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ACTUARIAL STANDARDS BOARD (ASB): CURRENT HOT TOPICS

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This session will focus on significant Standards of Practice (SOP) topics that are breaking at the time of the meeting. The panelists will discuss the most recent developments and there will be time for questions and comments.

MR. GARY CORBETT: I'm the current chair of the Actuarial Standards Board (ASB). We have six members of the ASB here and we are covering all specialty areas. We have Dan McCarthy, who's our life and health insurance expert; Fred Kilbourne will cover the casualty area; Harry Sutton will discuss health insurance; and Ed Burrows will comment on the pension area.

MR. EDWARD E. BURROWS: After a gestation period that makes elephants look quick, we think at our January meeting we will be able to authorize the final publication of the economic assumptions standard. That's not definite, but it's looking that way. It was a lot of work, but we're kind of pleased with the results. This is the first of what will eventually be four standards that will come together under *Actuarial Standard of Practice (ASP) 4* as the umbrella pension standard. The other three will concern noneconomic assumptions. (We spent a long time discussing the term *demographic assumptions* before we rejected it.) When we're done, we'll have a battery of four pension standards that we think will serve as the details under the umbrella of *ASP 4*. We're also hard at work on a standard related to qualified domestic relations orders (QDROs) and other domestic relations affairs. It turned out that there was more of a need for a standard in this area than any of us had ever anticipated. We have what we think is a blue ribbon task force consisting of actuaries and attorneys active in this area. It's coming along nicely.

Gary, if there's time perhaps later on, I'd like to talk about this issue of how we go about putting together a standard that is more than just a codification of generally accepted practices. That actually raises the bar, so perhaps that's something you'd like for us to put off until a later time.

MR. CORBETT: Let's see how much interest there is in that among the people who had an interest in the pension area. Are there some specific questions you might have or comments you might like to make?

MR. BURROWS: We have what we hope you will agree is a good explanation of how the economic assumption standard works and we'll explain the amendment to *ASP 4* whose time we think has come.

MR. CORBETT: Harry, what's happening in the health insurance area?

MR. HARRY L. SUTTON, JR.: We had two meetings of our health practice council at this meeting. We've been working on three standards, and we've had one with a lot longer gestation period than what Ed was talking about, which I will get into. We also will have a session on certifications for small group. At our last meeting we approved the publication of the first draft of the standard which will probably be sent out in December [1995]. We just have to review the final wording of a few changes that were made, but it's approved for exposure. Some of you may want to talk about that. I'm involved in another session on small group reform rate certification being run by Ted Lyle, who's the chairperson of the health committee. We're willing to discuss the general direction of that standard here.

Compared to some of the standards, we are asking a number of specific questions about whether you feel there's enough detail in the standard. Probably the most important thing is that we make a provision for qualified opinions when you're filing rates. Consultants who have filed rates have already filed many qualified opinions because the state laws vary so much. So far, the states have approved the rate filings on that basis, but there could become some concern about it. I'll pass on that for now because we are going to discuss it at a later session.

We're working on two or three other standards. The one that the health committee of the ASB has been working on periodically for six or eight years is a general rate-making standard for health insurance. When I first became involved with it four or five years ago they tried to split it into small group, large group, individual health insurance, and so on. We also had HMOs coming onto the scene, which complicated the original split. We've tried to make our newer standards applicable to HMOs and similar organizations. With all the people, including regulators, that we had on the committee, we could never come up with anything, so now we're actually looking to use the casualty ratemaking standard as a model. Ratemaking does not involve setting prices. Rather, it's estimating the net cost of various health products. To get away from the concern about discussing pricing issues, we're probably going to approach it going forward more like casualty standards.

Casualty actuaries have a standard for risk margins, a standard for expenses, a standard for profit margins and cost of capital and so on which tends to get around the problem of whether you're trying to fix prices, an area which has seemed to bother a lot of people who work on these standards. I think we have a very good approach. I would guess we would get a draft exposure submitted to the ASB probably by the second quarter of next year. We've had a very difficult time wrestling with all these health standards, and they've frequently gone back to the committee to clarify what the board really wants.

I can't say how much emphasis we're going to place on other forms of health insurance in the rating mechanism. It's another complexity. There's disability income, and we have a separate committee for long-term care which is undergoing quite a bit of major revision because of the new laws and the federal statutes and the valuation and nonforfeiture aspects. So there has been a great deal of change in the long-term care business in the last couple of years, and we're going to revisit our standard and update it for those elements.

We have a credibility standard that has already been out for exposure jointly with the CAS and SOA actuaries. That will be coming back to be finalized some time in the next year. We've had other projects suggested. We're not sure if the NAIC will pass any of these access bills or if states will start regulating guaranteed issue for individual coverage. They might mix that in with small group or it may be separate, or it may be mixed in with uninsurable pools. Nobody's quite sure where it's going, but there's a desire to create access to health insurance for everybody, whether it makes any sense or not. If those things are required, we'll obviously have to start addressing them. In some of these areas we try to build on the NAIC model. The only problem with that is very few states have passed them in that form, and so while we may use that as a frame of reference, we have to continually refer to the fact that the states that you're dealing with may not have the model in place.

There has been some discussion in the past of working on a definition of trend, but that's a little further down the line. I think we have some modest reformatting to do of some of our older health standards.

These are the projects we have underway. We would like to hear from you about what other areas or even which areas that I've mentioned would be most important to get standards on.

MR. FREDERICK W. KILBOURNE: I'd like to talk briefly about a health-related standard. I'm referring to the social insurance standard that applies to all of the four specialties that are represented here. It sometimes seemed a little bit orphaned because it covers so much and yet involves directly so few actuaries, but, of course, it affects us indirectly as citizens or as actuaries. The exposure draft is out. When I last checked, there had been very few responses, which is understandable in terms of all of us being very busy with our own direct specialties. I'd like to encourage all of you to review that and, if you are moved to make comments, please send them in. [The deadline was December 15, 1995.]

