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LATEST NEWS FROM THE NAIC

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There are constant changes to the regulations for statutory reporting of which the actuary must remain aware in order to file appropriate NAIC statements. Some of the current issues are new reserve laws, regulations for term insurance reserves, update rules for asset valuation reserve (AVR)/interest maintenance reserve (IMR)/risk-based capital (RBC), etc. This session will bring the actuary up-to-date on all of the latest developments.

MR. DANIEL J. KUNESH: I am a consultant with Tillinghast in Chicago. We are privileged to have a high-powered panel of presenters on three topics that I believe to be of strong current interest to actuaries today. Perhaps these topics would not be headlines in *The Wall Street Journal* or be seen on CNN news. Certainly they wouldn't draw the attention that perhaps the New York legislature has with respect to the accreditation program, or the IRS challenge to annuities. But in many ways, the problems that will be discussed cut to the heart of products sold by most companies represented here and can have a serious implication to surplus and financial condition in the future.

Our first speaker will be Dennis Stanley, a consultant with Milliman & Robertson in Seattle. Denny is chairperson of the Annuity Valuation Resource Group. He will discuss current developments with and the current status of the annuity valuation law.

Denny will be followed by Howard Kayton, an executive vice president with Security First Life Insurance Company in Los Angeles. Howard is chairperson of the resource group assisting in the development of a model annuity nonforfeiture law. Howard is going to talk about two topics. First he will discuss the current status of the annuity nonforfeiture law, then he will add a few comments about the model life insurance nonforfeiture law.

Third, Don Maves, financial officer of Kemper Life Insurance Company of Long Grove, Illinois, will talk about the NAIC's model regulation for reserves of life insurance products with nonlevel premiums or benefits. This topic is best known to actuaries as the former Guidelines XXX and EEE. Don is the chairperson of that specific resource group.

So as you can see, we have three chairpeople of resource groups to the NAIC, and I think that's a powerful panel.

Let me explain our format. Each speaker's portion of the program will be followed by an open question period. Then after we go through the three presenters, if there is time, I'll make some comments on the investment law, and then throw it back open for questions. Denny Stanley, our first speaker, tells me that he was recruited for his group for a six-month period back in 1992. He was supposed to be done in December 1992. Well, he's still chairperson of that group.

MR. DENNIS L. STANLEY: I think the lesson is that nothing in the NAIC takes six months. It's a very slow process, and if you think anything could be done in six months, particularly when you're using volunteer help, good luck.

How many have been following the NAIC development with respect to annuity nonforfeiture and valuation issues? It appears to be about half of you. Let's begin with an overview of the players and where my group, the advisory group, fits in. Overall, the charge that was given to us was to develop a new annuity valuation law to address some of the perceived problems in the current valuation law. The ultimate group that we report to is the NAIC Life and Health Actuarial Task Force (LHATF). LHATF is co-chaired by John Montgomery and Dwight Bartlett. A subgroup of LHATF (which includes most of the active members of LHATF) called the Annuity Working Group, is the group I report to. The advisory group has prepared two relatively comprehensive reports. There is an October 14, 1993 interim report and the April 27, 1994 report that was delivered in Kansas City. These two documents provide considerable background of what our advisory group has done. If you may want to get a copy of these, they are included in the NAIC LHATF mailing.

Another issue I want to discuss is the proposed guideline for valuation of two-tier-type annuities. That effort is being headed up by Frank Dino of the Colorado Division of Insurance. The most recent document for that work is a March 22, 1994 draft proposal.

The charge that was given to our resource group was much longer than this. The major point was to essentially retain the concept of formula reserves as we presently know it for annuity valuation. I think the first two charges are kind of apple pie type things, and had a consistent application interpretation. We have interpreted this to mean do not let the label on a contract drive the valuation principles, look at the fundamentals of the product. There was also a suggestion to reconsider the plan Types A, B, and C in the current valuation law largely because the valuation interest rates vary considerably among those categorizations. There have been product types that sort of fit within two categories, and there is a concern that the industry may consistently select the one with a higher valuation rate. The idea of changing fund method was originally developed for GIC-type contracts.

Finally, the idea of should the valuation interest rate be locked in forever from the year of issue concerns regulators. The 1982 valuation interest rate for immediate annuities is 13.25%. Since it is hard to find investments in a company's portfolio that were purchased in 1982, an argument follows that perhaps the valuation interest rates should change over time.

For those of you familiar with the commissioners annuity reserve valuation method (CARVM), it currently incorporates the concept of greatest present value. In addition, current CARVM does not apply to group annuities. Since we are considering the idea of having a uniform valuation base that applies to both group annuities and individual annuities, we feel the greatest present value concept should be reconsidered. An example that we encountered is that for terminal funding group annuities. It is not unusual for those products to have subsidized early retirement benefits for the deferred life in these contracts. The value of the subsidized early retirement benefits oftentimes can be 20–30% of the premium.

Under a classical CARVM valuation principle, you would reserve with the assumption that everyone retires early. The typical pricing uses an assumed retirement date somewhere between early retirement and normal retirement. Experience has demonstrated that annuitants do not select against the insurance company merely to take advantage of that early retirement option in the contract.

Discussion of this issue lead our group to propose that the CARVM shift from a greatest present value concept to an expected present value concept.

This idea was introduced in that October 14, 1993 report that I mentioned earlier. And at this point, the regulators are not totally comfortable with the concept since it has not been fully developed. However, they appear to be open to the idea and have asked us to continue to develop the concept.

A major issue concerning regulators is how to appropriately limit the actuary's judgment in setting assumptions. One of the ideas that we have incorporated in this new definition of CARVM to preserve the current level of reserves for the typical single premium deferred annuity (SPDA). So while we are suggesting the idea that the reserve is the present value, we have retained some of the current idea that the reserve is not less than the cash surrender value. Also, for contracts with bail-out provisions, the reserve would not be less than the account value.

We have also introduced the idea that for contracts that have a cliff surrender charge, a systematic prefunding for the cliff is necessary. This is the continuous CARVM issue that was raised by Illinois a couple of years ago. Also, we are retaining the idea that initial interest guarantees above your valuation interest rate should result in additional reserves.

So to a large extent, while we are suggesting a movement away from greatest present value, we are retaining some of the elements of current valuation, which lead to roughly the same level of reserves for a typical SPDA.

The area that still needs a great deal of development, and the one I think that the regulators are not fully comfortable with, is the reliance upon the valuation actuary's professional judgment for selecting the valuation assumptions.

Our suggestion is to follow something similar to Canada where the actuarial profession develops technique papers that establish minimum standards for certain key assumptions. An example of a Canadian technique paper relates to Canada's term-to-age-100 product. This probably has no cash value and is priced on a lapse-supported basis. I mean if the persistency is 100%, the premiums are inadequate. When those products were originally developed, the pricing assumptions for the ultimate lapse rate may have been anywhere from 5% to 10%. As experience developed, it became obvious that lower lapse rates were being realized. The Canadian Institute of Actuaries developed a valuation technique paper, which limits the valuation lapse assumption to 3%.

