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State Variations and Their Impacts on Valuation

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Summary: Panelists discuss the impacts on preparing reserves and an Actuarial Opinion and Memorandum (AOM) caused by differing reserve requirements in each state. This session addresses compiling, analyzing, and opining on 50 sets of valuation laws, regulations, and procedures. The perspectives presented include those of an industry practitioner, a regulator, and a member of the AAA focusing on professionalism.

BACKGROUND

Ms. Shirley Hwei-Chung Shao: In the 1990s, the Standard Valuation Law (SVL) was revised and the AOM Regulation was first introduced. The result of these two was that actuaries would have to set up reserves that meet both the minimum valuation requirements (these are minimum standards from the state of domicile), and the minimum aggregate amounts in the states of filing. The latter requirement is a new requirement, and it is this one that presents challenges to the actuaries.

Additionally, by signature, the appointed actuary certifies that the reserves meet both standards. The appointed actuary is the person who is personally liable for strict compliance to requirements across states. The issue is that requirements differ from state to state. Therefore, the actuary must compile, analyze, and opine on reserves for potentially 50 states with 50 different sets of requirements.

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Back in the 1940s when the SVL was first established, the SVL language was somewhat confusing. Some people say that it required you to comply with all states' minimum standards. However, the spirit really has been one of reciprocity (if state A accepts state B's valuation, then state B reciprocates and accepts state A's valuation). Thus, in the old days, we followed the state of domicile's requirements and did not really look into other states. However, with the introduction of the revised SVL, we now have to look at each state's minimum aggregate amounts. What makes matters worse is the retroactive aspect of this regulation (it's retroactive to all in-force business). When many products were first priced 10–20 years ago, most actuaries just looked at their state of domicile's requirements without investigating other state's requirements. However, with these new requirements, some of the actuaries are finding out they have to strengthen reserves for their in-force blocks of business. This can be very demanding and very prohibitive.

CHALLENGES FACED BY ACTUARIES

Four main challenges, described in this and in the next sections, often arise in my conversations with other actuaries.

1. Is there a definitive source that covers the variations?
2. How do we define the variations?
3. What are the costs and benefits of complying with these variations?
4. Do we really understand the risks being placed upon the appointed actuaries? As a result of signing an opinion, we are professionally and financially liable.

Addressing the source of information—how does a valuation actuary begin to tackle compliance with the aggregate minimum reserve requirements in all states? In theory, he or she first will have to understand all reserve requirements for each product line in all licensed states. Second, he or she will have to understand each state's aggregation rules to the extent that one product line cannot meet the minimum reserve standards. A further understanding of the state's aggregation requirements may become necessary to determine if aggregation across product lines is allowed.

How do you begin this task? In theory, you should gather and then thoroughly review all relevant laws, regulations, bulletins, letters, and guidelines in each of the states. If you do that, you will soon end up with piles that would take over your office and you will probably go blind! This process would not be trivial since these requirements come from laws and regulations that vary by state and tend to differ from the National Association of Insurance Commissioners (NAIC) model regulations. Some of the states still have older versions of the laws and regulations. Some of the laws and regulations have different effective dates. Also, there are the less formal bulletins and letters we sometimes get or discover over time. In particular, in the group business, many of the tables are approved by the states' commissioners instead of prescribed in the regulations. While the actuaries are usually very familiar with the tables prescribed by their own states of domicile, it is more difficult for them to find the tables that have been approved by other states for those states' domiciled companies.

What makes matters worse are the interpretations. Everybody has different interpretations. The actuaries in different states have different interpretations of the laws and regulations, which makes compliance very complicated.

CURRENT PRACTICES IN COMPLIANCE

In practice, instead of going through the laws and regulations, some of the actuaries rely on various resources with summaries provided for review.

None of these sources is perfect. In fact, they all have shortfalls. They are often not complete in the subject area, not updated on a timely basis, and they do not provide enough detail to be used as a stand-alone resource. In fact, you can find a disclaimer in the Academy's manual. It basically says, use us but do not trust us. Basically, if anything should happen, we cannot rely on any one of these summaries to protect us from our legal responsibilities.

What are some of the variations? The list I have, because I am more from the individual side, is mostly related to the individual business. I am not going to go through each one of them, but I am just going to mention a couple that are more related to the group side. One is effective dates. Even if the laws and regulations are entirely the same, they could have different effective dates. They may be enacted in different years, and that would create a lot of problems, because you would have tables and interest rates that would become effective in different years. So which year to comply with becomes a real issue.

I will use group long-term disability (LTD) as an example. I will go through the complications my company would have to go through to try to come up with valuation standards. The other three things are also related to the group side. One is reinsurance. It is never clear whether the opinion should be based on gross reserves or net after reinsurance. Even if it is based on net, there is a further complication if your reinsurer is not licensed in all states. Then how could you come up with an opinion saying that the reserve meets the requirements in all your licensed states? It becomes a very big challenge.

We will talk a little bit about aggregation. Different states have different aggregation rules. Some states, New York for example, will not allow you to aggregate across different major lines of business, where the lines of business are defined as life, health, and annuities. If you have sufficiencies, in, say, your group life, you cannot use that to offset your deficiencies in group health (even though they both are group products in New York). That creates some aggregation problems. You have to look into each state where you are licensed to figure out what its rules are as far as aggregation.

AOM language and the format and presentation vary among different states. As an actuary, you may find yourself having to opine by writing up different language or trying to incorporate all the different language into one statement. The list goes on.

The other common question many people are asking is, what are the costs and benefits associated with this kind of compliance? For the industry and states, the cost can be very substantial and sometimes even prohibitive. These costs will ultimately have to be passed on to the policyholder. The question is, given the marginal benefits of these variations, is the exercise really worthwhile?

As for the costs—for every licensed state, it is theoretically possible for the regulators to go through and audit, review, and then enforce compliance of all foreign companies. In reality, with all the budget cuts and changes in administration, regulators are often faced with too few resources to adequately review every company.