MR. CORBETT: I realize I was remiss in not introducing a couple of people. Dick Robertson is the incoming ASB chair and Christine Nickerson is the director of the ASB, our full-time staff person in the AAA offices in Washington.

Are there any questions or comments on health insurance?

FROM THE FLOOR: I would offer one comment. Based on our experiences with our state insurance department, when it was wrestling with its rate regulation, there were many topics or many areas of discussion where it was very difficult for the department and the industry to sort out the features that were applicable to disability income, comprehensive medical insurance and supplemental medical insurance. I would offer a request to the ASB that they be very clear in distinguishing, either in separate standards or in the same standard, which practices or sections are appropriate to each of the separate coverages.

MR. SUTTON: That's exactly part of the problem we had with the ratemaking standard in the beginning—breaking the coverages down and addressing separate problems in developing the rates for various segments of the industry.

MR. CORBETT: Dan, please fill us in on what else is happening in the life insurance area, and then we'll move to the illustration standard.

MR. DANIEL J. MCCARTHY: I will begin with a nonsubstantive comment about the illustration standard. You've probably gathered from some of the comments that have been made that two of the issues the ASB grapples with from time to time are a long gestation period for standards and sometimes rather sparse comments from practitioners. We overcame both of those in spades with the illustration standard. I'll say a couple of other things, and then we can come back to that.

I think most of you in the life practice area know that there have been sessions covering research that has been done in the area of life nonforfeiture benefits. This is an area of research interest to the SOA. It is an area of public policy interest to the AAA. It is increasingly of interest to at least a small group of regulators, and I believe there is a plan afoot to put on a program for regulators at the NAIC meeting this December 1995 to raise their consciousness about some of the issues. If all that stays on track, it is anticipated that at some unknown time, there will be a proposal for a very different approach to nonforfeiture benefits than is taken in any state. If that happens, the law would be more conceptually based than it is now. Law and regulation would require an accompanying standard to provide guidance to actuaries who would be making certifications under that law.

The ASB had, at a recent meeting, an initial presentation on this subject. I think it's correct to say that, at this time, neither the degree of the head of steam for this project nor its timetable is clear. We don't really know if it's going to be a fast- or a slow-moving project, but we will be prepared to support it and work on the development of a standard as things gradually become clear. We've made a commitment to the people who are working on this process that we will maintain an active liaison with them; we'll provide comments, get their comments, so that even before we pick up a pencil to start writing a standard, we all have some idea of where we're going. I say that in part because the illustration standards process, that was regulatory driven from the outset, was done backwards.

Second, there is an existing standard on dealing with reinsurance, and it focuses primarily on the reflection of certain reinsurance items in financial statements. We have had, for a while, a request from a prominent regulator with some specific concerns in mind to take a look at that. More recently, there has been a suggestion that we take a somewhat broader look at the question of what constitutes risk transfer in reinsurance, either for statutory or GAAP purposes. At this point I don't know what's going to happen with that, but we have asked our life operating committee, which Ed Silins chairs, to take a look at the subject of reinsurance in that broader scope and figure out what, if anything, should be contemplated as potential revision to our reinsurance standard.

By the way, one of the things that the ASB has done procedurally over the last 18 months or so is to institute a process so that when one of our committees begins working on a standard, the first thing they do is develop a summary of what the standard might look like. We have been concerned in the past about people working in isolation and coming forward with a complete draft of a standard and then finding that there's just not a good fit between the committee's thinking and the board's thinking.

The idea of the summary is to save time on wasted work and get early discussion at a conceptual level. I'm sure that if the reinsurance standard revision goes forward, we'll have that kind of conversation.

I should also note that if there is a revision of the nonforfeiture law in the U.S. and an associated standard, and perhaps even if there is not, we will want to revisit ASPs 1 and 15 that deal respectively with nonguaranteed elements in life insurance policies and dividends in life insurance policies. It will be essential to revisit them under the current talked-about nonforfeiture concepts. In any event, there will probably be some activity there, although I don't think that would start at the beginning of 1996.

The only other thing I would say about the life insurance area is that the Life Committee has been understandably consumed by the question of illustrations for the past nine months or so, and now that we have reached the stage we have, they are going to go back and reassess their agenda to see what else they may have put aside during that period of concentrated work to see what should come up.

MR. CORBETT: Dan, there are a couple of areas that are on the agenda of things to be looked at. One is pricing documentation and it has been there for some time.

MR. MCCARTHY: Yes. It never quite gets to priority 1; it has been priority 2 for a while.

MR. CORBETT: A standard in this area would not tell actuaries how to price but rather what must be documented and basically what must be done in pricing a product. For instance, the standard could say that cash-flow testing must be performed when pricing certain individual products and the testing would have to be documented in a report. Also on their list are some of the problems coming out of demutualization. But this has never been given a high priority because of the relatively small number of companies involved. There are some very interesting actuarial issues involved in the setting up of a closed block and in the distribution of equity to policyholders.

MR. MCCARTHY: There was a session at this meeting about the illustration standard. We have had a kind of tennis match as we go back and forth between trying to establish a standard that depends on a regulation and trying to establish a regulation that, from the NAIC's point of view, depends on a standard. At this point the ASB has completed final work on a standard based on the exposure draft that we had circulated and the comments we received from that exposure draft at a public hearing which we held. In documentary form, companies provided, on a confidential basis, numerical tests of some of the requirements of the regulation that are carried into the standard.

