserves.

MR. KNOWLING: I totally agree. We may be more stringent on the base line case. But when we get the sensitivity test, we allow a little more leeway. It varies from company to company. We might say, we like to pass all of the seven required scenarios. But when you get to a sensitivity test, where you bump lapses up, or bump prepayments up, it might be acceptable to flunk one of them.

MR. SMITH: But if you fail it because you accounted for shareholder dividends, you don't have to worry.

MR. KNOWLING: You said "determine the criteria." I think it's real important that you determine the criteria for yourself, preferably before you have all the results to look at. After you do, document it. You must have some discipline in that process. So you can work with management and work with that difficult decision that might come along to increase reserves.

MR. LIKKEL: You don't want to manage your criteria to get the results you're looking for.

MR. SMITH: Yes. It's a continuous spectrum isn't it? When you're doing the runs, you gain more insight, and it's hard to set the criteria, a priori because you don't have the insight that you have afterwards. On the other hand, you don't want to rationalize yourself into the decision that you don't need additional reserves. So it's kind of a continuous spectrum.

FROM THE FLOOR; Just a follow-up question. It seems to me that after you've done all the additional analysis, you should run more scenarios. Maybe it should come down to some kind of a probability that you ascribe to passing or not passing. It could be 75%, 85% or 90%. That's the way it seems to me. Let's ask the panel if they agree with that, too? In their own minds, do they derive some type of a probability, and then try to work off of that?

MR. LIKKEL: You probably do that implicitly. You could run random scenarios. And then you could explicitly assign. But even with random scenarios you have to decide, is it 70%, 80% or 90%? I guess I think in terms of a real solid probability, and to me that has a 75% or 80% kind of probability. But I don't write it down. I don't try to quantify it explicitly. How do I interpret moderately adverse conditions? To me moderately adverse conditions means there's more than a two out of three chance.

MR SMITH: There is a problem with explicit determination, although it's kind of a weighted-average probablistic approach. I think back three or four years ago, when we reviewed a company that was primarily traditional life business, and they failed the down scenario. They said, well, no problem. The interest rates are never going to go to 3%. We were going to ignore this. Somehow you document that it's going to look bad. If you assign a probability to the likelihood of a scenario occurring, you're placing yourself in the position of an economist or an investment advisor, which is a position that typical actuaries don't want to be in.

FROM THE FLOOR: Isn't it true though, one of the reasons why I asked the question was, I think part of it is that we use the scenarios to identify what the risks are. To sit down and say that somebody passes six out of seven, or seven out of seven scenarios, doesn't necessarily mean that probability is high or low. You have to look at the risks or products, and how the assets and reserves fit together to determine if there is a problem. If you pass 80 out of 100 scenarios, it may be that there's 20 scenarios of something significant that are consistent throughout them that would identify a risk that this company may need to address.

MR. SMITH: Absolutely. You take that into account. You need to understand the reasons why you failed. You need to know what your definition for failure is. If the determination for failure is that you have negative surplus at the end. Well, that's one definition of failure. Another definition might be that you were negative in the interim. Which is another definition. Does the panel consider the level of surplus that a company has when you determine whether to give an unqualified opinion?

MR. LIKKEL: I'll take a shot here. My personal opinion is that the interim results are generally not relevant to a reserve adequacy opinion. I cite support for that by the explicit omission of language dealing with interim results from Standard of Practice Number 22. You may recall that there was some language about that in the draft of the standard of practice. It was removed when they published the final standard with commentary in the preface to the final standard of practice. The commentary was to the effect that we wanted to make sure people didn't misunderstand that this is not a solvency test; it's a reserve adequacy test.

So I don't think in a formal sense that interim results matter directly for reserve adequacy. I think the reality of the situation, considering the potential liability of the appointed actuary, and considering the assumptions you use, is that you almost do have to look at interim results. In dealing with the assumptions, you have to recognize that poor performance at intermediate points may have an impact on the choice of assumptions beyond that point in time. So if the ship is sinking or going under water for the first five or eight years, even though it theoretically comes back up through profit in the later years, you may call to question some of your assumptions. I referred to that earlier when we talked about the dividend situation.

An M&R document, which developed some internal guidelines that we had brought forth from a committee from M&R consulting actuaries suggests to the appointed actuary that he should look at the interim results and perhaps caveat his opinion and/or memorandum if it's indicated that an infusion of capital may be necessary in the short run.

So, again, we blur the line a little bit by looking at capital adequacy. But I think the reason is our concern about liability and what the consequences are if the company has trouble.

