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CURRENT DEVELOPMENTS IN FINANCIAL REPORTING

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Speakers: DONNA R. CLAIRE
FRANK P. DINO

Speakers will discuss the latest developments at the NAIC.

MR. FRANK J. BUCK: I am the chairperson of the Financial Reporting Section Council. This program is an NAIC update, and we have two speakers: Frank Dino and Donna Claire. We will concentrate on matters of the NAIC. At the recent NAIC meeting, XXX and GGG were both passed.

The first speaker is Frank Dino. Frank is the chief actuary of the Colorado Division of Insurance, and he has been there for a number of years. He started as a teacher, which is one reason why he seems to speak fairly well. Frank has recently been appointed chairperson of the NAIC Life and Health Actuarial Task Force following John Montgomery, and he will talk to us about his vision for the future, where that Task Force is going, and how he is going to change everything in the regulatory environment of the NAIC.

Donna Claire is president of her own consulting firm, Claire Thinking. She is a member of the Board of Governors and a member of the Life Practice Council of the American Academy of Actuaries. She has been recently appointed head of the SOA's Task Force on Life Nonforfeiture. Donna has headed up the Life Actuarial Practices Task Force, and she has been instrumental in the formulation of New York Regulation 126 and in the whole concept of the valuation actuary.

MR. FRANK P. DINO: Just to get a feel, how many people attend the NAIC meetings? (Not many.) The NAIC, the Life and Health Actuarial Task Force of the NAIC, conducts a lot of business that affects our lives. You really ought to get involved. If you do not go directly, I hope that maybe you or other people from your company at least follow it through the professional associations, the ACLI, or whichever else. But the Life and Health Actuarial Task Forces over the years contribute a lot of regulation and documents and standards and rules that you have to live and be governed by.

John Montgomery was the past chairperson (he is retiring from the California Insurance Department in June 1995). There were several models that he had started that have not come to fruition. Of those, the annuity nonforfeiture law, the life nonforfeiture law, and the annuity reserve standards, or the commissioners annuity reserve valuation method (CARVM), are all currently open and on the table. Although things have been changing over the years and we do try to monitor problems and policy forms and current needs of regulators and industry, three of the most significant of the four models that affect our everyday lives are currently on the table. We have an opportunity right now to change the direction of how things will look in the future. We really need to take advantage of this and tie everything together and do what is necessary to get very good models, very good standards, that will last the next decade. I do not want to go in and start patching up little problems here and there.

Currently the annuity nonforfeiture law has been in process for about four years. There was an industry advisory group that originally put it together. It came before the Task

Force, and it had many ups and downs. In December of 1994, the Life Task Force actually approved the current draft of the model and sent it to the "A" Committee, its parent committee, which must also approve it. At that level we requested that the "A" Committee actually not adopt it, but put it out for exposure, and we have been actively working during that timeline between then and now to correct a few final problems that we believe are correctable so that the model, in fact, can be adopted come June 1995. So we see the Annuity Nonforfeiture Law significantly changing and having some different standards.

The new law will have different products that will be permitted to be offered that were not able to be offered under the old law. It will have a significant impact on reserving and reserve reporting. The prior nonforfeiture law set a very specific standard, but the current nonforfeiture has a two-stage determination of benefits for the deferred annuity, the account value times the guaranteed purchase rates, which is the current standard, but the law also has a standard to use the current purchase rates, which is something that has not been in the current law. I see that as being a material issue that will affect all valuations and all numbers that come out of that.

The life nonforfeiture law has had a more rocky road. It has been in place, I guess, for close to nine years. It has had many problems over the years. It has changed directions and had several restarts and refreshers on it. Back in December 1994, there was a motion made by Commissioner Wilcox to defer any further development on the model until we could really get our hands around what we are trying to do and what we are trying to obtain from the model. So we stopped development.

We have not come out with any drafts since then, and I have gone back to, "What are we trying to do?" That is, we are going back to basic principles. We have been discussing what we want to accomplish out of the model. Where do we want it to go? We looked at exactly what the current model has. We went back to some of the old reports. We went back and looked at some different countries' standards, and we issued a position statement that has been adopted by the working group and the Task Force.

One of the significant issues that will affect how that model gets developed is that we are looking at a possibility of not requiring or mandating cash values. We went back to say, "What is nonforfeiture?" Nonforfeiture is being able to give the policyholders a return for their money if they contributed too much in the early years. We discussed it at length, and there are very many people who want to stay with the old regime of, if you have overpaid, the company gives you back cash. You are entitled to it. But what we decided on was that, if you have overpaid in the early years for the expenses and benefits incurred, you are entitled to something, but not necessarily cash. So we will be requiring some form of paid-up benefit, and we are also looking at requiring maybe an annuity, but we are considering—and I stress considering, because it is not concluded and we do not have consensus yet—of not having mandatory cash surrender values.

The product design may still want to have cash surrender values or the industry, and the public may dictate that it still wants that type of product form, but we will allow the industry to price for that kind of product. If you want to call it a put option back against the company as I think Walt Rugland has always referred to it, then you would be able to price for that differential.

The old model nonforfeiture law was clearly set on the prospective formula basis, setting up all the standards, setting up the maximum expense allowance, the adjusted premium, setting up the mortality tables and the exact tabular formula. When universal life came out ten years ago and when this model first started, it started developing into a retrospective accumulation model. One of the complaints that the industry has always had was that the two methods were not exactly consistent with each other, that companies could devise two different products with the exact same benefit return to the consumer and the same premiums, yet the two models would develop two different sets of nonforfeiture values. I guess you have to admit that is a valid point, that if you ignore what something is called or how you get there, if the consumer has the exact same benefit stream, we should hope to get to the same answers.

So we are looking at trying to eliminate two sets of standards and have only one standard that affects everything. What this means is that we are going back and revisiting the old rules, the old prospective tabular formula with adjusted premium definitions and everything else. In the model law there are about four pages just defining all those formulas and how to do that present value calculation.