The ASB recently voted not to adopt the standard because, as I say, it depends on a regulation that doesn't exist yet. We expressed the view that if there is no change in the regulation when it is adopted (assuming it is) by the NAIC in December 1995, we will adopt the standard in the form we put together at our recent meeting. We will hold a special conference call meeting in December 1995 to do that, assuming that the NAIC goes ahead. If they make some changes in the regulation, we will have to assess what they are and whether they are totally unrelated to subjects of the standard or related in some way before figuring out what we're going to do. The people in the NAIC who've been prodding this process are hopeful that they will get a model

regulation adopted without change, but predictions in that area are dangerous. We want to have something ready to adopt if they adopt the draft they last showed us.

The effective date that we've put on the standard, assuming that the regulation is adopted in December 1995, is March 31, 1996. The model regulation itself provides that no state is to make it effective before January 1, 1997. We have been assured, by the way, there are at least a couple of states which, if the model is adopted by the NAIC, will promptly move to get it in place effective January 1, 1997. The reason the standard bears an earlier effective date is because we consider it likely that if the regulation is adopted in model form by the NAIC and is passed in some states, there are companies that will want to begin looking at their practices and may actually want to get, for internal purposes, a certification from an illustration actuary saying, in effect, if the model were in place today, their practices do or don't meet it. In order to provide guidance to the actuary who may be asked to do that long before any law is actually effective, we've put an earlier effective date on it. That's all that's intended by that effective date.

MR. ARNOLD A. DICKE: Is this draft available now? The timeframe required to address the standard could be very substantial. If you have to test every product in a very significant way, it's going to take a great deal of time, and you might have to revise many of your products. You certainly have to revise your illustration system. I don't think people could ever hope to get this done if they don't start right now.

MR. MCCARTHY: Arnold, that's a good point, and I should have mentioned that. It is not actually available today because all we have is a marked-up copy. As soon as the changes are finalized, copies will be available upon request and we're going to put it in on-line. So, it will be available as soon as we can get the production work done for the very reason you mentioned.

MR. CORBETT: We intend to put a notice on-line of what the board did.

MR. MCCARTHY: That will just describe the action, but I would hope that by the time people begin reacting to that we'll be able to provide some text. Changes in the regulation, some of which were substantive, have caused, in effect, mirroring changes in the standard. As a result of the exposure draft comments we see primarily extensive clarification rather than fundamental change of direction, with the exception, as I noted, of things that are now different in the regulation, in which case we've followed through with the standard.

MR. CORBETT: Let's open it up to questions in the life insurance area, either on the illustration standard, on some of the other things that Dan has mentioned, or other areas of life insurance that you think the ASB should be considering.

MR. DANIEL F. CASE: My remarks will have to do with mutual life insurance company GAAP. It seems to me that the ASB gives attention to work involving determining numbers in the appropriate way, such as coming up with numbers that are right or that are at least in conformity with generally accepted actuarial standards. However, it seems to me that getting a correct number is only half the job. What's equally important is labeling the number in the correct way. It seems to me that if you have done a large amount of work, and you came up with a number that reflects the

assets of the company, and then you put it into a statement and label it as the liabilities of the company, that's the same kind of misinformation as presenting the wrong number or giving a number that wasn't the assets. The information that you're presenting is a number and a label that tells what the number represents. They are equally important. I think that if the board is concerned with how actuaries determine a number, it is also properly concerned with how that number should be labeled when it is presented.

I don't want to go into a lot of detail now because the matter that concerns me may get resolved. My hopes are not high and there may not be any need for the board to involve itself, whether or not the board would have been so inclined to involve itself if there had been a need.

The matter that does concern me is how the bottom line or residual item in the balance sheet of the mutual company GAAP report should be labeled. Any of you who read an article that I wrote in the June 1995 issue of the SOA newsletter, *The Actuary*, on the subject of mutual company GAAP will know the nature of my concern. I believe that the bottom line of the balance sheet of a mutual life company GAAP report should not be labeled "surplus" and should not be labeled "policyholders' equity." A letter in response to my article appears in the October 1995 issue of *The Actuary*. I would urge that everybody read that letter and my response which also appears in the October 1995 issue of *The Actuary*.

I'm hoping that when the audit guide, which the AICPA is preparing, appears in exposure draft form, will say something about this and it will give the correct guidance to preparers of financial reports of mutual life insurance companies. I, of course, will be submitting a comment on that exposure draft. I don't know when the final audit guide will appear or whether it will resolve the problem, but if the problem does not get resolved in that way, I would hope that the ASB, if it's not too late by then, would step in and give guidance to actuaries who will be involved in the preparation of mutual life insurance company GAAP reports. This guidance could help actuaries do what they can to make sure that the bottom line of a mutual life company GAAP report is not labeled "surplus" or "policyholders' equity" but is labeled something descriptive that will inform readers as to what that number truly represents.

MR. MCCARTHY: I have three thoughts that I would like to offer. The first is process. You should know that the ASB and its committees welcome ideas or proposals for standards from any member or from anybody, member or not. Dan has availed himself of that process, which we appreciate. The life committee has at least taken a first pass at reviewing Dan's proposal. I bring to your attention the process and encourage you to use it.

Second, one of the difficulties we've had is that it seemed to us that the issue is perhaps not so much related to a standard, at least not now. The issue would benefit from a discussion between actuaries and accountants. The Academy has a Committee on Relations with Accountants, and the AICPA has a corresponding Committee on Relationships with Actuaries. It seems to me that a subject like this is, at least at the outset, dealt with better as a discussion or a kind of interorganizational pondering rather than a standard.