For insurance companies, there are substantial resources already devoted to the domicile state's laws and regulations. To do work for your domicile state and then duplicate it 50 times has become very prohibitive. In addition to researching and understanding the laws in order to comply, we also have to perform reserve computations based on different standards. This can sometimes mean a major systems effort. In addition, this has to be done in the year-end when the actuary is already involved with asset adequacy testing (AAT) work. To perform this kind of reserve calculation, in addition to AAT work, has become very burdensome. At the end of this whole exercise, the company may have to establish more stringent reserves. There is also a big cost impact here.

I think the state regulators benefit in the current situation. They can exercise their extraterritorial impact and control over the nondomicilary insurers, asking them to comply with their own requirements. Also, because each company has to comply with regulations in all different states, that usually means high reserves at the end of that whole exercise. Some of the state regulators feel comfortable with this conservative level of reserves.

From the insurer's perspective, there are no benefits in the current situation. The appointed actuaries are now responsible for performing AAT to ensure that formula reserves are indeed sufficient already. Therefore, some argue that the state variation concept is contradicting the whole valuation actuary concept.

Last but not least, the appointed actuaries are now being asked to undertake an impossible task—to understand, to compile, and to analyze all 50 sets of rules and then compute reserves based on these rules. With the downsizing of the corporations these days and more functions assigned to actuaries, we often find ourselves with limited resources. At the same time, the appointed actuary has pressure to sign. Some of the actuaries also are required to sign qualified language. This type of language is being frowned upon by the states. At the same time, the AAA is requiring the appointed actuaries to comply with Actuarial Standards of Practice (ASP), and we also have the Actuarial Board for Counseling and Discipline (ABCD) looking at all the noncompliance issues.

I question if we have raised the next generation of actuaries just to look into all the variations. For example, Milliman & Robertson (M&R) was talking about how they lost two actuaries because they helped the AAA prepare the valuation law manual. Since the work is so tedious and so meaningless, they lost actuaries because they do not want to do this year after year. In my company, the same thing has happened, although we have not lost the people. We have rotated them, so they still have to do this year after year just in a different area! It’s a type of work that I do not think should belong to the actuaries of the future.

I really think the pressure on the appointed actuaries is coming from all different directions. The actuarial profession is still grappling with what all this means in terms of their professional and personal liability.

When I talked to the actuaries about these problems and challenges, I was amazed. I do not think the actuaries completely understand the issues. They do not understand that their signature comes with legal responsibilities as well. Even if they do, I do not think they understand the legal ramifications and implications. I think the attitude of how they comply, even if they understand these rules, really depends on the attitude towards compliance. Also the cost and resource implications is limiting, especially for small companies, and so is their own understanding and interpretation of the laws and regulations.

In practice, we have seen all different kinds of opinions by the appointed actuaries. One single opinion means they usually use the AOM language which refers to the minimum aggregate amounts of all states. If the company uses a single opinion, it has the greatest potential for reserve redundancy. Some companies are using two opinions, one for all the SVL states, which is about 30 states as of the end of 1995, and another for the states which have not adopted a SVL. For the states which have not adopted the SVL, the language is just limited to the state of domicile; in other words, you do not have to worry about other states' requirements.

There are also companies that use multiple opinions. Maybe you want to do an opinion for New York, which is very typical. Maybe you want to do an opinion for another state, in which your reserves do not qualify (you do not meet the reserve requirements). You may just want to do a specific opinion for that particular state.

Finally, actuaries frequently sign a qualified opinion. The degree of the qualification actually goes from language like "to the best of my knowledge," to some explicit statement saying "I just do not meet your state's reserve requirements." It truly varies and we see this kind of qualified opinion (used in any of the three types mentioned).

AN EXAMPLE OF STATE VARIATION—GROUP LTD PRODUCT

I'd like to present our company's (Prudential) example of how we comply. Let me talk about the background. In 1988, the NAIC adopted a model regulation for Minimal Reserve Standards for Individual and Group Health Insurance. That model regulation requires the 1987 Commissioner's Group Disability Table (CGDT), which was developed by the SOA. The companies were allowed to modify the table, in the first couple of years of disablement, reflecting their own company's experience. Also, the valuation interest rates would be equal to the whole life valuation interest rates. Since then, the model regulation has been adopted and it has been amended several times since the original adoption. For example, in 1989, the interest rates were set to be as of the claims incurred date. In 1993, there were a couple of changes allowing you to use three to five years of experience modification with prior approval from your commissioner. Also, it allows you to use single premium immediate annuity (SPIA) valuation rates minus 100 basis points.

When our company did last year's valuation, we went through the following four sources of information to try to figure out what the regulations were in all the different states. We went through the National Insurance Law Service (NILS), where we subscribe to both CD-ROM and book versions ($25,000 each). We also went into the Academy's Life and Health Valuation Law Manual, which has some summaries. We also found a terrific article "Group Long-Term Disability Minimum Reserve Standards" by Jeffrey Prescott in the May/June 1995 publication of *Contingencies.* Mr. Prescott went through all the valuation requirements in different states for group LTD. We also talked with different states when we got confused—when we did not understand what their laws or regulations meant. These are all the places we went to try to understand.

Table 1 shows what we got after we went through all the different states. About 13 states adopted the regulation, and we looked at the different effective dates of these regulations. Remember, we talked about this before and even though the law can be similar, there may be different effective dates. The third column shows the different effective dates of the 1987 CGDT table. The effective date for that table may be different from the effective date of the regulation, because some of the states chose to defer the adoption of the table until a later date. Also, we looked at whether the states would allow the use of experience from year three to year five.

We also looked at the valuation interest rate requirements. We went through all these states and we found out for Prudential the strictest reserve requirements are in Wisconsin and South Carolina. As you can see, they both have the early effective date of the 1987 table and they both still also have the whole life interest rates, which are typically lower than SPIA rates minus 100 basis points.

