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CURRENT DEVELOPMENTS IN FINANCIAL REPORTING

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This forum will present the latest developments at the FASB, AICPA, NAIC, SEC, and Actuarial Standards Board (ASB).

MR. CRAIG R. RAYMOND: The financial reporting breakfast was a very good program that covered a wide range of financial reporting topics. What we would like to do in this session is to follow up on that. We will elaborate on some general financial reporting topics with a couple of very specific topics of interest. These are topics that, rather than describe what happens, describe what's happening. They are the types of things that I think we, as actuarial and financial reporting professionals, need to be thinking about and concerned about. I also think they are the types of things we should consider getting our voices heard on and involved with in the industry. For this forum we have assembled an esteemed panel.

Our first speaker is Helen Galt. Helen is the company actuary and the appointed actuary for Prudential. She is responsible for the coordination and oversight of all actuarial activities for Prudential as well as its risk management for those operations. Helen will talk about a very specific issue with regard to the valuation actuary opinion that is of interest to everybody who has to sign an appointed actuary opinion.

Then we will follow up with Errol Cramer, who is senior actuary at Allstate Life. Errol is Allstate's appointed actuary and handles financial reporting responsibilities. Errol is also the co-chair of the American Academy's Task Force on the Annuity Valuation Law (AVL). Errol will talk about the effort to revise the AVL.

MS. HELEN GALT: I would like to comment today on a valuation actuary issue that is of particular interest to me and I hope to the rest of the group here. As I am the appointed actuary for Prudential, I take valuation actuary topics very seriously. I feel that my professional reputation and my personal assets are on the line when I sign that opinion. So my motivation is to make sure that I and the rest of the valuation actuaries at the Prudential are complying with both the letter and the spirit of the laws and regulations. Sometimes that is not particularly easy, so I hope that we and the insurance regulators can work together to achieve more effective and efficient compliance. I will focus on one of my favorite topics—the "this state" requirement.

As you know, the actuarial opinion memorandum (AOM) regulation says that the opinion paragraph should include the following language —"the reserves and related actuarial values concerning the statement items identified below meet the requirements of the insurance laws and regulations of your state of domicile, and also are at least as great as the minimum aggregate requirements required by the state in which this statement is filed."

This is a very simple statement, but it raises many pragmatic issues that make me lose sleep. There has been an NAIC working group formed to document and propose some resolutions for the kinds of issues that we'll talk about. It consists of Shirley Shao, one of my associates at Prudential, Donna Claire, of Claire Thinking Inc., Harold Phillips from the California Insurance Department, and Troy Pritchett from the Utah Insurance Department.

What are the issues? First, there are some challenges with making sure that we know what the minimum aggregate requirements are in each of the states. There are several sources of information that are available to us. First, there's the *Life & Health Valuation Law Manual* from the American Academy of Actuaries and the Society of Actuaries. There's an electronic abstract of the manual that Milliman & Robertson has put together and the *Red Book* volumes from the National Insurance Law Service (NILS) Publishing Company. There is also a CD-ROM version from NILS, and *Valuation & Policy Form Compliance Service* volumes from the ACLI.

However, each of these sources tends to come with a disclaimer about the timeliness and the completeness of the information. For example, the *Life & Health Valuation Law Manual* says, "The summaries in the manual have been provided to assist the actuary in identifying differences in valuation laws of various states. However, they're not a substitute for thorough review of the laws, regulations, bulletins, and other correspondence of the states." It says specifically that "The summaries in the manual may be subject to error."

At Prudential, the actuaries in each of the major lines of business are responsible for researching the valuation requirements that apply to their particular lines. As each state passes the new version of the standard valuation law, we come back to all of these sources and, in most cases, go back and read each state's laws and regulations in great detail to make sure we understand the rules; and that has required a great deal of effort.

One of my particular concerns is state requirements or interpretations that have never been formally incorporated into a law or regulation. For example, one large state recently resurrected a 20-year-old letter or bulletin on term insurance reserves which imposes different requirements from the recently adopted Guideline XXX. We are currently researching the implications of that letter for Prudential term insurance reserves. I fear that in the past, old letters or ancient bulletins that may have been sent by the states, other than our state of domicile, have other interpretations of laws or regulations that we may not be aware of.