Third, in the end, there is an AICPA pronouncement that says GAAP statements will have certain words in them. Issuing an actuarial standard that says GAAP statements shall not contain those words is basically fruitless. We're going to have to see how it plays out before we know where we're going, let alone, where we want to go. In the meantime, and I'm not taking issue with the substantive point Dan made, it may be that it's a better topic for interorganizational liaison and discussion, perhaps in the context of an exposure draft, than it is a subject for a standard which is why at the moment we've decided not to act on it. That's not necessarily a permanent decision.

MR. JAMES A. GEYER: One thing with regard to standards that has interested me for some time has to do with reserves, in particular the issue of reserve adequacy or conservatism. As I've moved around to different parts of my own company, I've seen different standards apply to what is an adequate reserve. People talk in terms of probabilities of either 66% or 90–95%. I know this has been discussed for a long time within the standards community, and I think the actuarial profession has backed off several times from providing better guidance. It seems to me that, with the emphasis on risk-based capital in the last couple of years, there's a renewed need for stronger guidance. In particular, companies that hold reserves to a 95% standard of adequacy differ from companies that may use a 66% standard of adequacy. Using the same risk-based capital formulas, or definitions, for those two companies really doesn't make very much sense. I'd like to know whether this issue is going to be considered again. What are your thoughts on that issue?

MR. MCCARTHY: When the ASB dealt with the standard for expressing an opinion as to annual statement reserves (the opinion that's adequacy driven as opposed to the one that's formula-driven), there was a draft that said that the criterion, in effect, ought to be a 50/50 criteria. If you could say that on the average you had enough there to meet the obligations, that would be a suitable test. The board was uncomfortable with that; it believed that was not a strong enough test but, on the other hand, nobody professed to know the shape of the underlying distribution. I must say that sometimes these discussions about 66% and 90% or 95% seem to suggest a degree of precision that I'm not sure we've attained yet. So, at that time, we were content with putting wording in the standard which said that the test you ought to be applying was greater than a mean value test without trying to describe how much greater.

I think you've probably seen, as I and many of us have, with the advent of serious focus on risk-based capital, companies actually having weakened reserves from levels that may have been very, very strong. They use, in effect, the argument that they're not getting any credit for that, so they put it in a different place on the balance sheet: "Let's call it surplus rather than reserves." That may well be something that is, therefore, going to have to be revisited, particularly since I think that technology and our ability to estimate continually improves. But at this point, to my knowledge, it is not on the Life Committee's agenda. I think that there has been so much focus on what reserve adequacy means in the last couple of years that it will probably come back soon. I will make sure that the Life Committee is aware of that because there's no question that companies with very strong reserves are not getting credit for that. Various ways are being found to let a little of the air out of that balloon.

MR. KILBOURNE: The casualty committee is working on a standard on risk margins, in particular, as this applies to reserves. There's some question about possibly folding

that into a proposed standard on profit and contingencies. We life actuaries have long been critical of casualty actuaries, rightly concerned about the fact that they, in setting reserves, have ignored the time value of money. Speaking now as a casualty actuary, we have been critical of life actuaries' lack of concern about the partial ignoring of the time value of money and the partial ignoring of favorable levels and trends of mortality in the valuation standards. I believe that the actuarial profession loses credibility when we are perceived as being conservative people who always are looking to sock away money rather than coming up with the best estimate that Dan referred to in his 50/50 example. I think it'll be important for us to have the establishment of our best estimates of reserves, rates, or whatever, as our goal. We should directly address the question of risk margins without at the same time falling prey to the idea that the only variability is a statistical function. I don't want to see us get to be like all the polls that say invariably that the margin of error is 3% or 4% in spite of the fact that the questions have been biased and the underlying uncertainties are far greater than those that are described by random distributions.

MR. CORBETT: I can't help but recall the Joint Committee on the Valuation Actuary in the mid-1980s which proposed two levels of reserves based on probable and plausible assumptions—the probable being 50% or not much more and the plausible being something greater, which may approximate the increment of risk-based capital. Such an approach could bring GAAP and statutory statements closer together. Reserves would essentially be best estimates, which does not guard against insolvency. You would hold another level of something (surplus, perhaps) that cannot be distributed in order to assure solvency.

MR. MICHAEL E. MATEJA: I'd like to revisit the issue of sales illustrations. I have not dwelt on this standard or the proposed draft at any great length. My concern is for the implications of that standard as it relates to macro pricing and the use of marginal expenses. If the effect of the standard is to somehow make that practice obsolete, I would suggest that the ASB is indirectly promoting what I would call a retrogression in the work of our profession. It raises in my mind the whole issue of the Board's function in terms of looking at what regulators do. In your wisdom of bringing what I would call the objective standards of the profession, should you basically say, no, we're not going to have a standard for something that we think is just fundamentally flawed? When I heard the litany at another presentation on what I would call the shortcomings of this standard from a practical professional standpoint, I became very uneasy about this profession and its representatives on the Board saying it would write rules for our members to follow to implement something that is so flawed. I would like to hear the Board respond to this general or generic kind of problem and, if possible, to put it in the context of the sales illustration.

MR. MCCARTHY: I'm perfectly willing to start. I suspect others, both at the table and in the audience, will have further discussion. First, Mike, I think we were and are always conscious of the fact that we could reach a point where we would say we're not going to write a standard for something. I don't think we would take the view that we'd always write a standard for every regulation. In the particular case at hand we are, of course, not dealing with actual pricing. We're dealing with illustrations. I think that difference is more than one of form, but I acknowledge the importance of illustrations to the sales process. But, in writing a standard for illustrations we're not telling companies how to price. As you probably know, the regulators started, right or wrong,

from a concern saying, first, there are many sales conduct issues that they have to deal with in the market right now. Second, some of those deal with illustrations. Finally, some, but not all, aspects of the illustrations that are dealt with are a result of numbers that have a lot of air pumped into them. That's where they began and the first thought process was to make this simple. We have policies that have guaranteed and non-guaranteed elements. If you want to illustrate, that's fine; illustrate your guarantees. That has always been the alternative, just as we have an alternative not to issue a standard.