MR. SMITH: Doug you had mentioned that I had written something on shareholder dividends. I've also written something on this issue, which also elicited a very heated response in the literature. My premise was that we are in a very difficult environment litigiously, and if you accept my premise, which you may not, you don't want to sign an unqualified reserve asset adequacy opinion for a company that eventually becomes insolvent. I think it is a very strong premise. I believe you are going to end up wishing you would not have signed it, if the company eventually becomes insolvent.

If you accept this premise, clearly you have to look at things other than a projection focusing on primarily C-3 risks. You need to look at the level of surplus. I think you need to look at the possibility of a run on the bank. I think you need to look at the projected profitability of existing in-force business and the profitability of the new business. Is the company covering their expenses? I think you need to look at the capability of management, and whether they have a plan for the future.

Do you trust management? If you accept a premise that you don't want to sign an unqualified opinion for a company that goes under, then I think you need to look at things other than just a result of the projections before you accept the assignment of being the appointed actuary for the company.

FROM THE FLOOR: Brad, what do you do if you find poor capital adequacy even though the pure reserve adequacy looks good?

MR. SMITH: Well, then I think you make the man from California very happy and issue a qualified opinion to see what he does with it. I think that you caveat your opinions. There's possibly a going-concern issue. It depends on what you find. In fact, if you say, I'm going to issue a qualified opinion because I don't think management has a clue, you won't remain the appointed actuary very long. But that's appropriate. That's a much better situation to be in than in five years having an uninformed management in jail or in Switzerland, or being sued by all the residents in California.

FROM THE FLOOR: Maybe it's a question for Harold. Is a disclosure in the opinion, that the company may need an infusion of capital in the short term, but the reserves are adequate in the long term. Is that a qualified opinion?

MR. SMITH: Harold thinks that's a legal question. I was on that task force with M&R for the internal guidelines, and we determined that if you wrote anything other than the standard opinion, if it included exculpatory language, that it would be considered a qualified opinion. By definition, it was qualified to the extent that you wrote something in there that wasn't standard.

FROM THE FLOOR: So all of our opinions are qualified.

MR. SMITH: I guess that's right.

FROM THE FLOOR: It's a gray area obviously.

MR. ALLEN D. BOOTH: I'm hearing sort of a conflict between whether we're talking about reserve adequacy or capital sufficiency. I heard the statement earlier, "after all, we're talking about reserve adequacy not capital adequacy." Now what you just said was that you would review the level of capital. Is this not a conflict?

MR. SMITH: No. I've been asked that question before. It does seem to be in conflict. I had emphasized on the shareholder dividend question that I didn't think you should include the shareholder dividend because that was a capital adequacy question. Now I recommend looking at the surplus level of the company before accepting an assignment. I don't think that's necessarily contradictory, I think it's a question of what level of risk you, as an individual actuary, want to accept. Consider this before you take the assignment. I personally don't want to sign an unqualified opinion for a company that eventually goes under. I do not have the capability of projecting that with any certainty, but I can identify companies that are at risk. If the risk is too great, I probably would think twice before I took the assignment. I would hesitate even if the assets that support the reserves appear adequate, or it passed the 15 tests that I defined. I would be concerned if the risk-based capital (RBC) is 75% at the company-action level and not the authorized-control level.

FROM THE FLOOR: I guess you know, the opinion generally states that we don't assume or shouldn't account for a run on the bank. A company with low surplus is more likely to have that run on the bank or inadequate reserves.

MR. SMITH: Reserve/asset adequacy opinions do not typically account for a run on the bank. In my mind, that is a reasonable qualification to the opinion.

FROM THE FLOOR: We are beating this topic to death. But I just want to point out one other thing on this topic. I was probably one of the first actuaries who had the honor of being deposed regarding an asset/reserve adequacy opinion. The reserves were arguably passing. The company passed five out of seven at the end of ten years. But in seven out of seven the company was bankrupt within two years. I actually did the peer review on it.

It was a gray area. But the actuary who actually did the work had to answer many questions and is being sued by the regulators. Quite honestly it comes down to how stupid do you sound when you're giving the answer. In two years time they didn't have enough surplus. I knew that. But after ten years somehow they passed. Doesn't that sound like we've done a terrific job?

MR. SMITH: I agree. Because I believe that even if you did everything that you should have done and the company goes under, you are put in a position of proving in a court of law to your peers, that aren't actuaries, that, in fact, you were not negligent, because a priori you were negligent. The company went under so it's a very difficult point to have to defend. I think that you should consider that before you accept an assignment.

Doug this is your question. What do you do when a material event occurs between the valuation date and the day of the opinion?