Instead of assuming that that is the right answer and trying to get the universal life model to match that, what if we assume for a moment that that was never the right answer. Maybe that was good 50 years ago in the 1940s when it was developed, but what if the prospective formula is not right? We have asked the Society to conduct a study and a research project for us to consider the truest equity-based return indifferent of how complicated it may be. What is the right answer? If the goal of nonforfeiture is to have equity between terminating and persisting policyholders and to maintain equity and a fair and reasonable relationship between all policyholders of the company, what is a good way to get there?

What we are looking at right now is maybe we will start at least by analyzing it from an asset share approach and then compare that to the prospective model that we currently have and look at what we could do to basically rip up all the old rules. Forget the prospective model. What is one set of rules that would affect everything and give us one consistent, fair, and reasonable answer?

What that is going to mean is, if we could get this tremendous task accomplished, this gives much more discretion to the companies. You will have much more ability for product design and product innovation. You will have a general rule to follow of equity. You will not have a rule to follow that your product design must fit into this formula and you must take this benefit, plug it in here, multiply it out, and you have your answer. The days of nonthinking and just formula crunching have to come to an end. But with this comes added responsibility, because the responsibility of the ultimate equity between the products will have to be on the backs of the actuary.

So if we liberalize the nonforfeiture rules to some degree, we will tighten the surrounding principles and umbrella concerns around them, and the only person whom that could fall on is the actuary.

Many times companies will come to me as a regulator and say that we are interfering with business. We are interfering with product design. "What is wrong with this policy? Why can't I do this? It seems fine to me. Why can't we do this?" But because it does not fit

the statutory standards, we have no choice but to say no. We are looking at the possibility of changing that and eliminating that. You will have more freedom on design, but there will be significantly more responsibilities with it. Donna, do you want to add anything?

MS. DONNA R. CLAIRE: As Frank mentioned, he took over the Life and Health Actuarial Task Force and chaired it for the first time last month. I think at this point we have a unique opportunity as actuaries to make a major contribution to what we will look like in the 21st century. First, I would like to congratulate Frank. He has many good ideas and as long as he can keep going, I really think this can be accomplished. The project is on a very short time frame.

We have established the basic premises for the life nonforfeiture law. I would just like to read the first two: "To provide a minimum standard of return to the policyholders and not discourage or unreasonably restrict benefits or product design to the public while maintaining basic equity and operating in a sound financial manner." The second, just as important, is "To regulate at the least restrictive level to obtain desired results."

Many people, especially those who were not there at the Miami meeting, were not convinced that this will be changed, that we can really accomplish this, but right now we have a unique opportunity. Again, Frank has taken over. Bob Wilcox, commissioner of Utah, is an actuary. There are a number of strong new faces and also old faces that are looking at things a little bit differently. They realize that our competition has changed. Banks may get into some of our products, and so on. So I would strongly urge any of you who have any ideas to get involved.

For all of you who use Actuaries Online, I have put out a call for help. These basic principles really are what we should be shooting for. Exactly what is the definition, however, of fairness and equity? How do you define them? How do you come up with a formula that is completely fair or equitable? And also, quite honestly, the formula has to be able to be regulated. The regulators have to figure out what you are doing, too. You cannot just be a black box. I am chairing the Society Task Force that is looking into it.

Another thing we are looking at is, what are other countries doing? Right now the U.S. is the only one that requires cash values, and at this point we are thinking, "Well, why should we?" Other countries have faced some of the issues in terms of making sure the consumer is protected, so the Society research project will include finding out what other countries are doing, what the problems were, how they decided to solve them. In addition, there is an Academy Task Force working on assisting the regulators trying to define what the new law should look like specifically. But if we can do it, we at this point have a unique opportunity to take ourselves into the 21st century.

MR. BUCK: Before we move on, I would like to ask one question. We talked in terms of equity, and I think that is tremendous to give an equitable return to leaving policyholders. How do you plan to cope with the problem of the insurance companies investing long term? The policyholder has the right to get out at a short-term notice when interest rates could have fluctuated and the value of the underlying investments could fluctuate. How do you propose to cope with that in regulation?

MR. DINO: We are currently considering allowing in the life nonforfeiture law something that is currently being permitted in the annuity draft document, and that is to allow

for a market value adjustment and to allow that option at all times. Clearly it is something that the company would have to elect to have, because you could only enforce what is in your contract. So a company may not choose to have a market value adjustment in its contract and it is taking more risk, but the laws will allow you to exercise a market value adjustment if you put that in your contract. Also, by not having the cash value and only having a reduced paid-up or extended term insurance (ETI), you have the ability not to liquidate assets because you could simply keep them inhouse and maintain coverage.

The only cash-out option, so to speak, that will be mandated right now will be a life annuity. For example, if you have a whole life policy, 20 years in force with a $5,000 cash value, when you surrender, instead of getting that $5,000 in cash, which you could, again, put as an option, we will be mandating that that value must be available to purchase an annuity.

We may look at mandating certain settlement options. Again, you are buying an installment payout. You may have to be responsible for the $100 a month, but you do not have to liquidate all the assets, and you could control your investment portfolio a little better. Additionally, this should theoretically, help industry and improve pricing through some of the internal assumptions by preventing a lot more rollovers. This will eliminate the ability for agents to simply attack the cash value and keep switching policies from one company to another.

MS. CLAIRE: Yes, the thing is, by not requiring the cash values, we can design products where you actually can invest long. Insurance companies used to invest 30 years. They used to invest in industry for the long term. However, the problems with the early 1980s where people could cash out forced most insurance companies to look just short term. This way, if you have a product designed where you know the money is going to stay around for a while, we can lengthen the portfolio and actually change our investment philosophy, at least in part, back to what it used to be so we can invest for the long term, which can have a significant effect also in the investment marketplace.

MR. DINO: And what we hope is that it will have an effect and it will reduce prices. As regulators we want a good product and fair treatment of the general public. We want to give an environment to the industry to help the consumer. If we could improve your lives, we hope the industry could improve consumers' lives through better products and better rates. The ultimate goal is we would like better rates for the consumer. So this is not looking to say, "Well, we'll keep everything the same. We will just take more profit." I think we would be a little upset with that kind of a response.