This is an example of where practice in the industry led to a pricing assumption which was inadequate for valuation purposes. Ultimately there was a professional guideline that required a more conservative valuation assumption. This is the structure we want to develop. One in which there is considerable freedom to the actuary in selecting assumptions. But if evidence develops that suggests inadequate reserves for certain types of risks, then more specific guidance would be imposed upon the actuary for certain assumptions.

Another area that we have suggested is, if you have ancillary benefits in your annuity contract, then sensitivity testing to develop an understanding of the reserve level variation to the utilization of the benefit is required. You would have the responsibility to document the valuation assumption and to the extent practical, monitor experience and, if necessary, strengthen your reserve. Applying this concept to term-to-100, this price assumes a 20% lapse rate, and you reserve using a 15% lapse rate. This is fine as long as you demonstrate over time that lapses exceed 15%. But as lower lapse experience emerges, then you have the responsibility to start strengthening reserves.

I believe this concept makes a great deal of sense. If you want to have a lot of flexibility in selecting your valuation assumption, then you also have the responsibility of justifying your valuation assumption.

Let's shift the discussion from the benefits that you consider in setting reserves to the valuation interest rate. We have not recommended that the actual investments of the company be the basis for selecting the valuation interest rate. We have used an assumed investment portfolio. You might ask, why are you looking at assumed investments when the yield on the actual investments is a very key assumption in determining the level of reserve needed for a specific benefit structure. While we do not disagree, we feel that is an area that the cash-flow testing addressed. We are addressing formula reserves. For two companies, that have the same type of benefit structure and realize the same level of utilization assumptions for ancillary benefits, the formula reserve should be essentially the same regardless of the investment actually held. So remember that we are trying to set the valuation interest rates based upon the assumed investment portfolio, not the actual portfolio.

Current valuation interest rates are based upon a single Moody's interest rate index. We have proposed that the valuation rates be developed from the Treasury yield curve. Under a normal yield curve, this will result in lower valuation interest rates for longer term liabilities. We have also proposed reducing the six-month lag in the current valuation law to two months. Also, a specific company would have the option to completely eliminate the lag.

Plan Types A, B, and C and the change in fund method would be eliminated.

Current valuation interest rates have relatively high margins. Also, the margin in the valuation interest rate increases as interest rates rise. We believe this is largely due to the lack of a reinvestment assumption in current valuation techniques. We feel that the refreshing technique justifies lowering the margins in the valuation interest rates.

Let's define what I call valuation interest rate margins. When I say valuation margin, I mean the difference between the company's investment earnings rate and the valuation interest rate. Under current law, if you assume that a company is earning the Moody's interest rate, (1 – W) Moody – 3%. And that's what I define as the valuation interest rate margin. For the various types of annuity contracts, those weighting factors range from 35% to 90%. So if you look at the formula, you realize that contracts that have low weighting factors have large valuation interest rate margins. Also, as the Moody's interest rate rises, the valuation interest rate margins increases. We are proposing to reduce that margin since we are going to be refreshing the valuation interest rates over time. We believe that much of the current margin is driven by the reinvestment risk that was built into the 1980 valuation law.

In developing our formula for valuation interest rates, we reviewed ALCI investment reports over a six-year period. The industry achieved spreads over Treasuries ranging from approximately 115 to 150 basis points. Our proposal is that the valuation interest rates be 105% of Treasury plus 25 basis points. If Treasuries are at 10%, then the valuation rate is 75 basis points over Treasuries. If you're earning 100–150 basis points over Treasuries, then the valuation increase is 25–75 basis points.

Part of the conceptual framework for a 25–75 basis point valuation margin is to parallel a typical company's profit that's probably in the range of the profit objective.

Another idea from our group relates to the valuation for very long liabilities. These are liabilities that go well beyond 30 years, such as structured settlements or deferred annuities under pension plan closeouts. We believe the valuation interest rate for these extreme periods of time should be low. For example, if you have a liability obligation 40 years from now, the valuation interest rate ought to be something related to Treasuries for the first 30–40 years. We have not yet finalized what ultimate should be or where the inflection point should be. The whole idea is that it is to obtain call protection for liability cash flows that are more than 30 years out. You can certainly buy strip Treasuries within the 30-year horizon, but getting call protection beyond 30 years is extremely difficult.

So what does all this mean? I thought I would summarize what the valuation rate might look like for a few types of products. Take a typical declared-rate SPDA product. At the outset, the valuation interest rate would be five-year Treasuries with a 105/25 adjustment. And then over the next five-year period, the valuation rate migrates to a five-year moving average of a five-year Treasury. We are thinking that a declared-rate SPDA product is a relatively short-term obligation, and you ought to be rolling over your portfolio fairly quickly under that type of product.

A 5-year GIC benefit would be largely valued off of a 5-year treasury spot rate, but with appropriate adjustments if you had a benefit responsive type product. For the single premium annuities, as I mentioned earlier, we haven't really established the ultimate tail rate for level benefit immediate annuities. I expect we will end up with something related to 20-year or 30-year Treasuries. We feel the current approach should continue for modified guaranteed annuities that have market value adjustments that are held in market valued separate accounts. We envision an approach similar to a GIC for a general account product.

Having developing these concepts, we have completed some testing to see where the reserve levels would be. As an example, I will describe a fully purchased annuity benefit, various durations ranging from immediate term to very long term. The intermediate benefit reflects a level life annuity purchased at age 65. The long benefit represents an immediate annuity purchased at age 35. This is intended to be somewhat representative of the structured settlement business. The immediate very long term is an issue age 35 at a 3% geometrically increasing benefit. The last category is an age-50 deferred annuity with the benefits commencing at age 65. This is an annuity with a 15-year deferral period and a life annuity thereafter.

We have three categories of interest rate environments: low, medium, and high. The low environment represents interest rates in the range of 6%. The medium reflects interest rates in the range of 9%. And high reflects the 12% range.

You'll notice, in the low environment, the ratio of proposal is producing reserves basically at the same level as current for other than for very long deferred annuities.

The other thing is that in higher interest rate environments, our proposal produces lower reserves. At this point we have not worked with the regulators to come to a business decision as to where these initial reserve levels ought to be set relative to current reserve levels. There has been a question raised by one regulator that we perhaps have the reserves a little bit too low. So I think that things are far from being finalized at this point in time.

The previous table was the relationship of reserves at the outset. Consider taking the reserve levels and tracking them over time over a 30-year horizon assuming either a pop-up level or pop-down, 300-basis-point scenario.