TABLE 1
SUMMARY OF GROUP LTD MINIMUM VALUATION STANDARDS BY STATE

STATE	EFFECTIVE DATE OF REGULATION	EFFECTIVE DATE OF 87 CGDT	OPTIONAL USE OF EXPERIENCE YEARS 3–5	VALUATION INTEREST RATE
California	1992	1993	Yes	SPIA less 100 basis points
Colorado	1993	1993	Yes	SPIA less 100 basis points
Connecticut	1993	1994	No	SPIA less 100 basis points
Idaho	1993	1994	No	Whole Life
Maine	1991	1993	Yes	SPIA less 100 basis points
Michigan	1994	retro	Yes	SPIA less 100 basis points
North Carolina	1994	1994	Yes	SPIA less 100 basis points
Pennsylvania	1993	1993	Yes	SPIA less 100 basis points
South Carolina	1991	1992	No	Whole Life
Texas	1992	1994	No	SPIA less 100 basis points
Virginia	1994	1994	Yes	SPIA less 100 basis points
Washington	1992	1993	No	Life
Wisconsin	1992	1992	No	Whole Life

We went through a state-by-state reserve calculation. We actually calculated reserves on all different bases for each product line. For example, we did it for LTD, long-term care, and different product lines in group. We found out the most stringent requirements for LTD were in Wisconsin and South Carolina. Then, we went through the calculation for long-term care and found out the most stringent reserve requirement is actually Illinois. We finally came out with aggregate calculations and we still ended up holding reserves on a Wisconsin and South Carolina basis. This was a very tedious and time consuming calculation for us, and we came out with a single opinion for group products (we set up the most stringent reserve calculation for group).

What were the costs involved for us? We did this over a month and we used four actuaries. This is for all group products, not just group LTD. That's the cost involved for us to go through trying to understand, compile, analyze, and then do the reserve computation. We ended up with redundant reserves. We also came up with very frustrated actuaries in this whole process.

We also had some concerns at the end of this whole exercise. We did not know if we had covered all the variations. Our actuaries went through the search using the NILS CD-ROM version, so we did electronic research on different products. For example, we searched under "group," "disability," and "health." We were trying to search using key words, but we never know if we have done a comprehensive analysis that would have caught everything in there. Also, we found inconsistencies between NILS and the Academy Valuation Law Manual and decided to use the information in NILS. We found that we do not have a place to ask questions. Oftentimes we ended up asking the states, but even the states do not know the answers.

The most disturbing thing was that we could not find a source that would just give us updated information. For example, our 1996 year-end is coming up and we do not know what to do this year because nobody wants to go through the effort we went through last year. We would like to have a place that shows all the updated information, but we do not know where to get that information. We have not decided on the approach we are going to use this year.

ACADEMY'S EFFORT TO ADDRESS CERTAIN ISSUES AND CHALLENGES ARISING FROM STATE VARIATIONS

Mr. Larry M. Gorski: There is a major problem with compliance with the current version of the SVL and the AOM regulation. There have been discussions of various solutions to the problem at the Life and Health Actuarial Task Force for a couple of years, but nothing has moved ahead mainly because there has not been a concerted effort behind the various proposals. That has changed. In December 1995, the AAA formed a task force on state variations and valuation laws. The group is chaired by Shirley Shao of Prudential. There are various participants representing large companies, small companies, and regulators. It has broad-based participation. They have two basic objectives. One is a short-term objective of developing a framework to allow states to accept actuarial opinions based on the valuation requirements of the insured's state of domicile. Second, there's a long-term objective to develop a framework for achieving a more unified form of reserve standards and/or to place more emphasis on the valuation actuary concept.

The Academy's task force submitted a report to the NAIC Life and Health Actuarial Task Force at the June 1996 meeting and that report contained three basic recommendations. One, there were specific recommendations to change the language in the AOM regulation to recognize the preeminence of the domiciliary states' valuation requirements. Here the key phrase is preeminence. It does not mean exclusive use of the state of domicile's valuation requirements. Another recommendation was to eliminate Section 7 actuarial opinions. Everyone probably recognizes this second recommendation as being controversial. Third was to require an insurer to inform all states in which it is licensed about any special requirements or permitted practices of its domiciliary state.

PROPOSED FRAMEWORK OF TASK FORCE

I do want to preface my comments with a few general observations. The Academy task force was asked to prepare a report from a professional background, not wearing the hat of any insurance company, any trade association, or even a consulting firm, if he or she was a consulting actuary. I think there are probably elements of this report that are unnerving to companies, regulators, and actuaries. Their report is strictly from a professional standpoint, and I hope it is viewed as such.

The charts compare the current framework versus what it proposed under the recommendations. Under the current framework (Chart 1), the valuation actuary has to file actuarial opinions in each state in which his or her company is licensed based on the requirements of the state of filing. If a company is licensed in Illinois and California, the valuation actuary has to be familiar with the laws, regulations, etc. of both Illinois and California. Clearly, an actuary has a great deal of responsibility and I think 1996 highlighted some of the problems which can occur under the current framework with the discovery of Bulletin 74-11 in California. Under this kind of framework, the valuation actuary has considerable responsibilities and exposure to legal issues.

Under the proposed framework (Chart 2), again let us consider a situation where a company is licensed in Illinois and California. It is domiciled in Illinois but it is also licensed in California. In that case, the valuation actuary will be submitting to both Illinois and California an actuarial opinion based on the requirements of the state of domicile, in this case Illinois. In order to make this whole system work and to in effect shift the responsibilities in a reasonable fashion from the valuation actuary to the regulatory actuary, we have this concept of a central depository. This depository is going to be a mechanism for each state to summarize, in some coherent fashion, its valuation requirements for life, annuity, and health business. As each state accesses and submits its requirements to the depository, the regulatory actuary in California then will be able to assess the strength of Illinois' requirements relative to California's requirements. If the actuary in California feels that Illinois' requirements are substantially weaker than the California requirements, under the proposed framework, the State of California will still be able to ask the valuation actuary to submit an opinion based on California's requirement and that goes back to that byword preeminence. This report does not suggest taking away the right of the state to request an additional opinion. The states will have that right. Hopefully, they will use that right in a responsible fashion, but we are not suggesting that the right be taken away.

