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Hot Topics for Smaller Insurance Companies

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Summary: The status of emerging issues is discussed from the perspective of smaller insurance companies. Questions addressed include an update on illustration actuary requirements and the implications of the NAIC codification project for smaller companies.

Mr. Alex Zeid: We've assembled a panel of one former regulator, one current regulator, and one person on the firing line to talk to you about the *XXX* codification and any other issues from a regulatory standpoint.

Our first speaker is Abe Weishaus, an associate actuary from the Guardian. He's currently on the Education and Exam Committee, individual life annuity, and on the ad-hoc committee to update *XXX*. With that I'll let Abe take over.

Mr. Abraham Weishaus: According to our program, at the conclusion of the session you'll know which regulatory projects are on track and which are sidetracked. Well, I have to inform you that *XXX* has been sidetracked. More seriously, *XXX* has apparently become a very big topic. I've gone to two sessions

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already that referred to the latest industry updates to *XXX*. What I plan to do is give my personal observations on the process and add some more details as to what exactly the industry proposal contains.

As Mr. Tom Foley mentioned, the process started back in March 1998 when it became apparent that a couple of states other then New York were about to adopt *XXX* as of 1999. Many term writers found that they would have to eliminate their products or reprice them substantially if they were to comply with *XXX*.

In order to stop this upheaval of the term market, Steve Smith went to the NAIC and requested an opportunity to propose an alternative. Mr. Foley told him that the NAIC would listen, but only if he could get an industry consensus and could present a complete proposal very quickly at the June meeting. This, of course, is quite a challenging task. Notwithstanding, he worked very hard on trying to get this industry consensus. He contacted Armand dePalo, the chief actuary of my company, in order to bring large mutual companies into the process. From my company's chief actuary perspective, the need for *XXX* was much different from the need that Steve Smith perceived. From our company's viewpoint, if all 50 states adopted *XXX,* that would be perfectly fine. We could live with that. What we couldn't live with was one state, two states, or three states adopting *XXX*. Companies not licensed in those states would have an advantage over other companies. We prefer to have a uniform adoption of some sort of reserve requirement, which would have some sort of adequate reserve, rather than having a spotty adoption of a regulation which might require a stronger reserve.

I decided just to contrast *XXX* with the industry proposal. There are two features of *XXX* that I think increase reserves. One is the use of segmentation. In other words, you cannot avoid holding reserves by having a lot of high premiums after the end of a level term period. You have to segment the product. The other feature that raises reserves is the fact that this applies to all products. So, in particular, it applies to universal life with secondary guarantees.

To compensate for those things that raise reserves, *XXX* has a couple of things that lower reserves. One is a new set of 15-year selection factors based on experience from 1983 to 1986. Another feature that lowers reserves is the safe harbor feature that says, if you have a segment that's five years or less, you do not have to hold deficiency reserves for that segment.

Then there's another feature for which it's hard to determine whether it raises or lowers reserves. The guaranteed premiums are the premiums that are used for virtually all purposes, whether to determine where the segmentation occurs, or to

determine a pattern of net premiums and there is one minor place in the regulation where scheduled premiums are used. But I'll admit that's rather minor for this discussion. Otherwise, the guaranteed premiums are the main premiums for the reserve.

The problem with *XXX* is the high reserves that result. Since *XXX* has been adopted in 1995 by the NAIC, mortality has improved. Mortality in the 15-year select factors is based on experience from 1983 through 1986. More then a decade has passed since then. Mortality has improved significantly. Moreover, companies have introduced many preferred classes and superpreferred classes. Underwriting has become much more sophisticated and precise, particularly since the AIDS epidemic has caused blood testing to become more or less universal on almost all policies.

Also, the 15-year select factors are exactly that—they're 15-year select factors. They don't give you the slightest help. In fact, they hurt you for a 20-year level term product, a 25-year level term product, a 30-year level term product, or any product that goes for more than 15 years. There are no benefits in those select factors at all. As a result of all these factors, for a 10-year level term product, under 80CSO, we can calculate a basic reserve. I realize different software has different factors. But, I believe these are correct, plus or minus 10%. With 80CSO the highest basic reserve occurs at duration seven, and there's approximately $6.70 per $1,000. Under *XXX* you can lower that to $5.20 per $1,000. Typically, for a superpreferred class, the premium would be about $1 per $1,000 for this sort of product. As you can see, you have to put away a lot of your premiums to support just the basic reserve, let alone the deficiency reserve.

On a 20-year term product, the 80CSO reserve gets as high as $35 per $1,000, and, of course, *XXX* gets even higher since the select factors hurt you, whereas, typically, a superpreferred product would have gross premiums in the $2 per $1,000 range. In this case, you have to put away all your gross premiums just to support the basic reserve. On a 30-year term product, 80CSO reserves get as high as $153, whereas, typically, premiums on these products vary from $3 to $40. As you can see, the use of *XXX* would more or less eliminate typical 20- and 30-year guaranteed premium term products altogether, since no company could possibly afford to hold reserves for this product.

The other item that caused some controversy is the five-year safe harbor. This thing actually lowers reserves. Bob Barney is president of a company that deals with software that compares term products. He has conducted a one-man lobbying campaign throughout all the states to try to get this five-year safe harbor removed. His feeling is that, as a result of the high reserves we just mentioned, instead of 20-

or 30-year guaranteed term products, we are only going to have five-year guarantees. You're going to start having nonguaranteed term products if *XXX* gets adopted. As a result there will be indiscriminate and very mean competition. Each company will say, "trust me." Companies will start making ridiculously low premiums for the first five years, and they will say, "You can be sure that we won't raise our premiums after five years, but the other company will." There will be very mean-spirited competition. And, of course, it will be then meaningless to compare term products with each other, so those companies would be hurt as well.