So it's like we're starting in a 9% environment and making an immediate shift to either a 6% or 12% environment. So you'll see under the level scenario the proposed reserves stay at approximately 95% of the current level.

In the pop-up scenario, you will see that our reserve levels reduce. And similarly, if interest rates are declining, this refreshing concept will be strengthened with the reserves over time.

This illustrates how things are intended to work. While it's certainly debatable how quickly the valuation interest rate should move towards the current level, we believe the basic concept is appropriate.

The next example is for two types of SPDAs: one with a smooth surrender charge and one with a cliff surrender charge. We're not really proposing very much change in reserves. They're slightly lower in a higher interest rate environment because this is a product that has a one-year, policy-year interest rate, and you have some excess interest reserves in higher interest rate environments, which is represented by 97%.

The next example illustrates that you get some small movements in the reserve levels in the pop-up and pop-down refreshing for the deferred annuities. This amount is not substantial since interest rates are not a big driver in the reserve levels. You will notice in the 4.5-year range we see the impact of a cliff surrender charge producing stronger reserves. That reflects our approach for trying to prefund cliff surrender charges more systematically than under the current valuation law.

Well, what next? We have some indication from LHATF that we are on track, although there's still a lot of work to be done. The April 27, 1994 report I referred to was only a draft report. It is not complete. We need to do a lot of work yet in developing the framework for these technique papers. The regulators are saying, "Well, that sounds fine, but show us how it's going to work." I believe the work that Donna Claire did a couple of years ago to develop practice notes is a start. However, I believe that technique papers will need a higher level of authority from the profession.

Finally, I have a few quick comments on a current reserve issue that's under discussion. This is the proposed actuarial Guideline GGG that I mentioned before. I won't go through the history of where all of those proposals have been, but I will describe where the proposal is right now. The major issue is, what is the valuation interest rate that you should be using? Is it a Type A or a Type C contract? The industry was largely valuing the two-tier product as a Type A contract, and at one point, the regulators proposed it should be valued at a Type C, and hence a lower valuation interest rate and higher reserves. The current proposal is to view it as two contracts. If you look at the surrender benefits, treat it as a Type C contract, and if you look at the annuitization benefits, then treat it as a Type A contract.

The other new idea in the proposal is, for the Type A piece, you measure the duration based upon the issue date and the year that you assume someone annuitizes. Under current valuation law, as the duration increases, the Type A valuation interest rate decreases. So if you have a Type A contract with a duration less than five years, it's essentially valued as a single premium immediate annuity. If you have a Type A contract with a 20-year duration (where 20 years means you expect people to annuitize 20 years from the purchase date), the valuation interest rate is more like a Type C contract. I view the proposal as you grade from Type A valuation interest rates to Type C valuation interest rates over 20 years.

Another aspect of the proposal is that if your contract guarantees that annuitizations will be at the greater of the purchase rates in the contract and the current purchase rates, then you have a floor reserve of 93%.

MR. HOWARD L. ROSEN: Denny, I have a couple of questions for you about the earlier part of your presentation. First, regarding the valuation law, in general, have there been any considerations to revisit the definitions in Interrogatory 10 of the annual statement? I'm specifically talking about the fact that a surrender charge is at least 5% for at least a year from the valuation date. That seems to be very onerous as far as RBC requirements are concerned. My second question is also definitional. Has any consideration been given to defining what situations create a contingent surrender charge? I'm talking about things like death benefits and nursing-home-type benefits, which I believe most companies ignore and most states except Texas ignore. Also, what level of bailout would create a contingent surrender charge? So again, the first question relates to Interrogatory 10 and the second to contingent surrender charges.

MR. STANLEY: I guess I'll be real frank and honest on the first one. No, there has not been any consideration or discussion. But if you would like to clarify your issue, we would be more than happy to hear your thoughts. And we have a lot of things to think about, but we haven't really thought about it at this point.

With respect to contingent surrender charges, I'm somewhat expressing my personal opinion, but I think the majority of our resource group would agree that the bailout, or the contingent surrender charges would not include the nursing home aspect as Texas currently interprets it. I understand that Texas believes that there is a statutory requirement (due to the way the state's valuation law is written), which is forcing the regulators. I haven't talked specifically to Ted Becker whether he would feel differently if the wording of his law was different. Thus, I am not certain if he is coming from a conceptual basis or the technical wording of the Texas law. I think it's more of the latter.

With respect to what level of a bailout becomes meaningful, to me it certainly is something higher than the guaranteed interest rate.

MR. EDWARD L. MYERS: Could you elaborate a little bit more on the potential effect of actuarial guideline GGG? I guess I'm interested more in terms of what would happen if the new standard valuation law becomes effective? Does that supersede or minimize GGG's effect as a separate issue?

MR. STANLEY: At the onset, our group concluded that we did not want our thinking to be blurred with the implication of retroactive applications. We have been advocating that our ideas be prospective only.

MR. HOWARD H. KAYTON: Our material goes back a little further. I took the assignment of chairperson of this resource group four years ago, and at that point it was a one-year assignment. So it's somewhat consistent with Denny.

THE PROPOSED NONFORFEITURE LAW

Let's begin with the life insurance nonforfeiture law. Work on that began over ten years ago. Its genesis was a belief by the regulators that the Universal Life (UL) Nonforfeiture Law was not sufficiently restrictive. They believed that there is much "game playing" in the industry to avoid the intent of this law, and in fact, John Montgomery, who is chairperson of the LHATF, has totally disowned the nonforfeiture provisions in that UL law. Strangely enough, there is no agreement among the members of the LHATF that there is a need to revise the life insurance nonforfeiture law, but that hasn't stopped them.

Among the industry, I think there is universal agreement that the proposed law is just impossible. It has been described as "unfixable," and as "an embarrassment to the regulators." The approach that was followed in its development can easily become a basic course in how not to develop a product, Management 101. To begin with, there is no statement of what the problem is and there is no description of what changes are being proposed, why the changes are proposed, or what the regulators seek to accomplish once the change is made.

So far, there have been 27 releases of this law. There were 11 that were numbered with the letter C. Five were based on Walt Rugland's approach. Four were labeled as unregulated, which were the regulators' responses to Walt Rugland's approach. There are six versions labeled N, and I understand now there is an N-7, but I have not seen that yet. And finally, there's one called NFX, which is a modification of the existing law without as much change as in the N versions.

The current exposure draft, which has been pushed along by the NAIC's A Committee (the Life Insurance Committee), was soundly criticized at an open hearing in March 1994 in Denver. That version is called N-6, and for most people, that is the version that they have.

Let's go over what that N-6 proposal is, and why there are so many objections. First of all, it seeks to encompass all life products in one law, including individual and group, but continues to exclude variable, credit life, and the usual term-type products. It has three major classifications: (1) nonsingle-premium traditional products, (2) nonsingle-premium fund-based products, and (3) single premium, which is further subdivided into traditional and fund types. There is very little change in the regulation of the traditional products. They have the usual specification of minimum interest rates, mortality tables, maximum expense loads, and the method of calculating minimum cash values, which are independent of the actual level of gross premiums.