Another practical issue is that letters or bulletins are often sent out very late in the year. For example, last year, one state sent a letter at the last minute indicating its interpretation of reserve requirements for nonincidental death benefits on annuities. That sent us into a scramble to figure out whether and how we were complying.

Another area that presents problems is "tables approved by the commissioner,"—for example, for various kinds of group coverages. Now, we believe that we have a very clear understanding of what the state of New Jersey requires. However, other states may have reached agreements with their domestic companies that, again, we may not be aware of. There also seem to be other situations where there are unwritten agreements or understandings with domestic insurers about how certain policies or benefits should be valued. In

fact, the *Valuation Law Manual* documents certain state requirements that apparently have never been put in writing.

I've also heard that in some cases the official valuation requirements are being waived, because the insurance department would like a more modern law or regulation to be adopted, but it hasn't quite gotten around to it. Finally, I have concerns about the definition of the word *aggregate*. For the state of New York, we know that reserve adequacy must be demonstrated separately for certain major lines of business. How many other states have defined less formally different aggregation requirements?

How can the problem of incomplete or inconsistent sources of information be resolved? Now, I should emphasize that any ideas that I toss out here today are just ideas. They haven't been officially endorsed by anybody. One resolution to the first problem is to have some sort of a central repository system to summarize each state's variations from the NAIC model laws and regulations, as well as relevant circular letters, bulletins, interpretations, or guidelines. The states would be responsible for keeping the system up-to-date or at least verifying the accuracy of the information that someone else has compiled. Then the valuation actuary would be required to comply with each state's requirements as stated in that repository.

What are some of the pros and cons of this idea? If we had an official central repository of clearly noted variations, it would reduce the burden of the research being done by each of our companies. Obviously, the compliance responsibilities of the valuation actuary would be more clearly defined, and I think that regulators could also be more confident that valuation standards are being followed. On the other hand, companies would still need to understand and comply with all of the various state variations. We would still have an issue of eleventh hour updates to this repository that could be very difficult to deal with. Obviously, the states would have to devote resources to making sure that the repository is accurate. There are some other issues associated with this idea too. Who would be in charge of this system? How would it be funded? Would the states be willing to establish cut off dates, so that all of the valuation requirements that apply to calendar year 1995 would have to be defined by, say, October 31, 1995? Where would the legal status of this system be referred to? Would we refer to it in the Standard Valuation Law (SVL), in the AOM Regulation, in the NAIC actuarial guideline? It would have to have some official status.

In discussing this first issue, I assumed that the status quo would continue. That is, that the AOM regulation would continue to contain the "this state" language as it is currently written. This next issue relates to changing the nature of the compliance with the "this state" requirement to make compliance easier. As you know, even if states have adopted the SVL without any variations from the model or adopted a model regulation without any variations from the model, the effective dates of adoption can vary quite a bit. For example, some states adopted the dynamic interest rates for annuities as early as 1981; others as late as 1985. That can lead to some very substantial differences in reserve requirements.

For those of you who have not been looking ahead, you might want to review what happens to you when Arkansas and Oklahoma pass the SVL and model regulation. Because they

didn't act on dynamic interest rates until 1985, their minimum reserve requirements on such lines as group annuities are much higher than normal. In Prudential's case, we have estimated that the difference amounts to hundreds of millions of dollars. We have not estimated the effect for all lines of business.

With regard to model regulations, some states have never adopted certain models and so there is no specific guidance at all. Other states still have older versions of certain models on their books, while others have newer versions. One example of this kind of complexity is the fact that 22 states still have the older version of the minimum death benefit guarantee reserve model for variable life; and a handful of states have the newer version of the model, which takes quite a different approach to the reserve calculation.

Another example of this problem was written up in the latest issue of *Contingencies* (Prescott, Jeffrey, "Group Long-Term Disability Minimum Reserve Standards," 7, no. 3 (May/June 1995): 44-46.) In December 1988, the NAIC adopted a model regulation for health insurance reserves that encompassed group health. For the first time we had a model regulation that spelled out the minimum reserve requirements for group long-term disability. The model was subsequently updated in 1989 and 1993 with changes that affect the valuation interest rate and the morbidity tables that can be used. Now, 13 states have adopted one of these versions of the regulation with different effective dates.