MR. KNOWLING: I think that depends on what the material event is. Certainly you're required at the very least to disclose that there has been a material event, and what it was. If possible, we've had one assignment in the St. Louis office where the cash-flow testing was done just far enough after the date of the valuation that a number of material events occurred. Our response to that was to try to include, as best we could, all of those events in the projection. A big block of assets were sold and a new block of assets were purchased. There was also a big surrender spike. So we pulled all that in. Those would be sort of like internal events that occur.

Of course, the other thing was that six months time had passed. This was a special situation that required us to look at this prior date. And of course, we knew what interest rates had been during that time. So our response to that was to use the interest rates that actually occurred for the first six months, and then start our scenarios after that point. So we tried to include the material events as best we could.

MR. SMITH: Right. And material events could be internal or external to the company obviously. In the last month we've had a tremendous amount of interest rate fluctuation and yield curve movement. That clearly would have an affect. If that would have happened say, in January instead of February, what would you have done? Would you have attempted to redo your projections or would you have acknowledged in your opinion that there had been a change? There's a timing element to this. There's a block of time required to do this type of projection and analysis. What would your reaction have been had it been the end of January instead of the middle of May?

MR. KNOWLING: Well, again, I guess it depends on how much actually occurred. Certainly the more time that goes by, the more there's a chance of material events happening. But again, I think we would try to include it if we thought it was material enough.

MR. SMITH: This actually happened to a client of mine. I'm interested in both of your reactions. What would you do if, at the end of January or on February 1, the company had not reserved for an adverse court ruling; what if it received a major adverse court ruling that senior management clearly thought was going to be overturned. But it's going to be overturned two or three years down the line. Would you consider that in your opinion of the reserve or of the adequacy of the reserves? Would you even acknowledge it in your opinion?

MR. LIKKEL: Yes, I'll take a shot. I guess my opinion kind of goes back to is that a contractual obligation or related expense.

MR. SMITH: It might. One of them was a nonpayment of a policy benefit.

MR. LIKKEL: So there were punitive damages on a claim situation?

MR. SMITH: Yes.

MR. LIKKEL: I think you'd have to disclose that in your opinion.

MR. SMITH: Doug, you agree?

MR. KNOWLING: I think you would, too. In general, I would think regulators might want you to set up a reserve for that potential.

MR. SMITH: Well, the regulators can't set up a reserve for everything. Senior management does it. What if senior management felt like it was a bogus claim?

MR. LIKKEL: Well, the claim element is in the purview of the actuary. But the legal liability of punitive damages in the merits of the case is not in the actuary's purview.

So that becomes a legal and accounting question. Is the likelihood of payment sufficient to set up an expense payable? That gets away from reserves.

MR. SMITH: I agree. That was exactly the advice that I had given. I would acknowledge it, but caution that I'm not a legal expert. This is what the company established.

Here's a more technical question. What type of opinion, that is Section 7 versus an old style opinion with "good and sufficient" language, do you give in a state that has not passed the revised standard valuation law or actuarial opinion and memorandum regulation. The company is not required to perform an asset adequacy test under the revised law. That is, it would qualify for a Section 7 opinion, but your opinion is being filed in a state that has not passed the new law. So, typically, you have given the old style "good and sufficient" type opinion.

MR. LIKKEL: My general response is that I've been told by some regulators and other actuaries that it's reasonable to assume the model regulation will be adopted and act accordingly. Unless you have information otherwise.

MR. SMITH: The old standard valuation law has been passed.

MR. LIKKEL: Oh, I misunderstood then, Brad. I thought they were talking about if the law has been passed but not the regulation.

MR. SMITH: No. For instance, in the old style opinion, you had to give an opinion on the adequacy of cost of collection in excess of loading on due and deferred premiums. You had to give an opinion on the adequacy of due and deferred premiums, whereas, in the new opinion you don't.

MR. JEFFREY T. ROBINSON: I had that problem. I had a client in states that required a Section 7 opinion, and the domicile state required the old style. What I wound up doing was writing two different opinions. One for states that passed the memorandum, and one for the ones that didn't. It was a difficult question, because the old one was more of a severe test than the Section 7 opinion.

MR. SMITH: Yes. I had a more difficult situation where the state of domicile had passed the law. So the company could do a Section 7 opinion. The state that we were filing in had not passed the law. So, conceptually if you issued a second opinion, you would have to perform "good and sufficiency" testing, which the company management did not want to do because they felt they were exempted from the law.

MR. KNOWLING: Yes, there's a real cost to that. What did you wind up doing?

MR. SMITH: I don't know if it's going to work. We filed a Section 7 type opinion in the states that had not passed the law. So we did not opine on sufficiency in those states.