On the other hand, for the fund-based products, the draft specifies maximum expense charges, maximum mortality charges, and the minimum interest rate to be applied to the "conceptual" net premiums (which are the actual gross premiums less the maximum expense charges) to determine the cash values. The cash values thus become directly dependent on the actual gross premium being charged. For single premium policies, the cash values depend on whether the policy is a nonfund-based product or a fund-based product. Andy Ware, as representative of the Academy's Life Committee, pointed out at the Denver hearing that, since the expense limitations are applied before deduction of premium tax, it will eliminate all present single premium product designs from the market because there is no room for commissions or expenses.

The other onerous part of this draft is that there is a disclosure requirement (consistent with other current NAIC proposals), that requires illustrations of only guaranteed benefits or of historical experience. Actually, this law only allows you to illustrate guaranteed benefits. It does not allow projections or hypothetical results.

I did a survey among people who are very familiar with the law to determine the five best and worst features of the draft. I still have not found anybody who could offer anything good about it. I'll mention some of the objections voiced. First, everybody puts as their number one objection that the draft constitutes rate regulation of the fund-based products. Second, there are inconsistencies in the treatment of products (the law is trying to promote uniform treatment of all life products, and yet it starts out by categorizing them into separate sections, and regulates them using different formulas). It regulates out of existence products like single premiums, smaller contracts, products at younger ages, and second-to-die, some of which become uneconomical to issue.

Another major objection is that it is not likely to be accepted uniformly in all states. So, again, it will create nonuniform regulation; if the group of regulators can't agree on what constitutes a reasonable basis when it gets into the legislatures, it is going to be worse.

If you've ever tried to explain a nonforfeiture law to a group of legislators, it is an impossible task. Greg Carney was challenged by the California legislature to explain in 25 words or less what is a nonforfeiture law. He couldn't.

Another objection is that the law seeks to permit persistency bonus, but it also requires a smoothness test, which is totally inconsistent. I think the most serious problem is that there have been so many versions exposed to which people have not really been paying a lot of attention. It began moving toward passage in June 1994. I hope that will not happen.

What is going to happen with this law? Well, the Society of Actuaries recently commissioned a study to be done by Doug Doll of Tillinghast to determine what the impact of this law will be on current and potential products. It should be available prior to the June 1994 NAIC meeting. Also, I hope with the new cochairperson of this task force, Dwight Bartlett, who is the Commissioner of Maryland, it should speed things up. He has already started asking the questions that should have been raised ten years ago, but he still hasn't received the answers. I hope Doug's report will give the LHATF better direction. Clearly the law should not move forward in its present form.

THE PROPOSED ANNUITY NONFORFEITURE LAW

Let's switch over now to the annuity law where there's more agreement. But before we get into the proposal, I'd like to note that the concept of nonforfeiture with respect to annuities is a contradiction. Almost all annuities are issued as either single premium or flexible premium. Hence there can be no forfeiture. If there's no forfeiture, why regulate nonforfeiture? I raised that question with the regulators, but received no response.

Before we review the proposal, let me go back for a brief history of how we got there. The story begins about five years ago when the states of Washington and Oregon were attacking two-tier annuities as being misleading. The state of Washington actually regulated it out of existence. California subsequently announced it was going to study two-tier annuities, and John Montgomery appointed an advisory committee in the summer of 1990. That advisory committee, which initially included Harold Phillips, of the California Department, met several times and then presented a report in September 1991 (which we thought was our final report), in which the focus shifted from regulation of two-tier annuities to modification of the entire annuity nonforfeiture law. The LHATF reacted by reconstructing the advisory committee to include group and variable annuity writers, and a representative from the Teachers Insurance Annuity Association (TIAA). Eventually, this new resource group came out with a second report in December 1992 that eliminated the smoothness requirement, combined the rules for single premium and flexible premium policies, added compliance by actuarial opinion rather than prefiling actuarial memorandums, and eliminated the applicability to true group (from the onset we included group and individual because, in many cases, the same product is written as an individual product in some companies and as a group product in others, and yet group contracts have traditionally been exempt from nonforfeiture law). The new law will encompass what we call "not true group," or "pseudogroup policy."

The December 1992 report was exposed by the ACLI to the industry and many in the industry finally took note of this as a serious proposal. There were at least two exposure periods for comments and responses, one of the report itself, and later of the actual legal language that has now become the exposure draft. Unlike the life law, we started out with a report and tried to get concepts resolved before we actually wrote the law (on the life side, the regulators have followed the approach of using as their exposure piece the actual law itself).

The regulators were determined to get us to draft the law. They wanted to see the language of the law before the concepts were resolved. Finally, when we couldn't put them off any longer (they were threatening to do it themselves), we decided to draft the law. We thought that all concepts had been resolved before, and we distributed the first version of the law. It was written by actuaries, not by attorneys, and I think it's probably more "actuarially friendly" than most laws.

Keep in mind that the current version of the law is a compromise of many regulatory and industry positions. It's a compromise between (1) allowing product designs that are perceived as locking in the buyer, and therefore, viewed as abusive by the regulators, but safe by the industry, versus (2) the kind of product designs that are perceived by the industry as creating too large a C-3 risk and, therefore, creating a solvency problem, but are viewed as consumer friendly by regulators because there is little deterrent to lump-sum surrender. We have tried to balance these two perceptions.

To begin with, the exposure draft provides for an actuarial opinion, both at the time of filing your policies and when guarantees are subsequently extended. However, it does not require that these opinions be filed. Instead they are to be retained by the company and provided when requested, either by examination, market conduct study, or if regulators are concerned over the way you've been marketing products. Unfortunately, the regulators left this as the one open issue. I think they are really uneasy about trusting the company's actuary with that responsibility. It would eliminate much of the filing and yet would require updated opinions, which are not required by the current law. Under the current law, you basically prepare an actuarial memorandum when you first issue a policy, but never have to revise it. The exposure draft would require updated opinions. This uneasiness, by the way, is shared by a lot of industry actuaries who are uncomfortable about not receiving departmental approval prior to issue. They feel they won't have a safe harbor. I hope it will be resolved at the upcoming Baltimore NAIC meeting.

The main feature (and the most controversial) of the exposure draft is that it limits the spread between the account value and the surrender value to 10% (with an exception for 20% for the first $9,500). This limitation is both for front-end loaded products, or products that have back-end loads, or a combination of the two. The concern expressed by the industry is that the 10% spread does not permit a company to adequately provide for the risk of disintermediation. However, it appears that this finally has been put to bed by the regulators. They, for example, want products that come together at the end of some period of time, like after ten years, or at maturity. They do not see the need for a difference between surrender value and account value as a policy nears maturity. We have tried to explain to them that you can't allow a deposit into a product in the ninth year, and invest it at long-term rates and then permit a book value surrender one year later. I think we finally achieved agreement on that.