Table 1, from the *Contingencies* article, summarizes the kind of mess this creates. Note there are different effective dates for the regulation and the introduction of the 87 Commissioner's Group Disability Table (CGDT) Table. There are differences in whether or not you can use your own company's experience in years three through five, and there are differences in the permissible valuation rates. Now, I think this is an outstanding example of the complexities that companies are trying to deal with today, and a good indication of the amount of resources that one has to devote to figuring out what these minimum requirements are.

MR. RAYMOND: Long-term disability (LTD) is of real interest to me. This past year was the first time I was the appointed actuary for the Hartford Life Companies. My background is mainly individual and I never thought about LTD before. When I got to the point of having to sign the statement for our group company, the type of chart I had to use made me very nervous. I had an interesting experience talking to some actuaries from various companies. I found a number of them who, when I asked how they deal with this, said they qualify their statement with "to the best of my knowledge" and then strive for ignorance. I was somewhat troubled by that answer.

I made an active attack on this and contacted a few of the states that had the more stringent regulations and found a similar reaction from the regulators in a couple of the smaller states. They were amazed that nobody had ever asked them the question before of how to deal with this, because their requirements were out-of-date and maybe more stringent than the regular one. I found they were fairly cooperative. There were two states in particular that I dealt with that were willing to agree, in writing, to a different interpretation.

TABLE 1
SUMMARY OF GROUP LTD
MINIMUM VALUATION STANDARDS BY STATE

State	Effective Date of Regulation	Effective Date of 87 CGDT	Optional Use of Experience Years 3–5	Valuation Interest Rate
California	1992	1993	Yes	SPIA less 100 bp
Colorado	1993	1993	Yes	SPIA less 100 bp
Connecticut	1993	1994	No	SPIA less 100 bp
Idaho	1993	1994	No	Whole Life[a]
Maine	1991	1993	Yes	SPIA less 100 bp
Michigan	1994	-----[b]	Yes	SPIA less 100 bp
North Carolina	1994	1994	Yes	SPIA less 100 bp
Pennsylvania	1993	1993	Yes	SPIA less 100 bp
South Carolina	1991	1992	No	Whole Life[a]
Texas	1992	1994	No	SPIA less 100 bp
Virginia	1994	1994	Yes	SPIA less 100 bp
Washington	1992	1993	No	Life[a]
Wisconsin	1992	1992[c]	No	Whole Life[a]

[a]The statutory valuation interest rate for life insurance varies by the guarantee duration of the contract. Idaho, South Carolina, and Wisconsin refer to the statutory valuation interest rate for whole life insurance without explicit definition of this rate. Washington refers to the statutory valuation interest rate for life insurance without explicit definition of the rate. These versions are ambiguous as to whether the maximum statutory valuation rate for GLTD claims is intended or permitted to vary by claim according to the length of the benefit period.
[b]Michigan requires use of the 87 CGDT for all claims, including claims incurred prior to the effective date of the laws.
[c]Wisconsin requires use of 64 CDT for incurrals prior to January 1, 1987; either 64 CDT or 87 CGDT may be used for incurrals of January 1, 1987, through December 31, 1991.

One state did not realize that it did not have the most recent version of the LTD model and was willing to agree that if we followed it, that would meet its requirements. What disappointed me was that nobody else had ever asked the question. One individual asked me what other companies were doing and I said I didn't know.

As a profession, we've been sitting here and either ignoring it or finding other ways of getting around it without dealing with the problem. I think in general, if we take the types of approaches we're talking about here, there's regulators out there willing to listen. They're not trying to make this impossible for us, but we have not voiced much of an opinion yet.

MS. GALT: You were fortunate that you managed to get an agreement in writing as to what you planned to do. That isn't always possible. A partial resolution to this effective date problem might be to mandate compliance based on the effective dates of the domiciliary state's adoption of changes to the SVL, for example, interest rates and mortality tables.

Now, what are some of the advantages and disadvantages of that? Again, obviously it would reduce the amount of research and the amount of computations that have to be done to try to figure out whether or not you're complying. It should improve compliance

because at least compliance would be much easier and hopefully people would be more motivated to actually try to comply rather than plead ignorance.