MS. CLAIRE: Yes, the thing is, again, what we are looking at is benefits to the consumer, and we are not going to be eliminating any of the additional designs. What we are trying to do is let the consumer pick what he or she wants. If the consumer is really looking for term insurance or long-term death benefits, let him or her buy it. If he or she is looking for a product that is bundled, that has death benefits, also a possibility of retirement benefits, all wrapped in one product, perhaps even including such things as long-term care eventually, this way he or she can buy what he or she wants.

MR. DINO: There are some provisions of the nonforfeiture law that we could say maybe we have taken for granted and a lot of the provisions actually are protections to the company. Some of those areas that you have been accustomed to and that you like may

also have to change with this kind of approach. As an example, one of the very basic provisions of nonforfeiture says that you must offer a paid-up option to the consumer upon default of premium and then it goes on to say "and the company has the choice of what that option will be in its plan design."

To some degree, because the law says that the policyholder always has the ability to cash out under the current law, if he chooses not to, then the company is going to assume that it was selected against, so it wants to pick the nonforfeiture option that protects it a little bit. I am considering right now that that has to change. If we say that we are taking one consideration, one right away from the policyholder to cash out, then the company cannot also have the right of how to use the money without his choice. So if you think about it for a moment, the change of mandated cash value to optional cash value will have many repercussions.

Another one that is currently in the law right now, because of the cash-out right and the protection from the 1960s of the run on the bank, a provision was put in the law that says that a company at its option has the right to defer payment of cash values after request for a period of up to six months. Well, wait a minute. If we have just said to the policyholder, "You do not have a right to cash value," but if you sell a policy with a cash value and the consumer paid more for that right, how could the company unilaterally say, "We are not going to pay it," especially if you give the opportunity of market value adjustment? So many of the provisions of the nonforfeiture law will have to be changed and revisited to be brought in line with the whole goal of the ultimate protection that is being looked at. Everything has to be consistent.

MR. PETER L. HUTCHINGS: I was pleased to see among your basic principles that persisting policyholders should not be advantaged or disadvantaged by terminating policyholders. Perhaps this is an unpopular point of view, but today's insurance marketplace appears, at least to me, to include products that do not meet that standard. Now if we are moving in a direction of more company options and fewer constraints, how will we face a situation that is already unsatisfactory in this respect? How are we to avoid making it worse?

MR. DINO: I am glad you asked that. We do agree that current products do not necessar ily meet that standard. But liberalizing some of the standards does not necessarily mean that all of today's products will fit the mold, plus you could have more. Some products today will have to be redesigned. There are many products that we believe are problematical and for which the surrendering charge to the policyholder is too great. If you have been following some of the discussions at the NAIC, there has been a great deal of controversy around persistency bonuses, whether or not that in itself violates equity between terminating and persisting policyholders. But that is a very difficult issue and because it is difficult, you know what we did? Donna, Society of Actuaries, give us an answer.

MS. CLAIRE: Right now they are offering us a way to solve these problems and again the basic thing will be that the actuary will be certifying as to the equity, not only of every product but also the equity between products within a company to try to insure that you will not have unfair products out there, unfair in the terms of basically being supportable or being misleading to the consumer. Again, disclosure is going to be a very major issue here, too.

MR. DINO: We are looking at that, and again although there is no current nonforfeiture law that is currently being drafted, we are simply talking about getting a series of papers with outlines and principles and agreed upon bases before we start drafting a law. We do not want to start putting out a piece of paper to start editing when we do not have full agreement. But one direction that I am looking at, that has been broached with the Task Force and members of the Academy and Society, and is very similar to Standard of Practice 1, which deals with dividends, is that there will be a requirement in the law for actuarial certifications regarding this issue, assuring equity both within a policy and between policies of a company.

If you look at the actuarial opinion for Exhibit 8A in the annual statement right now, think of something like that being strengthened further. Then we are going to be requesting that the Society either start work on a new standard of practice or at least open Standard 1 and have that concept broadened to include all nonguaranteed element features of products, not just dividends for stock companies. This will go hand in hand with what is being done right now on the illustration disclosures, and we'll try to summarize that shortly.

FROM THE FLOOR: In a speech at this meeting, Dan McCarthy commented on a problem with the role of the actuary, and I think it is relevant to this. Dan observed that there is a debate about whether the actuary is a member of management or a closet regulator. I know many of us have heard that. Now, a sort of Gresham's Law applies—a bad product wipes out a good product. If the regulatory process puts this obligation over to actuaries and that in turn winds up being an actuarial sort of certification based on prejudging the situation, but if it winds up on the backs of the actuaries to decide whether a particular product fits the very broad principles that the regulations are suggesting, I think that you are propelling the actuary into being a closet regulator, exactly the role the company may have. I think there are problems with that. I am sure you have given this a lot of thought.

MR. DINO: I hope it does not go to that degree. Standard of Practice 1 talks about a plan of distribution of dividends. Consider that one step further. What if the company has to put together an overall plan—and let us call it a plan of equity—of all its products, both within and without. So within that plan then the company makes a written predetermination that one product line—this product line of all these categories of products—because of the investment of the company necessary to have an internal rate of return of X, and because of this designed product, the company will invest an average duration of so-and-so and will expect a certain kind of return on it. But another product, a health product line or a term product line or the fund-based product line, might have a lower rate of return, and the company will operate off a different margin and spread. The company will set all the rules down in advance of what is expected of the products. That is taking the actuary out of the regulatory mode. The company has to do its due diligence and determine exactly what it wants to do with its products, and then once it has that choice and that freedom and liberty, all I am saying then is live by it.