The exposure draft also contemplates that states will eventually permit an individual market-value adjusted annuity to be written out of the general account. The present nonforfeiture law doesn't permit market-value adjusted annuities, but they are written under the Modified Guaranteed Annuity Model Bill, which requires, that if it's an individual contract, it has to be written through the separate account; if it is group, it can be written through the general account. We're hoping that the states will eventually change that, and we have written a nonforfeiture law to allow it to be written through the general account.

The draft contemplates three distinct policy designs. So here, again, even though we're trying to get one law to uniformly cover all policy designs, we really had a problem applying one concept to the three types.

The three types are (1) continuous access annuity, where the cash values are always available; (2) the no-cash-value annuity, where cash values are never available; and (3) the restricted surrender provision annuity, where either cash values are only permitted periodically, or where the surrender charge is waived periodically. The first type is what most companies issue as deferred annuities today, either as single or two-tier annuities.

The no-cash-value annuity is probably only written by TIAA, and the restricted surrender provision annuity, which you can think of as the certificate of deposit (CD) annuity, is probably not permitted under the present law, but it is currently being written by about 10–20 companies in the various states.

Under the exposure draft, these latter two types can be written, but with much greater restrictions than the continuous access annuity. This is to avoid locking the policyholder into the product.

The interest rate minimums have been changed from a flat 3% in the present law to the lesser of three items: (1) 2.5%, (2) the five-year Treasury note yield less 1.5%, or (3) a rate specified by the commissioner. Mortality is the 1983 Table A with projection. Both of these, interest and mortality, can be changed with respect to future premiums on 60 day's notice. That's a big change. That would only be, of course, if it's written into the policy. If you don't write it into the policy, you cannot change it. It will be interesting to see if companies take advantage of this feature.

The policy fees can be a maximum of $40. Until yesterday it was $30 indexed from June 1993. It has now been changed to $40 with no index, plus $1.25 collection fee per payment. Both policy fees and premium taxes are deducted after determining that a policy validates under the law. So you don't have to worry about validating at various size policies, or worry about the various states' premium tax rules.

You are also required to guarantee that you will either apply the account value to the guaranteed annuity payout rates in the policy, or that you will apply the surrender value in the policy using current single premium immediate annuity rates.

There are many other differences including, as I mentioned, the fact that the new language is much more actuarially friendly.

If you want to see copies of the proposal, you have to subscribe to the LHATF minutes that Denny talked about, by calling Jean Olsen at the NAIC. The latest mailing, which is the April mailing that was mailed out about May 15, 1994, contains the latest final report of our resource group so far. There is also a letter in there that summarizes the 22 issues that were brought up by the industry in the latest exposure period. Also available is a report that was sponsored by the Society's Product Development Section. This is similar to the report that Doug Doll is now doing on the life bill, but this has been completed. It analyzes the effect of the annuity proposal on present product designs. It was prepared by Tim Pfeifer of Milliman & Robertson.

PROSPECTS FOR PASSAGE

What is the prognosis for this proposal? It certainly has moved along much faster than the life bill, and on several occasions we thought we were almost finished. The most optimistic timetable would have this be approved by the LHATF at the meeting being held soon in Denver. I hope its members will resolve the actuarial opinion issue at that point, and then they will send out this latest draft for a final exposure prior to the September NAIC meeting. If it is then approved at the September meeting, or reapproved by the A Committee, it could become a model law in June 1994. The reason there is so much of a delay is because it has to be approved by the NAIC Executive Committee in order to become a model bill. The Executive Committee meets at the beginning of the NAIC meeting before any other committee meets, so anything approved at that meeting has to be held over for another four months.

The probability of occurrence of this most likely scenario, I would say is greater than 50%. So it's probably more than likely that we will have a bill in December 1994. The NAIC Executive Committee had demanded that there be both a life and annuity nonforfeiture law passed at the June 1994 meeting, which would have meant that it became law at the end of 1994. But there's been a change at the NAIC. Because of the accreditation process, there have been many laws that have been passed and pushed through legislature, and there's a great deal of concern that too much has been pushing through, that every year the regulators are going back to the legislators and asking for another new law. Now they're going to try to sort of package all of these laws for a couple of years at a time and then push them through at once. So this takes the heat off this being passed at the June meeting.

MR. ALLEN D. BOOTH: I have a question about minimum payouts. It's proposed that the minimum payout be the greater of guarantees in the contract, or the current single premium immediate annuity rates at the time of annuitization. What if, under today's economic interest rate environment, I earn 6%, and ten years from now I earn 16%? Have I just locked myself out of the single premium immediate business? Is that correct?

MR. KAYTON: Remember that the 16% payout factors will be applied against the surrender value at time of annuitization. If you are willing to give a person his or her surrender value ten years from now when the rates are 16%, you should be willing to pay him or her a single premium immediate annuity based on that surrender value. It's hard to argue against that. On the other hand, if interest rates were at 16% ten years from now, you'd be in serious trouble if you were locked into 6%.

FROM THE FLOOR: I believe you said that John Montgomery had disowned, or some similar word, the nonforfeiture provisions under current or UL model law. In 25 words or less, would you brief the audience on why? Is that correct?

MR. KAYTON: Well, yes. I think he feels that it is being abused by the industry. When the law was being discussed, I think he objected to some of these provisions, but it was passed despite his objections. He felt it should have been much stronger at that time, but he did not prevail.

MR. TIMOTHY C. PFEIFER: I have two questions related to variable annuities under the nonforfeiture proposal. When the proposal is adopted, presumably there will be a conflict between the variable annuity model regulation and the nonforfeiture law. I just wondered if there was any activity that you are aware of in terms of changing the variable annuity model regulation so that the two are not disjoint.

With respect to the guaranteed minimum death benefit provision written into the current proposal, you are prohibiting a compound death benefit calculated using a rate higher than the valuation rate. When we go to Denny's valuation rule, which rate are we talking about?

MR. KAYTON: First of all, on the variable, our proposal contemplates changing or replacing the nonforfeiture provision in the variable regulation. Craig Raymond was on a group that was originally being asked to revise the regulation, and its members were also being asked to revise the nonforfeiture provision in the modified guarantee annuity law. But instead it has been encompassed in our proposal. Presumably, his group will subsequently recommend changes to the variable annuity model regulation.