On the other hand, states would have to concede their rights to control the effective dates for foreign companies. Certainly one concern would be whether this might require states to revise their SVLs or their regulations to recognize this kind of concession. Another difficulty, is that it addresses only one aspect of this whole issue of the state variations—and that's the effective date issue. This is kind of a messy and incomplete solution to the problem though, because it leaves several other sticky issues to resolve.

First of all, it probably doesn't work as neatly when you're talking about regulations rather than the basic SVL, because it's quite possible that your state of domicile may not have adopted any version of a particular regulation. It does not address situations where the state of domicile's interpretation of the valuation requirement may be different from another state's interpretation. Of course, we all know a great example of that is the various interpretations of what Commissioner's Annuity Reserve Valuation Method (CARVM) means. Again, we have this issue of where the legal status of this kind of waiver would be referred to.

Let me move on to perhaps the most important question. The real issue here, of course, is what level of reserves is adequate to assure that a company will be able to meet its obligations to its policyholders or contractholders. Now, one way of making absolutely sure that you're meeting all of the states' requirements would be to find the most stringent reserve basis for each major category of business for each year or years of issue, and then add them all up and use those as your resulting reserves.

Now, from a compliance point of view, that would yield a safe result, but it certainly seems to be excessively conservative and I doubt if that was anybody's intention here. Such an approach would also seem to be particularly unnecessary given that the valuation actuary is responsible for doing asset adequacy testing to assure that formula-based reserves are indeed sufficient to meet the company's promises. In fact, one could argue that the whole exercise of having to look at the reserve requirements in ultimately each of the 50 states seems inconsistent with the valuation actuary movement.

Another way of complying would be to incorporate all of the rules into one's valuation system, run the system 50 times, and take the biggest number. That's probably an impractical solution too. Of course, you'd have to check the New York requirements along the way. So what is a possible resolution here? It would be nice if each company would be permitted to rely on the valuation standards of its own state of domicile, provided that the state of domicile is accredited. If the domicile state is not accredited, then the valuation standards might be based upon some agreed upon set of NAIC models with some agreed upon set of effective dates. Now, this proposal would seem to be consistent with the philosophy that in order to obtain accreditation a state should have substantially similar key laws and regulations on its books. In fact, it would seem to reinforce the whole notion of accreditation. It also is consistent with the reciprocity provision that is in the SVL in Section Two. It would certainly simplify the state's compliance activities. While it is theoretically possible for each state to audit or review reserve compliance for every company that does business in its state, the cost of that would certainly be prohibitive.

If we instead went in this direction, state resources could be focused on a more thorough review of their domestic insurance company's valuations. There wouldn't be any need for insurers to compute and establish the most stringent reserves to comply with the variations in all the states. Instead, they could rely on state of domicile's formula requirements, and then the valuation actuary's responsibility would be to make sure to test those reserves for adequacy.

On the other hand, again, the states would be conceding some of their regulatory authority over foreign insurers. The process of defining what models to use and what effective dates to use for those situations where state of domicile is not accredited could be very time-consuming and perhaps contentious. Again, there's this issue of where the legal status of such a system would be recognized, but overall this certainly seems to be the most effective and efficient approach to this whole issue.

Now, obviously the real issues here revolve around designing a system that (1) gives comfort to the regulators that reasonable reserve requirements are being established, (2) allows companies to comply with those reserve requirements with confidence as to what the standards are, (3) keeps the cost of the regulatory oversight and the cost of compliance to the companies in some sort of reasonable bounds, (4) lets the valuation actuary concept work, and (5) helps the accreditation concept work.

The working group will be presenting a report to the NAIC Life & Health Actuarial Task Force (LHATF) in June. This issue is very complicated but, again, I would encourage you to share your concerns and ideas with any of the regulators with whom you deal or with the members of the working group so we can work together and find the best possible solution.

FROM THE FLOOR: It seems to me that if you can get the accountants to agree to it, then relying on the codification process to help with this issue could be worthwhile.

MR. ERROL CRAMER: Yes, I think that's an excellent suggestion, because the qualification standards acknowledge that there could very well be differences of other items by state, such as handling of assets. I don't think there's anything sacred about reserve liabilities. It's the only piece the balance sheet that requires you to follow a specific state. It's an extra requirement that I think was just purely historical. We have Esther Milnes, who's Helen's colleague. When the valuation law first passed, Esther was the one who proposed just accepting the home state as long as they're accredited. That's normally how statutory accounting is done.