Quite apart from the ASB, the life insurance industry was not enthusiastic about the alternative and perhaps somewhat belatedly but in great earnest and with a great deal of effort, began to work hard with the regulators to try to persuade them that there were other ways to deal with that particular issue. At that point the ASB's main role was to tell the regulators that if they are doing something for which a standard is appropriate, and if they think that's an alternative to the Draconian suggestion they made, we will commit to them that we will fast-track our work on a standard. We didn't say anything substantive at that point, but we said don't worry about the timing because if it's something we can do, we'll find a way to get it done on time.

Then the subject turned to some of the regulators' particular desires and these were negotiated extensively not so much with the ASB but with the industry. These negotiations were about three issues. One was, Do you use the portfolio or investment generation methods in setting recent experience for investment income? The answer is, either is acceptable. Probably nobody is thrilled with that, but nobody, including the regulators, could figure out what else to do.

The second issue pertained to the specific tests for so-called self-support and lapse-support (think of them as test A and test B). The regulators feel that they went a long way to accommodate the industry in terms of making those tests easier. Certain kinds of products were exempted from some of the tests and the time period for the tests was extended for some products also. We had numerical information submitted to us by a number of companies which seemed to suggest that if certain liberalizations were achieved, the tests were manageable and, as it turns out, the liberalizations that the industry sought were achieved.

The last question, and the one you allude to, is the question of setting expense assumptions for purposes of the tests. The regulators believed, at the outset, that they know what expenses are. Expenses are fully allocated expenses of the line of business or the particular category of business all the way up and down the line. It doesn't matter if the company is small or new. If the activity's small or new, that's the position the regulators are going to take. Large parts of the industry were not thrilled with that. Smaller companies, and new enterprises in particular, were concerned about it. The suggestion that was finally made to the regulators was an effort to move them off that. They made it very clear that they would not accept marginal expenses.

The industry spent a large amount of time lobbying that point and failed. You can debate whether it should have failed or whether the ASB should have pulled out, but nonetheless, it failed. The compromise that the regulators finally accepted was this structure we've arrived at essentially says that a company can either use its own fully allocated expenses or, if it wishes, it can use a table that is to be representative of

average industry expenses. In that latter case it has to demonstrate that those aren't below the marginal expenses. I don't think that demonstration will be hard to make.

There was a great deal of discussion at a meeting with the regulators attended not only by some ASB members but also by large numbers of industry members. It took place in Utah in August 1995. I think it's right to say that at the end of it no one was happy, including the industry, regulators, and ASB members. Sometimes that's a sign of a good resolution, and sometimes it's not. You can debate whether that's the right middle ground or not. It became clear that if there was going to be a regulation, it would have to allow the demonstration in illustrations of how the nonguaranteed parts of the contract work, and be subject to an actuarial opinion. It was my sense as an observer at that meeting that the industry people there, though they were not happy with it, would have virtually unanimously said "we'll take it if our only choice is illustrations showing guarantees only, and this is the best we can get in contrast to that." In light of that, the ASB felt that it should continue working on a standard with these aspects included. Now, as I say, people will weigh those issues differently, and maybe it'll be different two years from now. Who knows what will happen in the states when people actually try to get this thing adopted? Maybe that will change it. But our call at the time was this is better than the alternative. That's certainly a judgment call and judgment calls can be debated.

MR. DICKE: I tried to get some clarification of the phrase "fully allocated" at the Philadelphia NAIC Life Actuarial Task Force meeting. It was apparent to me, in the end, that at least a good portion of the regulators simply meant that they wanted some procedure by which all the expenses were allocated somewhere when they said "fully allocated." I think that many industry people, when they hear the phrase "fully allocated," immediately assume it means full absorption of expenses in which all indirect expenses are allocated proportionately to direct expenses. The NAIC people are probably unaware of some of these exact distinctions. I think what the NAIC had in mind is some procedure whereby all expenses are allocated.

In many cases we hear about macro pricing. Macro pricing actually makes room for all expenses. Keeping within a line of business is probably an important thing because I did hear some people saying, well, then we have to allocate a lot of expenses to the group plan. I'm sure that's not what the regulators had in mind, and it should not be appropriate to the standard if you're following the fully allocated approach, but in terms of macro pricing I personally think that can be used in a line of business. As far as I could tell, the regulators, if they fully understood it, would accept it. However, I have to admit I've had trouble explaining macro pricing concepts to management people with an accounting background, much less to regulators. I would hope that the ASB, if this is the way they understand the regulators, make it clear within the profession—because we can understand the terms we use—that those kind of approaches are appropriate.

There are many other allocating procedures, and I happen to have mentioned a number of them in discussions on Shane Chalke's paper titled "Macro Pricing: Toward A Comprehensive Product Development Process" (*TSA* Vol. XLIII, pp. 137–230, 1992). People are interested and try to think of some alternative ways that they can approach their business other than having full absorption

expenses. I think they're still available and I'm not sure this is quite as crippling as people say.

MR. KILBOURNE: I'd like to respond to Mr. Mateja's question about compliance standards. I think it's important to note that whenever the word *compliance* appears in a standard, it means that the standard is being prepared at least in part to address a requirement that represents a violation of GAAP. I certainly agree that it's extremely important that we have some limits on that. I can understand the importance of having some kinds of compliance standards and I understand the problem of which you're speaking in the standard that you're most concerned about. What we have done in all cases is to require that the practicing actuary comply with the regulation or legislation that's the subject of the compliance requirement. We also require that there be disclosure of the fact that this is in violation, or perhaps some euphemism that isn't quite as strong, of GAAP and the other standards. The argument is that if we don't do it, someone else will do it, and the results will be less acceptable.