Regarding the death benefit, there is a problem there. Some of the industry and some of the regulators are concerned that we're really providing a death benefit, or too much of a mortality element within an annuity. And the compromise here, again, was to limit the death benefit. We were to limit the guarantee that a company could make to the valuation interest rate. And again, it's a convenient interest rate. The valuation rate is presumably the rate that companies can safely guarantee. Some of the people, some of the regulators, some of industry, in fact, were saying that you should not permit guarantees of interest rates to be made in variable annuities. Here, again, is an example where some companies are actually issuing this benefit, but some of the regulators are saying it can't be done. So here, again, our solution is a compromise.

MR. PFEIFER: The question I had was, when we get into the valuation environment that Denny was describing, which rate are we talking about?

MR. KAYTON: I went to that session at this meeting trying to find out the answer to that, but the panelists didn't give it. I'm not sure. I think Denny might want to respond to that.

MR. STANLEY: I certainly am not writing the nonforfeiture law, but I would tend to think it would follow the new valuation rate, which would essentially be a five-year ruling, five-year Treasuries. That would make a great deal of sense to me, but I don't know. I haven't really given it a whole lot of thought.

MR. THOMAS P. MCARDLE: I was wondering if the committee discussed whether there should be a higher maximum policy fee for variable products because of the higher administrative cost? And would we still be allowed to charge $10 a transfer between accounts?

MR. KAYTON: I think the $10 transfer is in there. The higher policy fee did come up because the present variable annuity law allows $30 indexed to the cost of living since June 1979, and we tried to put that in. But the regulators overruled us. They believe that the industry should be able to do better than the cost-of-living index in terms of rising costs of administration. I tried to recommend half the cost of living as an index, but they wouldn't buy that either. They seem to be more interested in revising the law every ten or so years.

MR. KUNESH: Next, Don Maves will talk about a model law that's much closer to becoming a reality.

MR. DONALD P. MAVES: I'm glad you clarified that. I guess as far as seniority, I'm third on the list to Howard and Dennis. I've only been chairperson of my technical resource group since January 1993. However, my group itself has been going on since 1989, so I don't know. I guess if we had a fourth speaker here, it would be going on about ten years. We have one, two, and now five years, so you figure out the pattern.

I will discuss the model regulation commonly known as XXX (or Regulation 147 in New York). To do that, I will cover five topics: (1) the history and current status of the model regulation; (2) a few numerical examples; (3) a summary of typical questions and comments that we have received; (4) the changes likely to come in a redraft; and (5) possible product design responses to XXX.

CURRENT STATUS

What is the current status? The short answer to that question is that the NAIC LHATF exposed the latest draft for adoption in December 1993, intending to complete NAIC action on it by June 1994. At its last meeting in April, the NAIC Task Force asked our Technical Resource Group to recommend any changes based upon the comments received. We will be submitting a redraft for the NAIC to consider at its June 1994 meeting. About the same time, the New York Insurance Department exposed its version of XXX for adoption later this year. That Department recently exposed a redraft. The NAIC model and the New York model differ, but more about that later. The regulation is available in ACLI General Bulletin #4728 (December 23, 1993), but it does not, of course, reflect our latest redraft.

Rather than give a complete history of the development of XXX, I refer you to a presentation I made at a Society of Actuaries meeting in 1989. It can be found in the *Record,* Volume 15, Number 3B, pages 1653 through 1659. It covers the rationale and the initial development of this project. I must point out that the meeting occurred in 1989, at which time the project was almost one year old. So we are in the sixth year—longer than the time that many of the term policies issued then have stayed in force. An excellent and more recent summary (although still out of date) by Andy Ware appears in the *Record,* Volume 18, Number 3, pages 1330 through 1342.

Ironically, and you will see why in a moment, this issue appeared long before 1988, but apparently with not nearly the same amount of controversy. Donald Sondergeld published a paper titled "Changing Premium Valuation Method" in the 1978 *Transactions,* in which he proposed a new method of valuation for term insurance with varying premiums. That just happens to be Volume XXX.

I have selected some key provisions of the regulations, and I will describe the rationale for them.

The regulation contains a new mortality selection for use with all plans, not merely term insurance. These selection factors reflected updated, improved mortality since the development of the 1980 Commissioners Standard Ordinary (CSO) tables. The improved mortality also was an attempt to provide relief for "Preferred" or "Super Select" rate classes in which the expected mortality is quite low, but which cannot currently be reflected in the reserve determination. The technical resource group extended the use of the new factors to all plans, because the underlying experience included more than merely term insurance.

The technical resource group also proposed a reserve segmentation method in which policies are split into one or more segments. The predecessor guideline (Actuarial Guideline IV) defined level premium segments. XXX defines "levelized" segments, comparing the slope of premiums to the slope of valuation mortality. The intent is to minimize manipulation—for example, raising premiums per unit by a penny to create short segments. New York's regulation required the use of current premiums to determine segments. However, the NAIC model permits the use of guaranteed premiums. The result is generally longer segments in New York.

In recent years, we have seen more "term-life" UL plans enter the market. A typical plan design is quite similar in many respects with traditional UL: account values, interest credits, mortality and expense charges, flexible premiums, and surrender charges. However, these plans also had a "secondary guarantee" feature in which the policy would remain in force, even if the account value were negative, provided that the policyowner has paid the minimum specified premiums. The minimum specified premium test, although cumulative in nature, usually is expressed as a level premium per year. The secondary guarantee periods in most cases ran 15 or 20 years.

Although term-like UL was originally exempt from the requirements of XXX, regulators believed that these plans exploited a loophole around XXX and thus must be subject to the same type of reserve as term insurance. Their concern was with long secondary guarantees—"long" meaning greater than five years.

The model regulation contains a five-year exemption, or safe harbor, from deficiency reserves under certain conditions. Five years was originally in Guideline EEE for UL, as an attempt to exempt traditional UL from having to comply with term insurance requirements. It does have other ameliorative effects, however, among which it balances reserve concerns with market concerns, and it helps smaller companies remain competitive.

Within the last year, both the NAIC and New York changed the operation of select factors. Smoothness was a concern, especially going from duration 15 to 16. As it now stands, both models allow for unique selection factors, subject to certain conditions: (1) they may not be less than those in the models' appendixes; and (2) they may not decrease by duration. Select factors in any case may not be used beyond the first segment, unless it is less than ten years, in which case the currently available ten-year select factors can be used through policy year ten.

The effective date for the NAIC regulation is January 1, 1995. For New York's regulation the effective dates are January 1, 1994 for direct business, and January 1, 1995 for reinsurance assumed (except that in the latter case, New York's regulation applies to reinsurance assumed from a New York company on or after January 1, 1994). New York also has a five year grade-in for in-force business, but it grades to the greatest of unitary, cash value, and prorated cost of insurance, not to a full XXX-type reserve.

Years ago, one of the main features of this regulation was an actuarial option related to the level of mortality used for deficiency reserves. While there is still some support for this concept in both the industry and regulator groups, the current approach is more of a "cookbook" approach.