So let us say for a moment that for nonguaranteed elements that on the company's current product it wants to do a spread of 150 basis points to crediting. But then it closes out a plan code and because it is not a current product that is being driven by its agent, and it is still a very similar interest-sensitive product, it only credits those people 75 basis points. What is the rationale for having a different crediting rate between an open and a closed

block of business other than the agent's motivation? I would consider something like, for no other reason unless there was another reason why one product line had a higher risk that you had to have a different margin and justify that margin, then you cannot do it.

So put in your plans to justify what you want to do and then follow those rules. That plan will be available to the regulators, and we should be able to take that plan and say, "On this product for these durations, we get this return, and if we have these expenses on the early years, we will level them off and have these persistency and renewal bonuses. Here is our structure of this product, and we are going to preset that." Then the regulators could follow and see if that correct return and product design is being complied with.

Then we could take a very similar product and look at the sister product to it and say, "Is it treated reasonably the same? Not identical, but is it treated reasonably to that?" We hope if the company is responsible for putting a comprehensive plan together currently the way that it would be under Standard of Practice 1 for dividends or for regulatory purposes for diversification of investments, or currently the way the company is required to if it invests in noninvestment grade securities, that it must have a plan of investment in noninvestment grade securities and operates off structure. Instead of simply saying products could start generating themselves and the company could react and just change its rules to a consumer based on what is happening, all I am asking is preset the rules within that product to be fair, and then if you have to deviate for some reason, you have to come to the commissioner so we are aware of it and could either approve it or there has to be just cause for it. But all of your expenses and product design crediting strategies should be tied to some kind of risk characteristics of that product. You can't just artificially and discriminatorily charge one product line a higher rate for no apparent reason. That is all we are trying to get at. Does that help?

FROM THE FLOOR: I think you are addressing some things that I think are very important and I certainly agree with. One thing is that, when you start looking at things like principles for nonforfeiture, you easily start seeing then they start touching on principles for other things like illustrations and nonguaranteed elements. In my mind it is all kind of tied together, and there is no way that you can deal with one aspect of that separately. That is why I like what I am hearing here. There could be practical problems, and I am sure some people are probably reacting to that. It is probably a question of just how far you go with some of the things that you are saying. Some of the issues will be very difficult to administer at the regulatory level, but I am sure you'd work that out.

But I would like to make one comment. Donna asked me to look at things that could be applied to nonforfeiture, and I looked back at some of the literature from as far back as 1937. One of the interesting things is in light of current actuarial technology and financial technology, a lot of those principles are based on an environment where industries never change.

MR. DINO: I agree and we did go back and that is where we tried to come out with that little statement of basic principles. Believe me, when we sat with the Task Force and the working group over two conference calls over this single document of six, seven statements, this was not easy. There are a lot of different personalities. There are different age categories: the younger, more innovative and the older, more set in their ways groups.

But we were able to reach this position, and I think this is good. I think it is a good position so far, a good starting point. You are exactly correct, though. This does touch on everything, and with that we have to be careful. In fact one of the statements, a measure of consistency between annuity nonforfeiture and life nonforfeiture, has to be desirable.

Although we have completed or are in process of now completing the annuity nonforfeiture law, the laws we put on the books will be there for a long time. We have to be careful that they are the laws we want. We have to be careful that they are the laws that will integrate among each other. So as the annuity nonforfeiture law is two strides in front of the life nonforfeiture law, we have to be careful to juggle them to make sure that everything is done consistently. But clearly this also affects the valuation standards, and it affects the illustrations as currently going on. Luckily Bob Wilcox, who chairs the disclosure group, also sits on the Life and Health Actuarial Task Force, so there is a direct dialog going on with that. The illustrations have come out with another draft regulation, another draft model.

One way I see things is that a law should be a general authority. A regulation then could get very much more specific on specific problems. A regulation is easier to change with the dynamics of the current marketplace. So if you have a general standard in the law on basic principles and there is a problem that you find out something's being abused, you could fix it on a narrow focus with a regulation. So although the regulation currently on disclosure is a much tighter approach, I do not see that as being inconsistent, because it is fixing a known problem now, and a regulation is easier to change as product designs change down the road. There is a standard of practice that is coming out hand in hand with the disclosure, which is currently still in draft form, but it should be exposed soon, so everyone make sure that you take advantage of that and send the comments in.

The annuity reserve law, the valuation standard, was requested as a project about three years ago, and it was referred to the Denny Committee, or the Donna Committee. Because of all the time and effort that was going into the nonforfeiture law both for annuities and life, the annuity valuation law did not receive much attention from the Task Force and that was our fault. We simply did not give it the attention it deserved. So we have asked that that group be reconstituted, and it has been formed as an Academy group now to revisit that.

Doug Doll and Errol Cramer are responsible for chairing that group. They will be relooking at valuation standards. Is the current interest rate and the formula currently correct for use on annuities? Is it dynamic enough? Do we need to go to a more dynamic yield curve approach? Should it simply be a marginal approach against nonforfeiture? Should they be directly tied together rather than two independent laws? As far as the type categories, A, B, C, and issue year change in funds, with any luck, consider those thrown out the window.

Curtate CARVM is gone. We are going to be continuous with anything that is done. Donna also sits on that committee. Maybe you can give us a brief update of where you are.

MS. CLAIRE: The committee just got reconstituted as an Academy group last month. The members are meeting again at the end of April 1995.

If you accept our next report, we'll be done by your next committee. At this point I feel that we should make sure that we are going to be consistent with the new nonforfeiture laws that are coming out, also.

MR. DINO: The life valuation law, commissioners reserve valuation method (CRVM), has not yet been opened. That is the remaining fourth law that, as a package, basically affects everything we do. If we move to this degree on the life nonforfeiture law, it is almost inevitable that the life valuation law has to be reopened.

Also, based on what the annuity valuation law does, I consider that that may have to go hand in hand with the life. I am not sure where they are right now, but there was talk at one time about, "Well, why do we need CARVM so strict any more? It is overconservative." Everyone says that it is a worse case, and industry keeps telling me it is overconservative. I guess personally I have not been shown or demonstrated how it is overconservative. You do not like the number, because it is higher than your pricing assumptions, but it is a current reserve.