There are some things that we will not go beyond and this is generally accepted by the board and by the people who are involved in the standards process. Of course, there are going to be differences of opinion as to just where any particular proposed standard and compliance guidelines comes out. I would point out that at the recent ASB meeting there was, with regard to one of the compliance standards that was addressed, a very substantial minority opinion expressed.

MR. MCCARTHY: On Arnold's point, I would like to note that the language of the standard does not draw a tight noose around the definition of *fully allocated*. It does refer to reasonable methods of allocation but is intended to provide room for the actuary. In that regard, I believe the documentation part of the standard is very important. I think one of the things you need to be very careful about in this area is to be perfectly clear in your work papers. If you are using an approach other than the standard table which, in effect, becomes a safe haven, you need to be very clear about how you received the expenses you're using. That is going to be very important because if they appear to be ambitiously chosen, some regulator might want to look at them.

MR. CORBETT: I think we sometimes forget that in this area of dividends and nonguaranteed elements, actuaries have no statutory or regulatory role, or no necessary role in the company, unless a regulation like this is in force. We have a standard, *ASP 15*, that requires the use of the contribution principle for dividends, but it's not a requirement for a life insurance company. Admittedly, the company must disclose in the statutory blank whether they are following the principle. There's no requirement that a company use an actuary to determine dividends. There's no current requirement that a company use an actuary in developing illustrations. There hopefully will be such a requirement some time in 1996.

Let's say a regulation is enacted and we put out a standard that has the effect of saying a professional actuary shall not participate because it violates actuarial principles. If the companies, believing it is right and is in their best economic interest, proceed to do it, and there's no requirement in the regulation to involve actuaries, I don't think the public will be well served. Our decision in this case was that the public and the

industry will be much better served by the fact that there will be a strong actuarial role than if we had said we don't want to get involved in it.

MR. MCCARTHY: I agree with you, Gary.

MR. DICKE: An important thing came up at the Academy Life Practice Council meeting—I found myself almost guilty of disseminating a rumor. Luckily, Gary Corbett and Dick Robertson were there and called me up short on it. I want to be sure that we make something clear to more people. I have been hearing somewhere that some consulting company did tests and found that many products were not passing the tests under the illustration regulation and the standard. I'm not sure whether it's the regulation or the standard that got in the way but, in any case, as I understand it from Gary and Dick, you did not see that sort of situation in the documentation that was sent in. I was made to understand by another person that it's possible that one source of rumors is someone who's interested in seeing the regulation not pass; that may be a rumor as well. In any case, the point is we must avoid rumors of all sorts and try to get to facts rather than these impressions that we may be having. I'd really like to ask, What did you find out from the documentation in terms of the ability of products to stand up to this regulation and standard?

MR. MCCARTHY: First, regarding your second point, I have no idea who's spreading rumors. As to the first point, the tests that we received focusing on the 15-year test and the five-year test, the so-called lapse-support test, showed, by and large, that the products that were submitted passed the tests. They showed, in particular, two problems that were addressed in discussion with the regulators. First, second-to-die products tended not to meet the self-support test as established because it tends to take a longer period of time, in the design of those products, to recover acquisition costs. We had a number of submissions that showed that such products required 17 or 18 years. That was the basis under which the industry and some members of the board spoke with regulators and got their agreement to move that test from 15 to 20 years. The second problem pertained to some kinds of renewable term products, products without any cash values. If you applied the lapse-support test literally, that is, if you projected those products with 100% renewal and did not, as the regulation does not allow you to do, change your mortality assumption to reflect the better mortality that would result in that case, those products would go up in flames. The regulators agreed that was not the concern they were focusing on—this wasn't a cash-accumulation issue—and so they agreed that products that don't have cash values on a guaranteed or nonguaranteed basis during the test period are excluded from the so-called lapse-support test. Those were the two things that were found in the material that was sent to us. Did we get as much as we would have liked? No, but we did get a fair sampling of numerical tests from people who took some time to do it, and the regulators were willing to listen to the things that turned up. Is that a guarantee that everything passes? No.

MR. MATEJA: I'd like to make two points. First, I'm going to use the words *actuarial science* and say I think your charge is to provide SOP with regard to the implementation of actuarial science by the members of the profession. If I'm wrong in that regard, then maybe what I have to say would not be appropriate. When regulators, in their wisdom, find ways to implement public policy and they, in effect, put down something that is not actuarial science, then I don't think it's your job to implement it

by promoting standards. What I see embedded in this sales illustration regulation is nothing like actuarial science. I would tell you to steer clear of it. We have no reason to have a standard for it. You have great leverage, by virtue of your position. You can say, "No, we're not going to tell actuaries to practice in such a way because it really doesn't make sense." I think you need to use that leverage at appropriate times and, in effect, could influence the conduct of the regulators. The second point is that when we were developing reserves, it was clear to everyone involved in reserve standards and tests that there was a continuum involving pricing and valuation. I think we probably have just added a third dimension to that, which is illustrations, and I suggest that needs to be thought through a little more carefully so that through the course of this standard we don't wind up indirectly affecting something else that actuaries are probably obligated to do in accordance with other standards on pricing and/or valuation.

MR. KILBOURNE: With regard to your first point, do you think that we should not issue compliance standards at all?

MR. MATEJA: No, I think you're obligated, given your charge, where there are actuarial science issues. Where there are not actuarial science issues and it's not sound actuarial practice, then I'd say there's nothing involving actuaries.