You may have noticed sections devoted to cash value plans in the most recent regulations. The genesis was from the New York Department, whose actuaries were concerned with unusual patterns of cash values, and with nonsmooth cash values. As a point of interest, the original XXX in 1988 was accompanied by a proposed Guideline regarding cash values, but no action was ever taken.

EXAMPLES
I would like to present some examples that show the dramatic effects of XXX. These examples are all male age 45, nonsmoker, with premiums that are representative of the competitive term market today. The XXX means reserves shown are based upon the minimum standard in the model regulation. I have also illustrated reserves under the current unitary method in the standard valuation law.

Table 1 is a five-year level term guaranteed for ten years (preferred rate class). You can see the huge increases in reserves due to XXX, which are caused by large deficiency reserves. By the way, for the corresponding standard class, the deficiency reserves would be roughly half those of the preferred class. The base reserves would be the same for both classes.

TABLE 1
SUMMARY OF RESERVES
CURRENT VERSUS XXX
NONSMOKER PREFERRED FIVE-YEAR LEVEL

Policy Year	Current Unitary	XXX Basic	XXX Deficiency	XXX Total
1	1.05	0.62	8.43	9.05
2	1.23	1.61	8.64	10.25
3	1.42	2.07	8.99	11.06
4	1.64	2.04	9.50	11.54
5	1.77	1.57	10.13	11.70
6	2.04	3.10	8.52	11.62
7	2.35	3.88	6.52	10.40
8	2.58	4.15	4.42	8.57
9	2.83	3.92	2.23	6.15
10	3.12	3.12	0.00	3.12

Table 2 illustrates a ten-year term (again, preferred). Deficiency reserves have moderated, but the increase in reserves is still significant. The corresponding standard class has no deficiency reserve.

TABLE 2
SUMMARY OF RESERVES
CURRENT VERSUS XXX
NONSMOKER PREFERRED TEN-YEAR LEVEL

Policy Year	Current Unitary	XXX Basic	XXX Deficiency	XXX Total
1	1.05	0.62	4.24	4.86
2	1.23	2.43	3.43	5.86
3	1.42	3.75	2.71	6.46
4	1.64	4.62	2.09	6.71
5	1.77	5.12	1.52	6.64
6	2.04	5.29	0.99	6.28
7	2.35	5.15	0.48	5.63
8	2.58	4.68	0.04	4.72
9	2.83	3.82	0.00	3.82
10	3.12	2.46	0.00	2.46

Table 3 illustrates a 15-year term guaranteed for 15 years (preferred class). Deficiency reserves are huge, but even without them, there is a big increase in base reserves.

Some articles that I have read mention that the primary objective of product design is to avoid deficiency reserves. I disagree. I believe that the primary objective is to maximize the enhancement of company surplus. In that context, the amount of deficiency reserves is merely one consideration—not an unimportant one, but not the sole focus.

TABLE 3
SUMMARY OF RESERVES
CURRENT VERSUS XXX
NONSMOKER PREFERRED 15-YEAR LEVEL

Policy Year	Current Unitary	XXX Basic	XXX Deficiency	XXX Total
1	1.05	0.62	11.27	11.89
2	1.23	3.60	10.01	13.61
3	1.42	6.15	8.83	14.98
4	1.64	8.31	7.71	16.02
5	1.77	10.17	6.63	16.80
6	2.04	11.78	5.56	17.34
7	2.35	13.16	4.47	17.63
8	2.58	14.29	3.43	17.72
9	2.83	15.12	2.45	17.57
10	3.12	15.55	1.52	17.07

Let me illustrate with perhaps a trivial example in Table 4. The 15-year standard class result has deficiency reserves on a CRVM basis. As you can see, we can eliminate deficiency reserves by holding net level reserves. However, you may not want to hold the additional base reserves required for net level.

TABLE 4
SUMMARY OF RESERVES
XXX NET LEVELS VERSUS XXX CRVM
NONSMOKER STANDARD 15-YEAR LEVEL

Policy Year	Net Level [a]	CRVM Basic	CRVM Deficiency	CRVM Total
1	3.59	0.62	0.99	1.61
2	6.42	3.60	0.26	3.86
3	8.81	6.15	0.00	6.15
4	10.81	8.32	0.00	8.32
5	12.50	10.18	0.00	10.18

[a]There are no deficiency reserves on a net level basis.

TYPICAL QUESTIONS AND COMMENTS

Obviously, we get two polar comments that either the model regulation is too restrictive and will destroy the term market; or the reserve requirements are too liberal, and many term writers are headed for failure. It is impossible to satisfy both sides of that issue, and politically it is probably not possible to completely satisfy either side.

Other common comments that we have received include the following:

> It may have unintended effects upon traditional UL, because of the limit on secondary guarantees. I sense some sympathy from the regulators on this, but the issue they (and we) have is how to defined what should be excluded from the scope of XXX.

It forces companies to hold unneeded reserves on attained age yearly renewable term (YRT) policies. Again, I sense some sympathy from the regulators, but the issue is still how to define what is excluded.

There are other forms of insurance in which the same issue arises—for example, modified premium whole life with not more than one or two premium increases. I have even had someone tell me that his company has a graded premium plan that "clearly" should not have to have additional reserves. My first thought was that he must be selling the same products as my company, but the real response is more like, "Clear to whom?" The issue becomes who gets to define which policies are fine, and which are underreserved.

Another comment is "why can't select factors be used after the first segment, especially on a plan such as YRT that has short segments?" There appears to be some confusion on this, but, as I stated before, the model regulation does allow the current ten-year select factors beyond the first segment (but in no case beyond the ten years).

Finally, some commentators want New York and the NAIC to be consistent on which premiums to use for segmentation. That is a hard one to solve, because New York's actuaries are adamant that you must use current premiums, while most of the company actuaries are just as insistent that guaranteed premiums be used.

POSSIBLE CHANGES

As I mentioned, we will be submitting a redraft of the NAIC model regulation in June 1994. Although it is not yet final, here are the likely changes.

We have expanded the applicability and exemptions. We have followed New York's version closely. The regulation applies to group insurance in which premiums are guaranteed for more than one year. Variable life and variable UL are exempt. We have provided optional calculations for YRT reinsurance and attained-age-based YRT insurance—similar to current practice. Certain modified premium policies, those with not more than one premium increase that occurs within five years of issue, are exempt from segmented reserve requirements. Certain juvenile policies are exempt from unitary requirements.

Under the currently exposed regulation, it is possible to have a product in which gross premium always exceeds minimum net premiums, yet would require deficiency reserves. That was never our intent. In the new draft, one only calculated deficiency reserves if any gross premium is less than the minimum net premium.