CHART 1
CURRENT FRAMEWORK
REQUIRED FILING (STATE OF FILING)

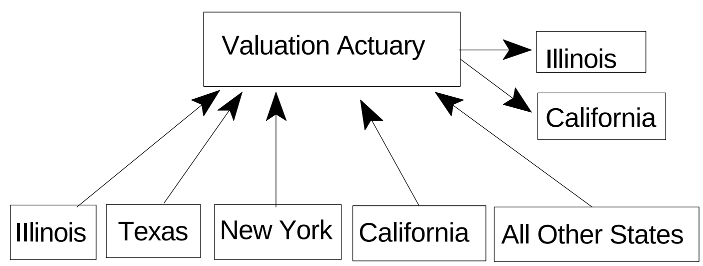
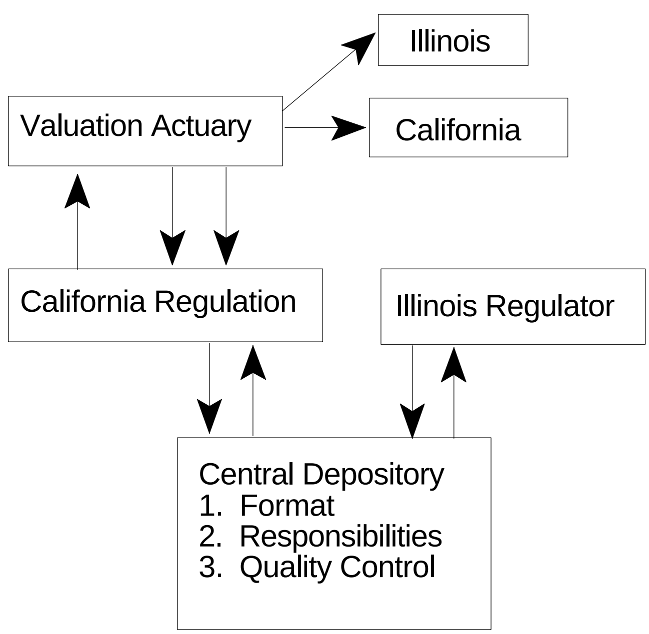


CHART 2
PROPOSED FRAMEWORK
REQUIRED FILING (STATE OF FILING)



There's the necessity of the valuation actuary disclosing to the California regulator any interpretations or permitted practices that the valuation actuary may have worked out with the Illinois actuary. Again, if those permitted practices are not to the satisfaction of the California regulator, he or she will be able to request an opinion based on the California requirement. Basically, this whole framework is an attempt to shift the responsibility to monitor and keep an archive of valuation requirements from state to state from the valuation actuary to the regulatory actuary. There should be some expense savings, but at the same time, it is in no way taking away each state's right to request that additional opinion.

CENTRAL DEPOSITORY STRUCTURE

Again, one of the keys to the success of this whole framework is the proper development and maintenance of this central depository. Questions have arisen on the format of the submissions that will enter the depository, along with responsibilities of quality control. The current thinking on the development of the central depository is as follows.

Initially there is a small subgroup of the Academy's task force that is developing a template to be used by the regulators to submit information about each state's valuation regulatory framework. That process is going on right now. There are two regulators and one consultant engaged in this work. The idea is to develop a two-dimensional template. The *y*-axis will identify product type. The *x*-axis will identify factors that impact valuation such as issue year, mortality table, interest rates, ability or requirements to use either a unitary or segmentation method, requirements concerning aggregation, and continuous versus curtate commissioner's annuity reserve valuation method (CARVM) selection factors whether they be 10 years or 15 years. We anticipate 50 or 60 different elements along the *x*-axis.

The NAIC will collect completed templates from the states, but will not be responsible for auditing. The NAIC's role will simply be as a depository and in no way are they going to be signing off on that work product as either being complete or accurate. As I say that, I am going to be changing my tune a bit, because as we were discussing the central depository idea, there were comments made by several actuaries who said they would like to have access to the depository in order to be able to, in effect, develop opinions based on the lowest common denominator approach Shirley was taking. We contemplated the idea of making the completed templates available to anyone (for a fee of course), and once we decided that we would make them available to anyone, issues of quality control become very important. Then the suggested use of that fee was to help support the NAIC collection function and maybe even get some auditing capabilities. Still in the discussion stage is exactly how steps three, four, and five will work.

Basically it is going to be a state responsibility to submit a template. The NAIC will be primarily in the role of a collection agency, but it probably will be made available to anyone, but that will entail some fee, with hopefully the attention to quality issues being addressed.

Another issue that came up in the discussion was since the states are responsible for submitting the documents, who should be responsible for any type of detection of errors in the submissions and the correction of those errors. It seemed to me that only the state of domicile can actually change the response for that state of domicile, even if that state may happen to be a weak state from an actuarial standpoint, and maybe there is a company in that state that has all the good intentions in the world and finds some problems with that response from that state. That company will have to work through that state to get it to make changes to the document. I do not think we envision a process where companies will be able to change the submission.

From the Floor: Can a state request an actuarial opinion on the reserves reflecting the state's valuation requirements?

Mr. Gorski: Yes. The state will always have the right to ask for a second opinion based on the state's own requirements.

From the Floor: Is the only acceptable technique for determining reserve adequacy cash-flow testing?

Mr. Gorski: This question comes up when we start talking about the elimination of Section 7 opinions and the kinds of issues that we can only anticipate coming from the actuaries representing small companies. There is always a question as to the cost of compliance with asset adequacy analysis.

The first point I want to make is that asset adequacy analysis is not a single technique requirement. There are many different techniques that are acceptable to demonstrate asset adequacy analysis. Cash-flow testing is not the only technique. In some situations, a gross premium valuation is all that is necessary. In some cases maybe even less than that is required if you have a health company with maybe group business, no long-term rate guarantees. Perhaps just a thorough review of the runoff of claim reserves may be all that is necessary.

From the Floor: Can the Section 8 exemption be modified instead of completely eliminating Section 7 opinions?

Mr. Gorski: The answer to this question is probably more in the hands of the regulators than in the hands of the professional actuarial task force and its report. Again, I am trying to differentiate between the report of the professional group versus the considerations of a regulatory group that has to deal with political realities.

Frankly, I was probably one of the people who had been suggesting changing some of the exemption tests. First, I would like to run through the exemption tests. There are basically three quantitative tests. One is the ratio of capital and surplus to cash and invested assets. Second is the ratio of reserves and liabilities for annuities and deposits to total admitted assets. Third is the ratio of the book value of noninvestment grade bonds to capital and surplus.

Neither of these three tests deals with interest-sensitive assets like collateralized mortgage obligations (CMOs), which has been one of the major modeling questions for cash-flow testing for a couple of years. There is no reference in any of these tests to derivative instruments, like futures and swaps, and we all know that there are small companies that do use these types of instruments. An opinion based simply on formula reserves does not get the job done.