There was one particular state actuary who didn't want to go along with it because his state has many variations. He wanted to keep that, which is unfortunate because I don't think there was a ground swell. There's no public interest. I think it was purely historical, and now it has become ingrained and does not serve any public purpose.

MR. RAYMOND: I think the requirement is actually part of the valuation law. The LHATF will inform the accountants about any changes that need to be made for consistency to the codification process. I think where this fits in will get back into the codification process.

I have become fairly actively involved in the last few years at the NAIC level and have gone to many meetings. One of the things that I've noticed is that it's easy to sit back in your office and read all the stuff you get. You can read the report from Helen's group and nod your head and say, "Yes, I agree with this," and then complain six months from now because nothing is happening. The NAIC receives very few letters of support. As I said, I've found that there's very little awareness that this is something that troubles actuaries. If you have opinions, even if you agree with what's being done, I'd encourage you to put it in writing and have that opinion seen and heard by people because it does make an impact.

Our next speaker is Errol Cramer. Errol, as I said earlier, is co–chair with Doug Doll from of the American Academy's Task Force on Annuity Valuation that is rewriting the annuity valuation law. Errol will give us an update on where that stands.

MR. CRAMER: I would like to provide some background to the Academy's Annuity Valuation Task Force and discuss its goals and timeframes.

Let's start off by looking at some of the valuation issues. The list below isn't all inclusive but, rather, gives you an idea of some of the issues that have come up in regard to CARVM. Many of you are probably familiar with these issues, for example, continuous versus curtate CARVM, GIC valuation plan type, CARVM for variable annuities, modified guaranteed annuities, prefunding of cliff surrender charges, and so on. There is a whole slew of issues that have arisen and which have been addressed in the past on an ad hoc basis.

Annuity Valuation Group—Valuation Issues

- Contingency Benefits (for example, waiver of SC)
- Continuous vs. Curtate CARVM
- GIC Plan Type
- Annuitization Options/Two-Tier Annuities
- Variable Annuities
- Modified Guaranteed Annuities
- Market Value Annuities
- Lag in Valuation Rates
- Group Products Exempt from CAROM
- Appropriate Conservatism for Ultra Long Annuities
- Pre-funding of Cliff Surrender Changes
- Appropriateness of Change-in-fund Method/Plan Types

The main group of the NAIC dealing with this is the LHATF's Annuity Working Group. The LHATF Annuity Working Group was formed to address two very specific issues, that is, nonforfeiture and valuation, and most of its activity has been directed towards nonforfeiture. There is a feeling, though, that annuity valuation is just as important and, it may be that the NAIC cannot go forward on the nonforfeiture side until it has an idea of where the annuity valuation is going to end up. So the focus certainly is on the valuation issues for now.

Regarding industry involvement, there was an AAA group in the 1980s dealing with valuation issues on an ad hoc basis, for example, trying to get CARVM treatment for

variable annuities. The culmination of this group's efforts was published in a report in 1991. Many of you may not have seen this report because it was not widely distributed. Rather, it was a report to the NAIC LHATF that interpreted current CARVM for contemporary products. This was not an attempt at a revision of CARVM, but rather set out a way in which CARVM could be "interpreted" to fit where not originally contemplated by CARVM.

It soon became apparent that there was a need to address issues that fell outside CARVM. Accordingly, in 1992 the NAIC appointed a Technical Resource Group (TRG) that presented its report to the NAIC in 1994, setting out proposals for principles underlying a new CARVM. The feeling, though, was that many of the issues that had come up in the past few years had since been addressed, for example, by Actuarial Guideline GGG, and maybe there was no longer a need to go forward with a new law. Developing a new law would be a very tedious process and it was questioned whether this was the most important priority for the NAIC.

In spite of these concerns, the LHATF felt there was a need for a clean-up or re-write of CARVM, and the result was formation of the AAA's Annuity Valuation Task Force. I'm not sure what the standing of the TRG is, but it was felt that a CARVM re-write was an academic actuarial issue better handled by the AAA rather than an industry group. I had been involved in all the prior groups, and now I co-chair this current Task Force with Doug Doll of Tillinghast.