MR. KILBOURNE: I'd like to hear if there's a valid counter to this. Compliance standards are labeled as such because they do reflect the tenets of actuarial science. If they were in every respect in compliance with those tenets, the word *compliance* would not be in there, and they would be regular standards.

MR. MATEJA: Then I'd like to see some tension between the ASB and the regulators to use the implicit power of the board to promote what I would call better science. I think better solutions ultimately emanate from better science. What I hear is that we don't have better science here; this is not an enduring solution.

MR. CORBETT: We should watch that we don't overstate this on both sides. We put out a compliance guideline to comply with regulations when the standard that goes along with the regulation would not be in 100% compliance with actuarial principles. That's not to say that 90% of it might not be.

There's a difference between actuarial science and actuarial principles. Although we might not regard the work that actuaries are required to do under this standard in accumulating 15-year asset shares as actuarial rocket science, it certainly is at the heart of actuarial science. I would say that there's a significant element of actuarial science being used in this regulation. However, the work may not comport 100% with actuarial principles. I want to draw a distinction between actuarial principles and actuarial science.

Mike, it seems to me that there are essentially two choices here. Either we refuse to cooperate with the regulators, in which case, in many states, we may well have ended up with a condition that is completely unacceptable to many of the employers of actuaries, whether we're consultants or company actuaries. This would be a regulation that would not have permitted the illustration of nonguaranteed elements. This would have essentially, according to industry spokespersons, put to zero the sales of many of

these products. Admittedly, that would not happen in all states. When this was being mooted by the NAIC, there were a few states, like Connecticut, that refused to pass this. They will just let the companies do what they always have. There was a large part of the regulatory community—perhaps reacting for the wrong reasons (the fall in interest rate caused vanishing premiums to not vanish)—that would have stopped companies from illustrating any nonguaranteed elements. That was one the first possible outcomes.

The second alternative was to allow illustrations of nonguaranteed elements under certain constraints. Early on, the regulators and the industry agreed that companies should continue to illustrate their current dividend scale. I can agree with the arguments that Daphne Bartlett and others advanced for grading the interest rate to some standard rate. I personally believe this might be a better basis for illustrations, but the ASB had nothing to do with this decision. It was basically agreed to by the industry and the regulators; that is, they would continue to illustrate current scale. Such a scale is not a projection. It's simply the current scale. But the regulators said the ASB needed to put some disciplines on it. Actually, the debate has been about how you come up with a disciplined current scale. Self-support tests are developed that involve essentially the accumulation of asset shares. Do we really prefer that somebody other than actuaries do that and that there not be any standards as to how such accumulations are done? I don't think that would be a good solution. I believe one or the other of those two undesirable outcomes would have occurred if the ASB had not participated actively in the process.

MR. KILBOURNE: I'd like to support what you said with an illustration. If we look at Medicare, we can see the trillions of dollars that Gary is talking about. If we were to say that we would support only those Medicare solutions proposed currently in the upcoming budget arguments that are actuarially sound, there is no way we could support the trivial tinkering that's being proposed by the House Republicans. They're proposing about $370 billion of savings over the next seven years. It is not much money because that only takes Medicare Part A up to the time when the baby boomers start to retire; it is trivial in that respect.

Beyond that, Medicare Part B is balanced only by the notion that it needs to be examined for only one year. I think that a strong argument can be made that we, as a profession, are doing irreparable harm to ourselves, as well as the public, by not standing firm for actuarial principles and insisting that—whatever our voice can add—that the problem goes far beyond the amounts that are being talked about now. However, if that is done, are we, with our loud voices and small numbers, going to carry the day? Is it going to be the choice between nothing being done or doing something that is at least a step in the right direction? I can see arguments on both sides. I think that effectively is what Gary is saying. He and I would undoubtedly differ as to where you should come down on this argument, but I certainly would agree that something that is going to have a practical effect in a positive direction is preferable to an impractical but theoretically sound answer.

MR. CORBETT: I want to make the point that the ASB is not the public policy voice of the profession; the Academy is. I have been critical of the Academy in this area. Although there are reasons for what happened, I don't think the Academy entered into the dialogue on illustrations early enough. By default, the ASB was pushed into the

position of representing the profession. I took the view early on that we would not take a position on what is appropriate to illustrate or investment year versus portfolio rates; these are both important actuarial elements. That was something that should have been addressed by the Academy. The ASB is not an advocacy group. The Academy is addressing the nonforfeiture issues at an early stage, and the ASB's role, while important, is going to be considerably more limited than it was for illustrations.

MR. MARK A. TULLIS: Although I agree with your comments, Dan, that this regulation and guideline doesn't tell you how to do pricing, it really does create a situation where, de facto, it would be very difficult to deviate much from the standards with regard to pricing. I agree technically with what you've said, and I think it's a more serious problem than what your comments would indicate.

My second comment is, there has been and should be a lot of concern and discussion about expenses. I know your firm has been very active in making comments, but I think it's a broader problem than that because, for example, by dictating interest rates, if you price on a ROE basis or value-added basis, it really creates an analogous problem to the expense situation. It's really a broader situation than just telling us we can or can't use macro pricing. To a large degree, there has been a de facto constraint put on how we price products.

Having said that, I'll make a third comment. I think it's important that we work with these people, even if it means we must compromise, not only for the reasons that Gary said, but because in my mind the worst situation we can have is what we had on the valuation regulation. We don't really address everybody's concerns, and we come out with a regulation that's not adopted by any state. Instead, we end up with a whole bunch of separate regulations which are very expensive to administer. If we don't compromise with these people, then we end up with 12 different standards that are imposed in each of 40 states; that would be the nightmare.