Exposure to equity risk is another item. Thus, unless one does some real analysis of the adequacy of reserves under different scenarios, one does not get a feel for the adequacy of reserves. It is possible that these exemption tests could be improved upon if these types of considerations were incorporated within the tests. That is probably easier said than done. It does leave some room for the possibility of that taking place, but that is really an appropriate discussion for the regulatory body.

From the Floor: How will insurers notify states of practice permitted in the state of domicile?

Mr. Gorski: This is something I have learned a little something about in the last couple of weeks. Starting with the 1995 filing with states, there is a requirement in the certified public accountant (CPA) audit report for a section that deals with permitted practices. It is something that is required by the American Institute of Certified Public Accountants (AICPA) *Standard of Practice* (*SOP*) *5*—"Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises." This disclosure has to contain a description of permitted practice, stating that permitted practice differs from the prescribed practice and the monetary effect of adopting that or utilizing that permitted practice.

It all sounds good, but it is really the first year of implementing this, and there are a couple of issues. Are the audit reports really complying with *SOP 94-5* in a reasonable fashion? Are all situations covered? For example, let's say a valuation actuary comes to me with a question concerning my interpretation of the application of the valuation law to a new product. The question is on an area where there is nothing set out in the law or regulation, but the action is a legitimate attempt to get some guidance from a regulatory perspective.

If I provide that guidance, should that type of guidance be something that is disclosed as a requirement of *SOP 94-5*. I think it is, because presumably that valuation actuary under the current regime would be going from state to state to find out how each state would be handling that. Now that actuary is only coming to Illinois if it is an Illinois company. I would think California and the other states would want to know how I am interpreting the valuation law in this new setting. With that in mind, it does make the process much more complex because you must consider all those interpretations within this type of framework.

From the Floor: When will the new requirements be adopted?

Mr. Gorski: Considering the NAIC and the regulatory processes, I cannot conceive of this being adopted or implemented before 1998. I guess it is possible, but that would be the earliest date assuming everything goes well.

From the Floor: Will inclusion of the valuation requirement on the template submission be considered for adoption by the states?

Mr. Gorski: Here is the issue. Let's say I feel strongly about some particular interpretation of the valuation law in Illinois and I write up a description of that and my view of my interpretation and I put it in this template that is then filed with the central depository. Does that suddenly become a regulation? Does that all of a sudden become the only interpretation of that situation? I think not. I think we still have to go through a formal regulatory process of adopting a regulation. I do not think this is going to be an ad hoc way of avoiding what would normally be the due process of adopting laws and regulations.

WINNERS AND LOSERS UNDER THE PROPOSAL

I have extended the list of winners and losers to include both actuaries and consumers. First let me again point out that this is simply my interpretation of winners and losers. This in no way reflects any thinking of the Academy's task force. In fact, it does not even reflect the thinking of the Illinois Insurance Department, because within our department we have got some dissenting views on whether we can buy into the idea at all.

First, I'll give the regulatory perspective. The issue of Section 7 actuarial opinions has been a thorn in the side of many regulators for four or five years now. Regulators never really liked the idea of giving up the old-style opinion which at least had some reserve adequacy built into it. The current Section 7 opinion is strictly based on formula reserves only, and it really gives the regulatory actuary no comfort as to the adequacy of those reserves. Regulators would win from that aspect under this proposal. However, they would have a tremendous amount of additional responsibility put on their shoulders and that is causing some regulators to think twice about this.

If there is any one class of entities here that is clearly the winner it would be the large companies. There is no question that in this framework there would be a significant reduction in expenses associated with regulatory compliance. Now does that imply the small companies are losers? I think not, even though that is the argument small companies are going to be making. My comments are really big-picture comments.

If you look strictly at this proposal, I think you probably would come away with a feeling that small companies are losers under this proposal, but I think that is somewhat of a narrow way of thinking. It has a narrow focus in the sense that there are about three or four or maybe even five different projects at the NAIC level that, in some sense, pit large companies against small companies and the tension is because of some form of cash-flow testing or cash-flow analysis. For example:

1. Prudent person law, which is being discussed at the NAIC level, gives insurers a significant amount of leeway to invest as they see fit. Attached to that is a requirement that companies monitor the adequacy of the asset cash flows relative to their other liability cash flows. It is somewhat like cash-flow testing, except that it is at a corporate level. If the small companies are willing to buy into the responsibility of doing some type of monitoring of cash flows on a global basis, they would be able to avail themselves of the prudent person rule.

2. Negative interest maintenance reserve (IMR) is another stumbling block that has been around for a couple of years. It has been linked to a requirement to do cash-flow testing to support the negative IMR.

3. More and more innovative products come out that require a more sophisticated analysis of reserves. I think the clearest example of that is the equity-indexed annuity. Right now, any company can file a product in Illinois and start selling that product, whether it be a large company or small company. At least from a large company perspective, we would have the

> knowledge that the actuary had signed off on the adequacy of reserves presumably looking at the investment strategy, insuring that investment strategy makes sense relative to the nature of the index using an equity-linked product, equity-indexed product, etc. But a small company can do the same and all we have is a formula-based reserve opinion that tells you nothing about the fundamentals of the business and whether it makes sense.

If small companies expect to be able to sell the same products as large companies, then I think they are going to have to take on the responsibility of adhering to the same types of requirement. I do not want to make it sound like this is an anti-small-company proposal, because it is not. I think if small companies begin to look at the big picture and realize what is really at stake here, I do not think they would take the view that they do.

Clearly the actuaries are winners under this proposal too, at least for the most part. They will have some shifting of responsibilities away from them to the regulators which is fine. Some of the legal liability issues will be cleared up. I guess there may be some actuaries who may lose jobs in the process. I think all in all the actuaries will come out ahead under this proposal.

Last, I think consumers will come out ahead, because I believe there is substantial value to a Section 8 actuarial opinion. I also believe there is value to reducing company expenses so they can provide products on a more cost-efficient basis.

From the Floor: What is the timing on the proposed framework? Your discussion implied that, in most situations, it would be after the fact.