I have been lead to believe that there may be a request to allow double decrement reserving practices on CARVM. Could we take a probability of election? Could we take persistency into consideration? In the past the answer has been no. If that direction is gone, and I have no idea how that will be viewed by the Task Force, that is a very significant move and probably more of an uphill battle than the nonforfeiture changes.

We have to look at the life standards, also. Are they that different that the same type of consideration should not be applied? In fact why are there two standards to begin with? What is the difference between CRVM and CARVM? The basic difference is the expense allowances that are built into CRVM.

What is the reserve? It is the present value of my obligations. I mean, why do we have two rules to begin with right now? Why can't there just be one basic formula? Why has it been developed the way it is? Annuities have had consideration that they needed special treatment, so they branched off and had a new rule to it, because under straight CRVM in the 1970s, I guess, it was determined that the reserves were not strong enough, so they came out with CARVM. Do we need two distinct sets of rules, or could the two rules be blended and have one reasonable rule for all insurance products, with insurance products being designed that are losing the distinction?

Universal life with a side fund—what is it? Is it a term insurance and annuity rider? Is it a life insurance policy? It qualifies for IRS, therefore does it make it life insurance? It acts like annuity, smells like an annuity. I could take that fund and do a lot of things with it. I could buy benefit streams. I could buy different options. Isn't that all a deferred annuity is? If you have two product designs, an annuity with a term rider or life with an annuity rider, and you get the exact same benefit protection and benefit options to the consumer, because they fall under two different rules, you get two totally different answers. How is that rational? How does that make any sense? All these things have to be considered.

MS. CLAIRE: As you can notice, basically Frank is trying to make all our jobs very interesting in the future, and again the future may be much sooner than many of us expect.

MR. DINO: Even having this dialog and discussions with members of the working group, the immediate response is, Well, how do I, regulator, know what the rules are? How do I know if it is fine or not? If I get a policy form coming across my desk, right now I have the actuarial memorandum attached with it that shows me an illustrative formula at age 35 and I can crunch it out on my PC behind me and match that answer. Right now I could take a policy form and come up with the cash value to the cent and match a standard company design. I lose that. Where does it go? How do I get control? How do I regulate the companies? That is a problem, and that has been a problem that has been voiced to us already. I do not know how we are going to overcome that. I want to, but I want to do it and get a right answer, not artificial products simply designed for the pure purpose of making my life easier. I want the right products.

MS. CLAIRE: Yes, I think in effect, change is uncomfortable. Change is especially uncomfortable for valuation actuaries, but the thing is we've got to look at it saying we've been given an opportunity. Sure it was comfortable. We knew what we were doing, but we've been given an opportunity, in effect, to grow up, to take responsibility, and actually I would argue to become a true member of management, to give management the best advice possible on how to design the products that would both benefit the consumer and keep the company solvent.

MR. DINO: On this year's annual statements, you have noticed that there was a change on the reinsurance interrogatories. I think this was the first year that it came out. Historically the reinsurance interrogatories in my mind have been a problem. The form was a circular type to complete. You had to complete a footnote under one schedule as "yes" in order to fill out the interrogatory, but in order to get "yes" on that footnote, you had to answer "yes" to question six in the interrogatory. I sampled several companies in my state and they were just all blank. I mean, I do not know if they intended blank to be "no" or if they intended the blank to be they couldn't figure out how to fill it out. In my life at the division, I have never seen one completed ever. So a couple of years ago we took on the task of rewriting and revising those general interrogatories with the idea to keep them a little bit more in line with the model life and health reinsurance regulation. That was completed, and the changes do appear in this year's annual statement for the first time. So if you have been in the habit of not filling out the interrogatories because you looked at them long ago and they simply do not apply, go back and take another look. They apply to everybody now, and it is valuable information that we are asking for.

It is a lot of detailed information. It is an analysis. There is one question that is the termination impact of all reinsurance on your books, period. If reinsurance is able to be terminated by either party, what happens if it is? So there are several questions on there, and it will take a little bit of development time to put it together, so you should be familiar with that.

For the 1995 annual statement, there will be some more changes. There was a research project that had occurred last year on modified coinsurance (modco) and the distinctions between coinsurance funds withheld and modco. Should those two types of reinsurance have different accounting rules and different methods of completion on the annual statements? A white paper was issued, and it went before the Accounting Practices and Procedures Task Force that Norris Clarke of California chairs. The decision was made not to change the current accounting, but there was a decision made that more detail is necessary in order to make the distinction between the types of products.

So in the 1995 annual statement, you will see that, on Line 1 of the liabilities aggregate reserves, there will be added parenthetical notes within it. I think right now, there is one. I think it is aggregate reserves, and there is the parentheses "net of something." Within the same line embedded, you will be asked to separate out what is the modco portion of that reserve. So there is going to be some added disclosure right in Line 1. Exhibit 8 will not change, but the Schedule S will change. There are several additional columns being added to actually show the modco reserve, to show the funds withheld. The funds withheld have never been able to tie on Page 2 to the asset where you have the aggregate amount. There will be, by treaty, the amount of funds withheld in Schedule S to tie back to Page 2. There is also a third category. I believe it is the surplus relief generated by the contracts, and there is a definition of the surplus relief in the footnote.

With part of that we have asked the Risk-Based Capital Committee to take another look at the formula and how it addresses reinsurance. We have had the concern at least that modco in particular is not being adequately addressed and correctly handled by risk-based capital. As an example, and companies may be filling their statements out differently, either correctly or incorrectly or trying to force a result, but under modco if the ceding company is holding the reserve, it still has the in force up in its exhibit of insurance in force. The assuming company does not have any reserve up, so when you do your C-2, when you simply do your net amount at risk, the ceding company actually does show that difference on its books and that should not be. The ceding company has transferred all that risk to the reinsurer. The reinsurer, when it does its net amount at risk, does not have the insurance in force, does not have any reserve credit, so it is not showing a risk-based capital impact. So we believe that the risk-based capital component of the C-2 risk for that book of business is being held in fact by the wrong company, the ceding company overstating its risk-based capital and the assuming company understating its risk-based capital. So we have asked the committee to look at that and attempt to correct that formula.