Let's look now at the Task Force's goals and time frames. The first point is the desire to incorporate all guidelines, interpretations, and so on, into law. There is concern that sometimes the NAIC has had to stretch the law in determining an interpretation or guideline. This leads one to question the legal standing of a guideline, whether it fits in with the current law, whether it can be legally enforced, and so forth. There is an opportunity now to make explicit what is and isn't the law.

The second point is the decision to retain traditional valuation principles where possible, that is, this should be viewed as a rewrite versus an overhaul of current CARVM. This is at the request of the NAIC who feel it is appropriate that current CARVM principles be retained as much as possible. Let's discuss further the distinction between an overhaul versus a rewrite. For example, an overhaul might include going to a GAP-type basis where the reserve is the account balance, with a separate deferred acquisition cost (DAY) based either on actual or formula expenses, and any additional reserves determined by cash-flow testing. This would be fundamentally different than current CARVM. However, the Task Force's charge from the NAIC is to take the existing law and existing principles, and rewrite them into something that's a bit more logical and a bit more practical.

In terms of the time frame, the NAIC has requested that the Task Force prepare a report by year-end 1995, outlining a proposed framework for a new CARVM. If all goes according to schedule, the report will be discussed by the NAIC and will be exposed publicly within 1996. Although no time frame has been formulated for acting on the Task Force's report, I anticipate the full exposure and discussion period will run through at least all of 1996. Allowing time necessary for the individual state adoptions, I don't foresee any new CARVM being in place prior to 1997 or 1998. Note that this would apply only to new

issues. An agreement with the NAIC is that a new CARVM would be a prospective application only. Regardless, I'm not sure if any prior valuation laws have ever been adopted retroactively.

The Task Force has an aggressive workload and will be meeting monthly through 1995. Although, the Task Force is open to nonmember attendees, in reality, it's a small working group of members very much down to the nuts and bolts as opposed to general principles. Public awareness and participation will likely have more appeal after a proposal has been sent to the NAIC and goes through the public exposure process.

Recommendations of the prior Annuity Valuation TRG that I mentioned came out in 1994 with a proposal for CARVM valuation principles. This report serves as the basis for the current Task Force's rewrite of CARVM. The following sets up the major points relating to the valuation rates.

The first point is that valuation rates be based on the treasury yield curve. Currently, the valuation rate is based on Moody's Bond Yield Index which is approximately a 15-year, single-duration index. The main result of using a yield curve as opposed to a single-duration index is that, under a normal, upward-sloping yield curve, longer-duration annuities will tend to have higher valuation rates. Under the current valuation law, the longer the duration of the annuity, the lower the valuation rate.

The second point is that the lag in valuation rates be minimized. Under current CARVM, there is essentially a six-month lag as the valuation rates are based on a 12-month average, ending mid-calendar year. This can result in inappropriate valuation rates especially for issues in the latter half of the year when market interest rates have moved significantly up or down.

The third point is the concept of "refreshing" of the valuation rate. There are two basic situations where refreshing would be applicable. One has to do with resetting the credited rate. For example, if a company invests assets for a particular product for a five-year horizon and resets the rates in the sixth year, the original valuation rate would bear no relation to the sixth-year portfolio rate or credited rate. It makes sense then that, at least periodically, certain valuation rates be reset.

The other situation in which refreshing would come into play is for very long duration liabilities, where, for example, the valuation rates are based on assumptions about interest rates 30 or more years hence. As time passes, the valuation rates could turn out to be very inappropriate. Although the basic concept of refreshing has been proposed, the actual mechanics still need to be worked out and this has become a major challenge for the Task Force.

The final point is that smaller margins for adverse deviations are needed than would be required in the absence of valuation rate refreshing, reserve adequacy testing and risk-based capital. The thinking is that there is now a clearer distinction between a reserve level needed for reserve adequacy versus company solvency.

The 1994 TRG major proposals regarding valuation methodology are as follows. The first point is replacing the greatest present value concept by something that's more of an actuarial present value, that is, allowing contingencies for utilization of certain benefits as opposed to assuming the worst case. The second point is that a certain amount of actuarial judgment should be permitted where appropriate. This already applies on the health side and for certain group annuities, for example, assumptions as to early retirement ages for terminal funding annuities.