Mr. Gorski: It will clearly be after the fact. The general concept is that the valuation actuary in a Illinois-domiciled company will automatically submit with the annual statement in California an actuarial opinion based on the valuation requirements in Illinois, but that California regulator will also have the right to ask for a second opinion. You will meet your professional and legal responsibilities, but the regulatory actuary has an additional right.

From the Floor: Right now the model law has a provision within it that says if commissioners have a problem with particular small companies, then they can require a Section 8 opinion. It seems to be that many of your concerns that you expressed about poor investments and derivatives and so on, are so isolated that you are subjecting many of the small companies to some excessive regulation that pulls the honest people (such as my company that has very safe investments), into a large number of regulations that are just not necessary. It can be very expensive for me to build a system and hire the people to get that kind of certification done.

To me it already looks like, within the regulations, the commissioners have the power to subject the small company to the Section 8 opinion if they want to and there are no limits on that. I guess my question is, "Why are we changing something that doesn't appear to be broken?"

Mr. Gorski: The current approach of reliance upon the commissioner's ability to request a Section 8 opinion is sort of a chicken and egg problem, because oftentimes you need the basic analysis to determine whether there really is an issue. It is difficult to determine whether there is a mismatch between asset/liability cash flows because the company holds some exotic CMO tranches unless the analysis has been done. In my position, if I try to suggest to the commissioner that we ask for a Section 8 opinion on a particular case, the company is going to respond by saying, "Prove to us there is a need for it since we only have high-quality investments."

Oftentimes the issue is not high-quality investments, but it is the cash flow and interest rate characteristics that are of concern. Changing the perspective on the requirement makes much more sense if we want to get at the issues that really are concerns.

On the other hand, asset adequacy analysis is not synonymous with cash-flow testing. For a company that has very vanilla-type liabilities and assets, all high-quality assets and very little optionality in those assets, maybe the actuary can get by with something other than cash-flow testing and still render an adequacy analysis opinion. That is the perspective I am coming from.

I have used the requirement that you are suggesting we look at. There was a case where a company was a Section 7 company and we required a Section 8 opinion. It was obvious to almost anyone what the problems were and they were not investment related; they were actually expense related. Since the company was so small and losing business, there was no way it could cover its expenses and claims through its premiums, reserves, and investment income. When the company did a gross premium valuation, reserves were increased on that. It does work at times, but to me a much better approach is to have the appropriate kind of analysis done upfront and eliminate those issues. Again, I tied it back to all the other issues that seemed to be tied in, and that is the negative IMR, which is an outstanding issue, prudent person law, and the ability to market products that demand a higher level analysis than simply signing off on the formula reserve opinion.

Mr. Arnold A. Dicke: It seemed one of the points that I remember being brought up, when Section 7 opinions were being considered by the Life and Health Actuarial Task Force, was the question of what the opinion itself actually said.

There was no language regarding sufficiency or adequacy or anything like that at all. Is that a major issue or are only the exemption tests the issue?

Mr. Gorski: No. I think that is a possible avenue for further discussion. It is possible that in certain situations, based on the company's product line, the recommended language for the opinions may be different than the language and opinion for a company that has both interest-sensitive assets and interest-sensitive liabilities. I think there is room for discussion about many different avenues, but those discussions are really appropriate for a regulatory body and not a professional group. We ask the professional group for their professional opinion on certain issues, not taking into account company realities.

A LEGAL VIEW OF THE IMPLICATIONS OF STATE VARIATIONS

Ms. Lauren M. Bloom: We have been speaking primarily from a life perspective. Let me start by saying I think this proposal which has been put forward has the potential to simplify life enormously for actuaries who are currently working across state lines and for companies who serve various states. I should also say that while most of my comments will be directed primarily at life, much of what I have to say is true for the health practitioners as well. I also want to point out that while I think this proposal is terrific, it won't be in place until 1998 at the earliest, and I think that is a beginning point, not a completion point because of the way this problem arises in the first place.

Reasons for State Variations

The reason that there are variations from state to state which create difficulties and complications for actuaries is because, in the U.S., there is a system of government which puts tremendous power into the hands of the state legislatures. Those state legislatures are ferociously independent of one another, which means that when the NAIC issues a proposed model statute or regulation or something along those lines, some state legislatures may look favorably at the models and adopt them.

Most of them, however, are going to the model as a starting point from which to sharpen their pencils and go to work. What that means is that every state is going to have its own ideas about how best to regulate and legislate insurers who are offering products in their state.

What It Means to Sign a Certificate

Recognizing that this is not a problem that is going to go away real quickly, what can you, as practitioners, do? This is one of those instances where the phrase "close enough for government work" does not apply. Even though you are doing work for state governments, "close enough for government work" does not apply. There are several reasons for this. The first being that the model actuarial opinion memorandum in the life setting, comparable models in the health setting, and most of the state variations where states have adopted those, require the appointed actuary to personally certify that the reserves meet the requirements of both the insurance laws and regulations of the domicile state and that they are at least as great as the minimum aggregate amounts required by the state of filing.

It used to be the case that you could say “NAIC model plus New York," but it is not that simple anymore. Other states are adopting new regulations and requirements all the time, so it has become more complicated. I want you to understand that when you sign that certification as the appointed actuary, as the signing actuary certifying for a health company or what, have, you, this is not a boilerplate. You are not simply putting your signature there because you have to fill the line in or they will not accept the opinion without it. You are personally responsible for that signature, and in the law the word “responsible” is synonymous with the word “liable.”

Under the model actuarial opinion memorandum and the model valuation law, your liability for negligence as the appointed actuary is limited to a liability to your insurance company and to the state insurance department, but that is under the model. Not all states will necessarily have adopted the model, and if you make a full certification, that may go beyond negligence in any event and be considered evidence of either gross negligence or intentional misleading behavior, for which you are liable to the world. It is important to understand that if you make a false certification, even inadvertently, you may be in serious legal trouble.

I should also point out that at least under the model actuarial opinion memorandum, the commissioner is expressly authorized to discipline an actuary who either breaches the SVL or the actuarial opinion memorandum requirements. That is one of those variations which most of the states intended to adopt. It means that if you are found by the department to have breached the rule, you can get in serious trouble. I should tell you that, legal obligations aside, you also have professional obligations, which, as Shirley Shao said, are overseen by the ABCD and under your code of professional conduct, which applies to you as members of the SOA and of the AAA. Those of you who are members of the American Society of Pension Actuaries (ASPA) or the CCA are all bound by the same code.