MS. CLAIRE: Just a couple of more things on annual statement changes. First off, the risk-based capital group has been reconstituted as an Academy group including reinsurance. The group is also looking at a couple of other things right now, and one of the jobs that is probably down the pike is to make sure the C-3 risk factors are correct in the risk-based capital.

In addition, there are a couple of other annual statement changes. One was a change to the instructions to try to clarify the things that got the most questions in the Academy section of Actuaries Online, which was the reconciliation that valuation actuaries must do against the accounting statements.

There are several other things coming up. The major item is the accounting firm that the NAIC hired to relook at statutory accounting principles is proceeding with its work, and in the next few months and actually throughout the remainder of the year, you can expect to have a number of papers on issues coming out. Again, there is an Academy Task Force to respond to the actuarial issues that will be raised in this, but I expect this work to become fairly intense over the remainder of 1995.

MR. DINO: Donna is alluding to a project at the NAIC, the Codification Project, to look at all of the accounting manuals. The group has not yet started rewriting the chapters that affect the reserves and the topics of interest directly to the Life and Health Task Force, but

they are coming. One chapter that has already been drafted that will clearly affect us is, in fact, reinsurance. I believe it is Chapter 24. Chapter 24 has been rewritten. It is a material, significant change from the current reinsurance chapter. Part of the Codification Project is almost following FASB. The new accounting practice procedure manual will in fact establish rules. It is not simply a how-to. It is a what. It will establish standards of contract revisions. It will establish, if you have certain terms, how you account for it or otherwise not. It will establish certain reserve standards. The accounting practices and procedures manual basically could have the effect of a law, and it could change your lives and some of the ways you do things. So as these chapters come out, you have to look at them very closely.

The reinsurance chapter is being greatly expanded. It will be adding some information on reinsurance categories that have not been in there before. It will change some of the discussion of modco in light of the white paper that came out in 1994. It will be adding an entire new section regarding assumption reinsurance with the NAIC model on novation that you have 12–14 months and two notices to the consumer to reject or consent to the transfer, otherwise the business may not be transferred. How do you account for it during that term? That 12 months will cross a calendar year. How do you account for it? So there is an entire new section that is being added on assumption reinsurance.

With that in mind, the Task Force has also asked the Society to give us some comments on material issues that it thinks might be necessary to approach through changes in the accounting manual. As an example, is there something that is in the accounting manual right now that is nowhere in law? The law talks about CRVM, but if you read the law to terminal reserve, the accounting manual creates mean reserve practice and allowance and midterminal reserve practice and allowance. That is nowhere in the law. That is the accounting manual. Is that something we want to continue to perpetuate? Do we want to continue to have that? Do we want exact daily reserves, as an example? The accounting manual dictates all that, not the laws. Donna, have you come to a conclusion on that yet?

MS. CLAIRE: We are working on it.

MR. DINO: One thing I did ask Donna to look at is whether or not the loan provision and deferred premium provision that are currently being reflected on the asset page of the annual statement should be more accurately reflected as an offset to a liability on the liability side. Especially with cash-flow testing, deferred premium, and policy loans, should those be netted out in line 1, the aggregate reserves, and reported on a net basis, which would be similar to some other countries' practices rather than the way we are currently doing it? With the valuation actuary and cash-flow testing, to some degree that is the way you test anyway.

FROM THE FLOOR: Back to the RBC, I am not clear on what you are saying about the problems with modco.

MR. DINO: I have seen the in-force exhibit completed both ways.

FROM THE FLOOR: But that is a mistake then.

MR. DINO: Yes. So in fact we've written that up in the instructions in the accounting practices procedure manual to clear up how that in-force exhibit should be completed. We are trying to improve the instructions to compensate for that.

FROM THE FLOOR: So people are confused with reporting in force and with reporting reserves?

MR. DINO: Yes. They are matching the two in many cases. I see that simply as a reporting problem, but because these reporting problems in the past did not affect anything, I guess we did not track it too much or care about it too much. But now because it has an impact on other calculations, we are trying to look at it a little closer, and we have noticed that as an error. Whether it is simply an error of a company or if it is an error of design or if it is something that we could correct through improved instructions, we are at least trying to address it from all avenues to get it fixed. Donna, you have something?

MS. CLAIRE: No. I was going back to the accounting thing. If anyone thinks of things that should be changed—again the Academy committee is looking at where we can make changes or should be making changes in terms of the actuarial issues—just contact me.

MR. WILLIAM J. SCHNAER: You mentioned that the NAIC wants to upgrade the status of the accounting manuals to be similar to that of the financial accounting standard (FAS) or collection of the FASs. It seems, in my opinion, that right now the amendments to the accounting manual are frighteningly casual, they are often done without exposure, they are done often in one meeting, and they are also frighteningly vague. But I think that you can get away with that, because the accounting manual does not have the force of law. I am wondering if you have any plans to try to formalize and make more rigorous changes to the accounting manual once, if indeed, it achieves the status that you are hoping?