In the current draft, it is not clear how to calculate net premiums within a segment that has an unusual cash value at the end of the segment or at the beginning of the segment. We will not change this to reflect that within a segment, the present value of net premiums must equal the present value of death benefits plus the present value of any ending unusual guaranteed cash value, less any initial unusual guaranteed cash value. This closely follows New York's regulation.

There has been some confusion about the appropriate use of policy fees in the calculations. We will try to make it clearer. You ignore level policy fees in determining segment lengths. After you determine segment length, you may use, but are not required to use, policy fees to determine basic reserves and deficiency reserves. You may use them for deficiency reserves even if you do not use them for basic reserves.

One way to seemingly avoid "secondary guarantees" on UL is through the use of a primary guarantee. For example, one could guarantee level cost of insurance charges at some low level for a long period such as 20 years. Then there is no minimum stated premium, although there is a de facto minimum level premium. New York's redrafted regulation handles this situation, which we intend to parallel.

RESPONSES TO XXX

How can companies design profitable yet marketable products for XXX? Easy—do *not sell them term insurance. My marketing people told me to tell you that.*

I do not have a simple answer to that question, and if I did, I would not disclose it anyway. You have to look long and hard at the length of the initial premium guarantees, and what the effects are upon your profit measures, and how marketable the resulting product is.

Companies have tried selling long, level premium plans with guarantees shorter than the level period (e.g., ten-year level plan with five-year guarantee). Their success has not been overwhelming; however, most of those products were competing against longer guarantee products.

Some people may try to sell participating term with premiums at such a level that reserves are tolerable. Then the dividends are the difference between the participating premiums and whatever the desired nonparticipating premium levels are. Simple in concept, but maybe not so simple to market successfully.

How about this solution—ART (select, not attained age) makes a comeback! And ART brings with it all the baggage that it carried in the early 1980s—high lapse rates, increased replacement activity, turmoil in the reinsurance marketplace, and so on.

My own outlook? I think that we will definitely see significant shortening of guarantees, and possibly some premium increases. You can bet that the most successful products that come out of the gate in 1995 will have a host of imitators in short order.

This regulation is quite complex. I urge that if your company has not yet considered the effects of this regulation, start now! Neither valuation actuaries nor product actuaries can afford to delay as the effective date inexorably approaches.

MR. BARRY JACOBSON: I have a comment and a couple of questions. One way to predict the market for 1995 is to watch New York in 1994, because that state is a year ahead. So you might get some ideas for 1995 by looking at what is happening in New York in 1994.

I have a couple of quick questions. What is the probability, in your opinion, of the January 1, 1995 implementation date? When will we know whether that will happen or not? Second, do you think one solution might be financial reinsurance to fund the deficiency reserves? Or do you think that the deficiencies are so high that would be out of the question?

MR. MAVES: The answer to the first question is greater than 50%, but not close to 100%. I guess right now there is a 60% change that it will happen on January 1, 1995.

As for the second question, I guess financial reinsurance would be a potential source of relief. It depends upon the price and the availability. I do not know what arrangements exist for relief of this type.

FROM THE FLOOR: Will the XXX apply to only new policies, or is it going to apply to existing products as well?

MR. MAVES: There's no retroactivity in XXX. There is a retroactivity feature in the New York version, which is a five-year grade-in. It is not retroactive completely to a XXX type reserve. It is the greatest of the cash value, pro-rata cost of insurance, or unitary reserve.

FROM THE FLOOR: You said the New York law is effective for a domiciled companies in 1994. Yet reinsurers would not have to comply until 1995. What is that going to do with reserve credits in 1994?

MR. MAVES: Originally, I thought that was a problem. In some of the earlier drafts in New York, it seemed as if the reinsurer would not have had to hold those reserves in 1994. New York is quite strict about mirror reserving, as I understand it, so that could have been a problem for direct writers. But in New York's latest draft, the reinsurer would have to hold XXX reserves on 1994 business assumed from a company licensed in New York. So the direct writer could take full credit for the reinsurance.

FROM THE FLOOR: I have read comments that the current wording might require substantial extra reserves on YRT-type plans because of the requirement to hold the greatest of the unitary reserve, the cost of insurance, or the segmented reserve. Is that true, and that is the intent?

MR. MAVES: It was true. It probably still is true in the latest draft that has been exposed. However, that is not the intent. The redraft that we will submit to the regulators and the New York draft both contain relief for YRT reinsurance and for attained-age YRT on the direct side. There will be an optional calculation similar to what I believe is done in current practice. Essentially the base reserve would be a pro rata cost of insurance, (half c_x as some people refer to it), and the deficiency reserve would be the present value of the excess, if any, of the net premiums over the gross premiums.

MR. PFEIFER: Will the rewording of XXX include an exemption for variable UL plans that have a no lapse guarantee in excess of five years?

MR. MAVES: Yes. All variable UL plans will be exempt. I have not seen any such products as you described, but that does not mean that there will not be such products in the future.

FROM THE FLOOR: You seem to be coming close to using the Canadian approach. Why haven't you gone to that totally?

MR. STANLEY: Well, I'm also on the Academy Life Committee, and we wrote a white paper in 1991 related to just some concepts on how to apply the current valuation law to some contemporary products that it really didn't fit. The theme of that paper was that it's appropriate to have fairly liberal interpretations of formula reserves because we have the valuation actuary concept in place, and if this results in weak reserves on a formula basis, the valuation actuary will catch it. And we felt pretty good about that concept, but I have to admit that we got our head handed back to us on a platter from the regulators. They were not ready to fully move towards the idea of the valuation actuary and complete dependence upon that professional judgment.

So we're dealing with a spectrum of where we used to be with cookbook formula reserves. And we have the valuation actuary, the Canadian approach, that is wide open for the discretion of the professional, and we're just taking a step in that direction. But it's a long process and you can't get from A to B overnight, and I'm not sure when or if we ever will get fully to the Canadian approach, given the size of the industry, the number of companies, and perhaps the lack of cohesiveness among the regulators, the industry, and the profession.

MR. ROSEN: I have a general question based on your last comment, Denny, but I'd be more than willing to have anybody respond to it. Why is it that the regulators seem to be willing to allow the actuary to accept total liability, but no authority?

MR. STANLEY: You get what you take, I guess. I don't think I really have an answer.

MR. ROSEN: I'm sorry. It wasn't perfectly clear. As far as the valuation actuary concept goes, in some states, specifically California, there is a complete liability on the part of the valuation actuary down to a personal liability, if you believe the current wording. However, based on your last statement, the regulators aren't willing to accept the judgment of the valuation actuary in setting certain assumptions. It seems somewhat inconsistent and a little consistent with our federal government allowing, in some cases, people to die for their country, but not to vote.

MR. STANLEY: Well, I guess I would step back though. It's the formula reserve concept, and the cookbook, and the auditability of it. You know regulator's are comfortable with formula requirement. And as we move in new directions, this comfort is eroded.