MR. MCCARTHY: Harry might want to elaborate on this but, if you want to see the nightmare situation, look at the certifications that actuaries have to make on small group rating questions. There must be 20 different versions.

MR. SUTTON: There are more than that. Almost every state is different.

MR. MCCARTHY: Mark, your point is well-taken. It's going to be interesting to see what happens at the state level. If the model is adopted, the next issue will be what will the industry decide to do from a lobbying point of view. Will they decide they are better off to have one set of rules or will they seek, in certain states, a different sets of rules? It'll be interesting to see what happens.

MR. CORBETT: Your comments on pricing cause me to say that, even though this did not affect pricing, our legal advice is that we shouldn't put anything in a standard, unsupported by a regulation, that would affect how companies market their products. Therefore, all the meaningful restrictions on illustrations are included in the regulation, with the standard generally interpreting the regulation.

We're somewhat concerned that this legal interpretation is going to restrict us too much in the future by preventing regulators from delegating to the actuarial profession as

much as they would like, as much as is done in many other countries, such as the U.K. We have commenced research into whether there are ways that the ASB, or perhaps some other board, can play a stronger role if we are formally delegated authority by state legislation that is comparable to how the FASB is delegated authority to set accounting standards by the SEC.

The ASB is a private body, and the Academy is a private body; we're subject to all antitrust constraints. We have no protection whatsoever. Therefore, we are extremely leery, perhaps to a fault, of doing anything that is unsupported by law or regulation, that can affect a company's competitive position—and that extends beyond pricing to how a company illustrates its products.

MR. DICKE: First, I'm not sure you do yourself a service by saying that compliance standards are things that are in violation of actuarial principles. I've always thought that in a situation in which laws and regulations have been adopted, and you have no control over them and something actuarial needs to be done, you'll do the best you can to apply actuarial science to that limited problem.

MR. MCCARTHY: That's a kinder way of putting it.

MR. DICKE: I think it's much kinder. Unfortunately, the other way of expressing it could lead to a misunderstanding.

MR. CORBETT: If we can write a standard that is in 100% accord with actuarial principles, we will do so, and we won't write a compliance guideline. An example is the two standards on statutory opinions. We feel that the one standard that requires the actuary to comment on reserve adequacy before signing the opinion is in accord with actuarial principles.

The NAIC wanted the same standard to apply and the same opinion to be expressed for the exempt companies where no cash-flow testing was required. The ASB dug in its heels and refused. How can an actuary attest to reserves if he doesn't test for adequacy? Therefore, we developed a compliance guideline for the actuary who signs opinions for exempt companies.

MR. DICKE: That's a good example of the distinction and the right way to put it. Where are things going and how will the Academy be involved? The nonforfeiture work is being done with less constraints on us from the regulatory side. It's coming from regulators who, after the illustration experience, came to the conclusion they'd like to go further. They'd like to see what actuaries could do if they were given control of the situation through the regulation. They recognize that they have given us some control in a regulation. Otherwise, as Gary has pointed out, we have no ability to control the direction of nonforfeiture values.

Nonforfeiture is the first area, but we have been made to understand that if that area is successful, the illustration area could be revisited. I think the right thing to do is to not lose track of all the objections we have to the current situation. Let's make nonforfeiture work and, if we do, then let's remind people that regulators are willing to revisit the illustration area. We could do a lot better job than was done the first time around.

FROM THE FLOOR: I was out at Snowbird, and I think a reasonable compromise was reached. I didn't care if everybody went away unhappy. Maybe that is a good compromise. One thing that struck me when we were going through the data on the lapse-support test was that most of the actuaries there had applied actuarial principles in the way that all of us would apply them (that is, they had gone in and taken account of the secondary effects). Several companies had requested that there be some sort of lapse rate added to the lapse-support test. I'm not sure what all the implications were. Some of it was just political, or some people actually believed that there shouldn't be secondary effects from a zero lapse rate, however the ASB did, as a compromise, go against good actuarial theory.

MR. RICHARD S. ROBERTSON: I want to resist the implication that what was done was contrary to sound actuarial principles. It wasn't an actuarial principle at all. It was a definition of what was considered to be a policy that was lapse-supported, and that's not an actuarial issue. Lapse support is whatever someone thinks it might be. I think we had preferences to how that definition might run, and I think that was why you could not get a strong consensus either way even among the actuaries present. But I think it's carrying too much weight to say an actuarial principle requires that the definition run a certain way.

MR. CORBETT: There was a lot of discussion that the tests should never have been labeled "self-supported" and "lapse-supported" but just test A and test B. Then how could one say what was the underlying principle for it?

MR. ROBERTSON: Any of us would have said from a professional point of view that if you reduce the persistency and say what's going to happen economically, you would have reflected secondary effects.

MR. CORBETT: Let me describe exactly what happened regarding the use of a persistency rate other than zero, like 3%. This will be an example of how different people are involved and we don't all agree on everything. There were about four ASB members at the Snowbird meeting on the Life Committee. The members of the ASB don't have a vote on that committee. However, we did sit in on their meetings, and I proposed that companies be allowed to use a 3% rate rather than zero, which I thought was reasonable. The Life Committee voted it down; that's their prerogative.

MR. MCCARTHY: I think it's important to say why. Regulatory input that the ASB and the committee received at that point, indicated that was going to be a no-deal. I don't disagree with your point that we perhaps could have argued that differently, but the position was taken not on any basis of actuarial theory but on being reluctant to blow it out of the water.

MR. CORBETT: That was proven the next day when, sensing that a majority of the board members supported the proposal, I made a motion that the regulation permit 3%. The motion failed by a five to zero vote of the NAIC Working Group. This gets back to the point that we surely shouldn't throw up our hands and say, because the NAIC won't agree to our proposal, that we'll drop out of the process.