MR. DINO: I am going to actually respond to two points you made rather than your question, and I am going to have to take issue with both of them, I think. Although some items are vague, I would agree in some cases, the casualness is in the eyes of the beholder as far as the development process. Any accounting manual changes must go through a certain protocol, certain committees. It has to always go through the Accounting Practices and Procedures Task Force at least. Usually it will come through another committee, also. It will always have exposure. I mean, that Task Force averages two to four hours each session, and there is always a lot of discussion on proposed changes. They are in the mailings, and they always go between two meetings at least for exposure comments. I do not think I have ever seen anything that has been adopted one time. Accounting practices and procedures changes, when done, go up to that committee's parent. Ultimately changes go to the plenary. Accounting practices and procedure changes do not get done by staff. They do not get done by us and by Task Forces. Ultimately we work on it. We have the dialog with the industry. We come up with the draft language. We come up with the recommended replacement page. Ultimately that document then goes to the commissioners at what is called the plenary session, and it is usually embedded in a packet, a little book, that is given to the commissioners called the Consensus Agenda and that staff recommends to the commissioners, "Here is a summary of 50 items in this book that have been done," and within that it'll say the accounting practices and procedures changes and either list them or have broad statement categories. I am not exactly sure which. But all

that is given to the commissioners, and at the next meeting—it has to sit for another meeting and for another exposure period to the commissioners—the commissioners either approve it or sometimes, they take extracts out of that document and send it back to the Task Force saying, "No, we will not approve this. Continue to work on it." So it does have a certain protocol and protection around it. Changes are exposed. If the industry's not following them and doesn't send comments or opposition or information or position papers, or if you do not send letters to the commissioner, the changes will slide through very easily. But changes do have that protocol and exposure period.

As far as the force of law, as far as Colorado is concerned, we passed a law and we entered a sentence directly into our law that says that "all companies are subject to the insurance laws and regulations," and then, right after it, we continued on "and the accounting practices and procedures as adopted by the NAIC." We have that in our laws. I thought most states are going that route, and that is why these manuals have much more importance. I believe that is tied with the accreditation project among the states, and that is why the NAIC went on a $30 million contract over a three-year period so far to get an independent CPA firm.

Where necessary we hold formal public hearings and completely restate and recodify all the rules. So it was a massive effort to get these charges together as a standard that is interpretable and is intended to be the accounting standard to follow rather than, to some degree in the past the manual has been a journal of regulatory notes on topics, a lot of them disjointed, a lot of them not consistent with each other. So that is why the commissioners actually took it out of our hands and contracted out to do a complete recodification and restructuring, and in some cases that is why the standards will in fact change. It is not just going to be paraphrasing the book. It is going to be a compilation of changes. So we have to all keep up and keep an eye on it.

The last topic is reinsurance. The NAIC did pass a model regulation on life and health reinsurance. Effectively, this was the financial reinsurance restrictions as to what must be contained within an agreement to allow reserve credits, otherwise it would not constitute qualifying reinsurance. There have been many questions since that adoption a couple of years ago, and the Task Force does have a working group solely for the purpose of reviewing those comments that have been raised to regulators by different industries. We are putting together a question and answer, a Q&A, of commonly asked questions and positions and interpretations that we've given of the regulation, of different provisions of the regulation.

As an example, one of the most significant provisions of the regulation on interest sensitive products is that the asset risk must also transfer (I think the wording of it says "legally segregate") and there have been many questions about what constitutes legal segregation. Could we do this? Could we do that? Some people were fast to let us know that New York had allowed a degree of earmarking and segmentation on a structured plan. We are putting together a Q&A of the common questions and how we envision the common interpretation should be of those and some examples of different methods that may comply with those provisions.

FROM THE FLOOR: I assume you are aware that the Reinsurance Section in fact right now is discussing its latest paper by Diane Wallace on risk transfer.

MR. DINO: Yes.

FROM THE FLOOR: Will that be considered in looking at the model law now and ultimately taken seriously?

MR. DINO: I am not exactly sure how to answer that. One, personally I have not read it yet. I was hoping to leave early and go pick up a copy unless anyone has an extra one. It is not something that has come before the Task Force or regulatory body. It is in an industry paper that was put together the same as any other publication, which effectively has no meaning to us yet. We will look at it and consider it, but do we have any reason right now to negate or reverse or modify the current regulation? There is nothing I have seen that we have any intention to change the current regulation standard. Could you be a little more specific about how you think we should use it?

FROM THE FLOOR: I think what the paper does is for the first time put together a consensus of opinion of people in the field about problems in the past. It is new in that sense, but that is why I was suggesting it should be looked at again.

MR. DINO: Yes, I became aware of it actually just recently, and I have not had the opportunity to get a copy and read it yet. I do look forward to that. Prior to reading it, I can't answer on what effect it will have from the regulatory side though. As far as XXX and GGG are concerned, they are a done deal. I mean, no one cares about them any more. The two items that have been completed, in fact they were completed at the December 1994 meeting, were XXX and GGG.

Guideline XXX, as you know, is now completed. It affects term insurance, but not only that. It does affect certain universal life types of products. It establishes the valid interpretation for valuation standards. It originally was designed as a guideline, and as a guideline it would have had uniform adoption and applicability to all states. Through the development process, one thing that came out pretty quickly was that additional mortality improvements wanted to be recognized, so the developers put together a new set of 15-year select factors, significant select factors, in order to mitigate some of the effects of the reserve standards and to reduce them to some degree. Because a mortality table per se is adopted within it, we were not able to adopt it as a guideline. The guideline does not have the legal ability to adopt new mortality standards. That could only be adopted by law or regulation. So the model was altered to a regulation. As a regulation it is not directly applicable to all states. It is adopted by the NAIC as a model, so it is on the shelf. Now the states individually have to decide what to do with it and adopt it in its original form. It also has the danger now that states could adopt it in amended or modified form. As you know, although NAIC has models, some states will change models based on their individual needs. So it does have the possibility that, as it gets adopted in different states, it could be changed. That is something that you have to follow in order for states to adopt a regulation. There is a certain regulatory process, normally a formal hearing process, that has to be taken into consideration. I guess there are a couple of states that have initiated the process. We are not quite sure how many will have it by the initial intended target date of 1/1/96, but we are hoping that some states will start to move on it so we can get some momentum going.

MS. CLAIRE: Yes, and again everyone's looking at this as just term insurance regulation, but it actually applies to all nonlevel premium or nonlevel benefit products including

universal life with secondary guarantees, including such things as graded premium whole life. So it is definitely worth a close read. New York has its 147. It does appear that the earliest any other state will adopt it at this time is 1/1/96. There is a possibility—I would not give it a high probability—some may actually adopt it in 1995.