FROM THE FLOOR: What happens if you feel, in the case of the old one, you have to issue a qualified opinion. Whereas, in the Section 7 state you don't have to issue that language. Doesn't it kind of look silly to have a qualified opinion in one situation, or in one state?

MR. SMITH: Well, it wasn't qualified. It was the same opinion. It was a Section 7 opinion issued in both states.

FROM THE FLOOR: But you could get into a situation where the opinions could be different.

MR. SMITH: Absolutely. That relates to our next question actually.

MR. KNOWLING: Wait. We actually have three kinds of opinions. We have the old opinion, a Section 7 opinion, and a Section 8 opinion. And if we had to do cash-flow testing because there are states that require cash-flow testing, we issue a Section 8 opinion in those states that require it, and we do an old style opinion with a little blurb saying that we considered cash-flow testing in determining those reserves. That's it.

MR. SMITH: That would be an easy one if you were cash-flow testing anyway. I mean Section 8 opinion is kind of a subset of the old style opinion.

MR. KNOWLING: But there are things that are locked out in Section 8.

MR. SMITH: Right.

MR. KNOWLING: So we would do the same thing for the Section 7 situation. We would issue opinions appropriate for the state.

MR. SMITH: The issue becomes difficult to explain to management if it's a small company and it has been exempted from this requirement. And you having to go in and explain to them that you still have to do a good and sufficient opinion. We gave them the choice. There would be additional work required, but they could file a Section 7 opinion in the state that didn't pass the law to find out what their ramifications were.

MR. LIKKEL: I want to go back to what I thought the question was. I think there were seven states that passed the valuation law, but did not adopt the regulation. For those Section 7 companies, we did the Section 7 opinion with one exception. The one exception was unusual. The state of Alaska has adopted a version of the standard valuation law that makes no provision for a Section 7 exemption.

The model standard valuation law has language that says, the actuary shall do an asset adequacy analysis except as exempt by regulation. I'm paraphrasing here, but it does have that phrase in the requirement—"except as exempt by regulation." The state of Alaska's version of the law has no such phrase. It's constructed differently. It basically says, the actuary will submit an asset adequacy opinion, and there's no regulation that gives you any relief from that. We didn't know about that. We filed a Section 7 opinion for an Alaska domiciled company, because they qualified for Section 7, and we didn't realize that their law was a nonstandard version. It wasn't mentioned in any American Council of Life Insurance (ACLI) information or anything else we saw.

The person at the insurance department wrote to us recently and asked, "Where's your asset adequacy analysis?" We said, "we don't have one. It's a Section 7." Well, we realized what happened and wrote back and requested an exemption based on our understanding of and reasoning as to why Section 7 made sense. And we haven't heard back from the insurance department.

MR. SMITH: I think we have time for one more question. What are appointed actuaries doing to satisfy themselves that the level of reserves in the aggregate meets the requirements of the state in which the opinion is being filed?

MR. LIKKEL: We attempt to comply with the requirement. I guess, I haven't faced a situation with a large company with a really complex situation. Our clients have tended to be small to medium-sized and not leading edge or aggressive in their reserving practices. We look first for major differences in those states that are relevant. Have they adopted the new model law? We look for major differences on single-premium deferred annuity (SPDA) or universal-life-type reserves. We use the Academy notebook.

We also look for conservatism in their old traditional life, ordinary life reserves. If a company has been running for some time with 41 Commissioners Standard Ordinary (CSO) 58 CSO, low interest rate reserves, after they could have gone to the higher interest rates, and thus, lower standards. We view that as conservative; it can offset some of the miscellaneous requirements, including the different adoption dates. Basically we consider materiality as a key factor as well.

MR. SMITH: Yes, that's kind of a gray area though because your opinion is stating that the reserves meet the requirements not only in the state, but in filing or in domicile. Also, as stated in the policy form, it's questionable whether the degree of conservatism used as stated in the policy forms really comes into play. It's a sticky issue.

I'm interested in this question. Have people just ignored this and filed their opinion and stated that they comply with the state of domicile? I have. In Texas you didn't have to set up additional active life reserves for accident and health (A&H) business. So many companies used gross premium valuation type reserves. These typically do not meet the minimum requirements of states that did not allow you to do that. Quite frankly, it became a huge problem. For a company like mine, it was a calculational problem, and it was a problem that probably would have impaired the company, if not created an insolvency in the state of filing. We've issued the opinions that say, even for the states that adopted the new regulation, that it meets the requirements of the state of domicile, and we have not heard back from anybody. So again, it's a question of defining what you're opining on, and putting it back in the lap of the state to come back and say, well that's great. But we want a more expensive opinion.