The third point is setting maximum assumed spreads between the valuation rate and projection rate for cash value annuities. This is a new concept and requires some explanation. For example, if the maximum spread is 1.5%, future benefits in the CARVM calculation would be projected using the greater of the valuation rate minus 1.5%, and the guaranteed rate. The concept is that even though an insurer might be able to drop its credited rates down to its guaranteed rates, in reality the insurer could only do that if its portfolio rates were reduced. Market pressures and commitments in the way policies are illustrated would act as a restraint on dropping rates down to their guarantees.

The final point is the need for a gross premium floor for noncash-valued policies, such as GIBS and restricted or no-surrender annuities. Currently, New York has a 95% of fund balance floor for certain GIBS, and Guideline GAG has a 93% floor for certain annuities with current anodizations options. Rather than having an artificial floor, the proposal is to define the floor in terms of a gross premium type of reserve.

The Task Force is responsible for fashioning out a new CARVM from these proposals. The Task Force has set out for itself three principles under which to operate: first, there should exist a reasonable expectation that the reserves be adequate to meet the liabilities; second, there is a logical relationship between risks and reserves; and third, practicality should prevail.

Let's look now at some examples where the above three principles have come into play. For example, it does not appear reasonable that the valuation rate be based on current earnings yet benefits be assumed to drop to minimum policy guarantees. Also, it does not seem reasonable to set up significant interest "deficiency" reserves because of a formula difference in the valuation rate versus the credited rate where there is every likelihood the credited rate could be supported from portfolio earnings.

Regarding the need for a logical relationship between risk and reserves, it seems evident that if a product has more risk, it should have higher reserves, and if it does not have more risk it should not be penalized. Currently, a minor policy provision or change in policy design may not have much impact on risk but could significantly increase or decrease the CARVM reserves.

Regarding the need for practicality, it should be unnecessary to perform a large number of calculations for no added benefit. For example, a theoretically precise application of the greatest present value calculation under CARVM might require considering an infinite number of possible combinations of partial withdrawals, free withdrawals, and so on. It's not a very practical task and may not necessarily result in any material impact on the amount of reserves calculated.

The following are the Task Force's six working list items. After six months of meetings, the Task Force is currently working on the first item which is the handling of cash surrenders and annuitizations, that is, the basic CARVM for an single premium deferred annuity (SPDA).

The second item is the choice of appropriate valuation rates. As mentioned previously, valuation rates will be based off the treasury yield curve. Items to resolve include determining how many rates and what margins, or what factors to multiply or add to the treasury rates. The third item is how to handle benefits besides surrenders and annuitization. The fourth item is how to determine a reserve floor for annuities without cash surrender values.

The fifth item is to determine a practical way to refresh the valuation rate. The 1994 TRG had set out a proposed methodology but this could be quite cumbersome to apply and I don't think the industry would be happy living with it. To understand the potential complexity, consider a series of valuation yield curves that vary by issue year (or month), by historical trail of changes in market rates, and by product type. All this has to be simplified into a workable solution.

The sixth and final item is justifying a substantial reduction in reserves for certain ultra long annuities. The biggest impact of the proposals would be for these annuities. Under Guideline IX, certain non-level annuity payments are "carved-out" and reserved using conservative valuation rates. This typically applies to structured settlement annuities. The "carve-out" concept would no longer apply under the proposal and this could result in a substantial reduction in reserves for these specific products. However, this appears to be a situation where the current valuation requirements may not be logical. Nevertheless, it is necessary that justification and analysis be provided for any significant change in current reserve levels.

MR. RAYMOND: I know many of us become surprised when we see the final result of things that we thought had limited application, especially with things like GGG and what became of Guideline XXX last year. I know a few people who, when they hear work is progressing on a new annuity valuation law and interpretation of CARVM, immediately react by saying, "They're just trying to solve the problems with traditional SODAS and how you value them." Errol's group's project will affect all annuities, including some annuities that aren't covered by CARVM currently, because we're supposed to bring in group annuities. It is an all-encompassing law that includes group annuities, separate account products, and deferred and on-benefit annuities.

I think this project will affect everybody as a very major change in the way we value annuities. I hope we'll see your active involvement in the process as we move forward.