MR. DINO: GGG is another valuation standard document, and it was adopted as a guideline. GGG is the annuity side. XXX affects the definition of CRVM. GGG affects the definition of CARVM, so we hit both major models again. GGG in its early stages was targeted and intended to address a problem with two-tier annuities. In its final stage as it was adopted, it is not limited to two-tier annuities. It is, in fact, addressing all annuities. It is a general interpretation of CARVM for all annuity products, so that it is important to be aware of it and to follow it. It is effective upon adoption by the NAIC because it is a guideline. It is an interpretation. It has an effective date of December 31, 1995, so for this next annual statement it will be applicable.

MS. CLAIRE: And it also applies to all contracts issued from the date of dynamic interest, which is 1981 on and, again, as he pointed out, do not look at it just as a two-tier product. CARVM is defined as the greatest present value of all benefits, and a number of companies that have liberalized their annuitization benefits may be caught and do not realize it. You actually have to value all your possible annuitization benefits back to the valuation date and hold the reserve for the greatest present value.

MR. DINO: If you are holding cash value, you are not doing it right. I mean, you have to test all the different categories, and for each test, there is going to be a different definition for the valuation interest rate. So each potential annuitization and each potential option under the policy has to be treated as a stand-alone contract and revalued consistently.

MR. OWEN A. REED: I wanted to comment that GGG is a monstrosity. It is unrealistic that all possible guarantees should be given a 100% probability of occurring.

MR. DINO: Isn't that what CARVM has always said? I went back to some of the study notes from 1982 right after the law changed, and they go through a discussion that actually says very specifically that CARVM was intended to be a worst case and everything must be tested. The sample questions and the exam study notes and the exams at the time say that you have to go through that test of different annuitizations to find the worst case. Some of the text actually says, here are some considerations that you could look at, the trigger points when guarantees cease and when surrender charges change and where ratios are different. All the information back to 1981 has said you always have to do this. There has never been an indication that you didn't have to.

MS. CLAIRE: Yes, I hate to say it, but we probably are very guilty about reading the law back in 1981 or whenever it came out, and at the time because of the interest rates being quite high, the law probably didn't apply to most of your products. When new products were designed, some of the actual laws weren't reread, and they should have been. The same probably applies to the standards of practice. I will admit the first thing Frank and I worked on was GGG. Originally he had an absolutely horrible regulation. We worked on it.

MR. DINO: Horrible? The first one was a much more direct and much more simplistic answer. It simply said no.

MS. CLAIRE: Right. But the thing we did, the Academy was part of this, was went back and looked at the law. All it is is really an interpretation of the law.

FROM THE FLOOR: Please comment on variable annuities.

MR. DINO: One question that has come up over the years that we have actually never put resolution to, is whether or not CARVM actually applies to separate accounts. At one point in time there was a guideline, VVV, to attempt to clarify that, in fact, had problems with it. But the testimony that the Task Force heard, in particular Greg Carney comes to mind, said very emphatically CARVM does not apply to separate accounts. But with that in mind, we do apply CARVM to separate accounts because most of you take a CARVM allowance.

So the benefit stream is going to be, what is the cash value as one number, what is the annuity, present value, as another number, what is the death benefit reserve as another number? Take the greatest of those. So the death benefit reserve basically would be we hope less than 90% of the account value, so it would be embedded in there, and there would not be an additional increase in reserve for the pure death benefit.

MS. CLAIRE: Death benefits can be discounted for mortality.

MR. DINO: So the worst case, if you want to say, is elective benefits.

FROM THE FLOOR: What is the applicability of GGG to group annuity?

MR. DINO: It does not apply. It is for individual only.

FROM THE FLOOR: CARVM does not apply to group annuities?

MR. DINO: Under current law, I do not believe CARVM applies to group annuities. We are going to change that though. We are going to have rules for insurance, not for products.

FROM THE FLOOR: I have a general question. I do not want to open a Pandora's box here, but as I understand it, in Canada, there is a unified set of financial statements. What we call GAAP and statutory accounting practices (SAP) are unified. It is one set of statements for assets, differential on the reserves, to go from the one to the other. Is there any thought here that you have unified financial statements both for FASB or GAAP and for statutory or least just have some distant goal that one can work for to reduce all this paperwork?

MR. DINO: The answer to your question is, yes. Yes, there is thought, and the thought is that the answer is emphatically no. But with that there is actually another unified theory that would be nice, and that is that life insurance and property and casualty (P&C) insurance currently have a blue blank and a yellow blank, which are not all that different, and we ought to have a green blank for one.

MR. BUCK: Donna, do you want to bring us up to date on genetic testing?

MS. CLAIRE: Actually, there are a few other topics I just want to mention that the Academy and NAIC are working on. One is the "this state" requirement the appointed actuary must follow; many actuaries probably are not following it as the letter of the law. At this point, there is a tiny group put together to try to modify this requirement. For example, you really do, according to the letter of the law, have to take into account what year every state passed every law in terms of interest rates, in terms of the mortality tables. You have to make sure that right now you follow every single state that has a slightly different interpretation for continuous CARVM, and so on. What we are trying to do is to say that it probably does not matter as long as the state adopted a mortality table, that adopted it a year later, or whatever.

Another thing is we are trying to get a unified place where if states do have different requirements, we would have one source for an actuary to go to and rely on. This is work in progress. Shirley Shao of the Prudential is one of the people leading that. I would strongly recommend you support that effort, because right now as actuaries you do have legal liability for following the letter of the law.

FROM THE FLOOR: Tied into that is the Society able to provide any kind of material that says, in a given year this state has the most strict requirements in terms of reserves? Does it make sense that the whole country is trying to sort that out rather than one body identify which is appropriate?

MS. CLAIRE: The Academy attempted to put it all together with the state valuation law manual, but actually it depends on how the product's design is to the answer to that. We'd like input as to how that manual can become more user-friendly.

Roughly translated, there is a great deal going on, and there are many efforts that need volunteers. As he mentioned, the Society is certainly always looking for volunteers for the various Task Forces.