There are several precepts of that code that I believe you violate if you make a false certification. You probably violate Precept One, which requires you to act with integrity and in a manner to uphold the reputation of your profession. You probably breach Precept Two, which requires you to act with integrity, skill and care when you perform professional services. You may well be in breach of Precept Four, which requires you to follow the ASP. You may also be in breach of Precept

Nine, which requires you not to provide professional services if you have reason to believe that they may be used to mislead or to violate or evade the law.

Let me tell you that nothing drives the ABCD up a wall faster than seeing that an actuary has made a false certification to an insurance department. Before you certify the adequacy of your reserves, you have to be certain that, in fact, you are in compliance with the legal requirements of your domicile state and that you are meeting the minimum aggregate requirements of the state in which the opinion is being filed. Unfortunately, the environment in which you are working, in many instances, does not always encourage you to be particularly careful about these things.

Law and Regulations

We are all hearing about corporate “right-sizing," which is “downsizing,” which is laying people off, but what that comes down to is a demand. The professionals continue to do more with less. They have more work, less time, fewer resources and still have to get to the right result. That is inherently in conflict with the need to do good, careful, and thorough work.

We are seeing and hearing stories about actuaries getting laid off because their companies do not feel that the work they are doing is “value-added.” I think it is terrific that the Prudential is so careful, but I can think of several companies that might be very reluctant to have four actuaries dedicate a month to looking at legal requirements. I need to point out that you are not attorneys. Even though you can look at legal requirements and become familiar with them, recognize that you do not read them with a legal background unless you also happen to have a law degree.

Finally, let’s face it—many employers just do not understand what it is that actuaries do and may not fully appreciate the extent to which you personally are responsible for the certifications that you make on the work that you do. Part of the reason all of this gets so complicated is because the law is not a simple thing. It comes in a series of layers and every state has its own laws.

When we talk about model laws, what we are really talking about are statutes, which is to say laws that are passed by the state legislature. They are black and white rules. The minute you put words on paper, you immediately have a question about what it is they really mean. The next step is to issue regulations. Those come out of the insurance department and usually they have to be produced through something called “notice and comment rulemaking,” where the department sends up a trial balloon of a proposed regulation, everybody gets a chance to comment on it, and then they issue a final regulation, which, ideally at least, has been modified to some degree to reflect the comments received. That is “formal rulemaking.”

Many states and many state insurance departments have some less formal system which allows them to further embroider on, interpret, apply, and otherwise clarify (one hopes) the law, which includes opinion letters, private letter rulings, public letter rulings, bulletins, and so on. Every state is a little different, and the legal binding authority of those documents can vary enormously.

Then, there are all the interpretations of the statutes, regulations, opinion bulletins, and so forth. I have to point out that those are not carved in stone. They can change whenever you have a change in direction in the department, or when you have a shift in personnel. Different people have different opinions, and you can have differences of opinions even within a department. All of this fluctuates all the time. It is important to remember that the laws develop a crust around them too, which is something that everybody thinks happened or everyone understands something to the point where it develops a life of its own.

A classic example of this is the Supreme Court's decision in *Roe* v. *Wade*. *Roe* v. *Wade* does not give women a constitutional right to choose an abortion, but it has been interpreted that way for so long by the lower courts, by the press, and by the popular public, that even the Supreme Court refers to it that way now. If you went back and looked at the decision, that is not really what it said. The decision has developed a patina and everyone now thinks the patina is what it really says. That happens around laws and regulations as well, as everybody tries different approaches, and if nobody gets upset about it, you do it again, and the next thing you know, you have a common practice.

Be aware that laws that fall out of favor or regulations that cease to be implemented can suddenly reappear. For example, I understand that the Florida Department recently discovered a regulation that had fallen out of use, and for the longest time no one was following it. No one got in trouble, but it was still part of the law. Now they are enforcing it again. I also understand that California has had what it calls Bulletin 74-11, which I gather has been in effect since 1974, but unless they happen to check your company's reserves, you would not necessarily have known about that. When they issued a bulletin recently stating that Bulletin 74-11 remains in effect and that they intend to enforce it, a lot of people went right up the wall, because they thought they had a new requirement being thrown at them all of a sudden, even though it has been in effect for years.

With all of that, it is no surprise how Bob Barney (Compulife) in a November letter to Frank Dino (then chair of the NAIC Life & Health Actuarial Task Force) described the current situation as "a horrendous problem." I think that is particularly true for the smaller practitioners because they have to scramble to find the resources to ensure compliance. What do you do? What you cannot do is give up and go work with the NAIC models because, if you do that, you will make mistakes and you will end up in conflict with the state laws.

What Should Actuaries Do?

Your best ally in dealing with the problem of state variations is your company lawyer. If you do not have one, consider getting one. If your lawyer is currently charging on an hourly basis, consider putting him on retainer because your attorney is probably the best person you can find to help you sort out and work through the variations, given the fact that they do exist right now. As Shirley Shao said, there are not many clear places where you can compare the laws against each other but that is something that attorneys are trained to do.

Your attorney can help you untangle the conflicting requirements among the various states where you are doing business. He or she can help you figure out what a reasonable interpretation of the law is and how to comply with it, to the extent that there are problems. Your attorney can be a tremendous ally in helping you negotiate with regulators and other people who may have told you something that does not make sense. Also, your attorney can help you with documentation, which is a very important issue.

Another thing that you need to do is make sure that your company management fully understands the scope of this problem and what you personally have at stake. Get them to pledge support to you so that you can get the resources that you need to make legitimate certifications. Also take advantage of the tools that the profession provides you. Consider using NILS; consider using your company law library or any subscription service, but do not forget that the AAA provides a variety of services that can be of tremendous assistance to you.

An important resource to consider is the Life and Health Valuation Law Manual. It is available through the Academy. We do not guarantee that it will be absolutely up to date, because the states do not always get back to us, but it is a place to start. Use the ASP as you work and do not forget both *ASP No. 23* on data quality and *Interpretative Opinion #3*, which deals with your obligations of documentation. Those can be invaluable to you because they will help you think through the factors that you need to consider to do a professional job, and remember, as professionals, you are bound to follow those standards by Precept Four of the Code of Professional Conduct.

Remember to take advantage of practice notes that are issued by the AAA. They are not mandatory, but they're compilations of common practice by your colleagues that you can look at, and if they are helpful to you, use them. They may make it a little easier to thrash out ways of working through those various requirements in a way that makes good sense.

Take advantage of the *Academy Alert*. If you are an Academy member and you have not subscribed, let me encourage you to do so, because as laws and regulations change, the Academy tries to keep you up to date through the Alert Service. Also take advantage of Actuaries Online. It is a great place to get up-to-date information.

It is also a good idea to come to meetings like this one and compare notes with your colleagues. I do not mean you should compare notes on product development—that is illegal. Compare notes on what the regulations and the laws of the several states say and how various people are complying with them, not with an eye towards setting prices, but with an eye towards making sure you understand your legal obligations.

Make sure that you make a good faith effort to comply. Believe it or not the law does not expect you to be perfect, but you do have to make a good faith effort, and it is important that you document your compliance. In the law and in litigation, it is less important what you did than what you can prove that you did. It is very important that your documentation be in place and that you disclose the steps that you took to understand and comply with your obligations.

Again, it is very important to work with your company attorney on this, because different lawyers have different opinions about the levels of documentation that are appropriate and how long you should keep that documentation. It can become very important, because in civil litigation, almost everything is subject to discovery in this country. Right now, every piece of paper in your files, on your desk, behind the drawers and on the floor is subject to discovery unless you can bring it within the very few exceptions to the discovery rules. Think about going home and cleaning out your desks and talk to your company about whether or not you need a document retention policy. Again, get your attorney involved.

Generally, it is a good idea to keep certain things around. Use the ASP and *Interpretative Opinion Number No. 3* to figure out how much documentation you need. At the very least, I recommend that you have the following items:

1. Your final opinion
2. A copy of the memorandum
3. The work papers that would be required under *Interpretative Opinion No. 3* for a reasonably qualified actuary in your field to be able to follow and understand your work

4. Records of the steps that you took to address questions and concerns
5. Memos to files based on telephone conversations
6. Correspondence you had with people to get your questions answered
7. Checklists of the tasks that you completed. Make sure there are no holes in that checklist.

Generally, I encourage people to get rid of earlier drafted documents once documents are in their final form. For instance, if you have done an actuarial opinion and it is final, you want to throw out the first seven drafts beforehand, because the document speaks for itself once it is in final form. Please do not make notes in the margins of documents, and if you do, please throw them away. They are only cute when you write them; they are not cute when you have to show them to a judge. It has been my experience that clever people have a tendency to write clever notes that they regret afterwards.

To the extent that you have skipped over steps or neglected them, it is probably not a good idea to keep documentation of that fact around, but again, talk to your attorney and understand that once litigation is contemplated or in effect, you cannot throw out relevant documentation without obstructing justice. It is important to have a document retention policy and follow it.

It is also a very good idea to have within your company some form of a peer review program, and have it be a two-step peer review. One should be a substantive peer review, which requires someone else who is also qualified to look over your work product for compliance with standards, and general practice. Does it make sense, do the numbers add up, is this logical? It is also a good idea to have in your company what I call a procedural peer review, which is to say looking at the steps that you go through to complete an assignment, whether you have done what you ought to have done, whether you have documented what you ought to have documented, and to have that procedural process in place, quite apart from the merits of any particular assignment. I think procedural steps tend to improve the quality of your work and reduce the risk that you have released something with a massive hole in it.

Finally, when problems arise, and they will, first of all do not panic. It is not the end of the world. If you got a call from a regulator with a question about a work product, this does not mean that you are losing your house tomorrow. It just means that a question has come up. With that goes the corollary of please do not immediately dig your heels in. If a regulator says “I would like the following. . .” and your immediate response is to respond defensively, the regulator’s back is going to go up, yours is going to go up as well, and you are going to have a much bigger problem than you would have had initially if you would have kept it low key. Let your lawyer help you with that because when people call you with problems, most of the time they are not trying to give you a hard time. They just want you to help them resolve their concerns.

Finally, make sure that your company attorneys, the lobbyists, or whoever is responsible for tracking legislation, keep you posted regarding not only changes which have taken place in the laws that affect your work, but also changes which are being contemplated. Then you can tell them when you have a problem and they can go back to the legislators, and the regulators and tell them before the law becomes something that you cannot live with.

From the Floor: You talked about actuaries being personally liable for actuarial opinions and you recommend that actuaries use our company's attorney. Do you feel that's most appropriate if we're personally liable? Would there be an issue if we're using a corporate attorney as opposed to our personal attorney?

Ms. Bloom: With liability, it's important to remember that you can pass it around and get other people's fingers sticky, but it will not necessarily clean up your own mess. Getting the company attorney involved is a good idea, because that person can help you identify the sticky spots. Particularly in the phase where you are just doing the work, your interests and those of your company ought to be the same. Your company ideally should be wanting you to do a good professional job and exercise your best judgment on its behalf.

Using your company attorney at the point where you are beginning work or when you are first completing the project ought to be fine. If you get into a situation where your interests and those of the company are in conflict, then you may need your own attorney. That is something to be aware of, and I am glad you raised it, because that can happen. When you find yourself in a situation where your boss is saying come on, just sign it and you do not feel that you can, if it gets to the point that your company is refusing to support you in something that could make you personally liable, you may want to get your own attorney involved in discussions with your company. You may also want to consider looking for another job.

From the Floor: I would rather have four attorneys spend a month reading the laws than four actuaries, but would that create a situation where we would need to get a reliance statement and include that in our opinion and get a signature from the attorneys?

Ms. Bloom: Ideally I would like a cooperative relationship between the attorney and the actuary. I think ultimately that works to everybody's benefit, because we do not always understand everything that you do. What attorneys do is not always necessarily clear to actuaries, but if you have a good dialogue going, ideally everybody is working together cooperatively and you get to the right answer. Yes, by all means, consider getting that reliance statement and getting that signature. That way you can be that much more confident that the work you have gotten from the lawyers is good.