Other problems are guaranteed premium gains. The fact that all of *XXX* calculations depend upon the guaranteed premiums means that, once you go into a nonguaranteed product, you can just arrange your guaranteed premiums any way you like. You can make YRT guarantees and lower reserves. So *XXX* doesn't even accomplish its purpose in that case. The final problem is adoption, which I already mentioned. Companies like ours cannot compete with companies that are not licensed in New York or would not be able to compete in other states that adopt *XXX*.

At this point, by the way, Texas and Wisconsin are scheduled to have *XXX* in effect by January 1,1999. West Virginia also is supposed to adopt it. I'm actually not sure if their adoption is based on the 51% rule or not. Several other states have adopted it with the 51% rule. So far, states containing approximately 30% of the population have adopted *XXX*, or have considered adopting it with the 51% rule. So we're still pretty short of having *XXX* adopted uniformly.

As a result of these shortcomings of *XXX*, and as a result of the need to get this changed very quickly before it gets adopted by Texas and Wisconsin, the industry committee was put together. Our first meeting was April 2, and we essentially came up with the idea of, first of all, putting in a new mortality table, one that more realistically reflects current experience mortality and, second of all, loosening requirements for deficiency reserves. This was done while attempting to maintain *XXX* in its current form. The entire regulation is still there. Just a couple of more paragraphs are added, and some have been deleted. But *XXX* essentially has the same structure, the same segmentation, and the same rules. The safe harbors are removed. This is our concession to Bob Barney. We didn't want him lobbying against it. Nonguaranteed products would have no advantage over guaranteed products under our new proposal.

Next, scheduled premiums determine reserve. For some reason, I understand this has become very controversial. Mr. Foley, at the earlier meeting, seemed to be very much opposed to this. I believe the proposed regulation may have used the word

"illustrated" instead of "scheduled." Mr. Foley asked the audience what people thought illustrated meant. Our committee felt that illustrated meant the scheduled premiums, the premiums that you plan to charge over the next period of time. In other words, a 30-year level term product has level-scheduled premiums. If you don't want to guarantee them for all 30 years, but for only 10 years, OK. Still, the reserve has to be based on the scheduled premiums. We felt that this was, in fact, a more conservative way of doing the valuation than using guaranteed premiums. You can play around with guaranteed premiums, but you're not going to play around with the premiums you really intend to charge.

In fact, my company, Guardian, is quite conservative in terms of reserves. For years before *XXX* we used the scheduled premiums to determine the reserves. That was our main method. Of course, we felt this was more conservative. So I'm rather surprised that the regulators are opposed to this change or question it. I'm not saying this is always conservative. It can also be nonconservative in the following way. System-scheduled premiums are used to determine the segments. This means that the first segment of a level term product is the entire level term period. You can use the new factors that are developed for the entire period, but, the product segments much earlier if you use guaranteed premiums. Then you can only use the new mortality factors in the first segment. So, in that case, this becomes less conservative. But even that I consider as reasonable, since the whole idea of not being able to use the select mortality factors past the first segment is an antiselection against you. I think as long as you don't raise your premiums there's no antiselection. So I think scheduling premiums for segmentation is quite legitimate. The main features of this new proposal, though, which lower reserves, are the use of new select factors and relaxing deficiency reserve requirements.

Let me go into somewhat gritty detail as to how we develop new mortality factors. We started off with something called a Becker Table, named after Dave Becker at Lincoln, who suggested this approach. We started with a 75/80 table. We then revised it for 1983–88 experience, using the *TSA Reports* paper of the individual life insurance experience committee, showing mortality under a standard individual underwritten life insurance between 1987–88 anniversaries, Table 19. What that table says is that on the average, smoker mortality is 148.7% of the 75/80 table and nonsmoker mortality is 70.5% of the 75/80 table. So we started with those percentages of 75/80. Since this experience is centered on the year 1985, we projected this for 15 years to the year 2000, because we assumed this is when this mortality table would take affect. This was projected using population experience from Social Security, using the SOA Table AA. Approximately, this table says that mortality has improved at the rate of 0.5% a year at ages below 40, 1% a year for ages 42–44, and 1.5% a year above age 44. We projected that table for 15 years

using the same Table AA, and then we did perhaps what is the most controversial thing—we split the table into preferred and standard. The preferred table is 80% of the table we developed. The standard table is 120% of the table we developed.

Who determines what is preferred and standard? The actuary would be responsible for this determination. The actuary at the company would use his or her judgment to determine who is preferred and who is standard. You have 16 classes, and you're not obligated to put 8 in preferred and 8 in standard. You can put 12 in preferred and 4 in standard, whatever you feel is most appropriate. It just limits the actuary's judgment a bit. The reserve however, has to be at least as high as the gross premium reserve, so the reserve is still based on statutory principles. The gross premium reserve is only used if your reserves are so low that they're below that level. That was the Becker Table.

However, we ended up raising the mortality a bit for several reasons. One of the reasons I think is a little bit interesting. Bill Shriner of the ACLI, was at the first meeting on April 2. He insisted that we could not drop 80CSO under any circumstances, that we would not be able to get an industry consensus if we dropped 80CSO. At the time I thought he was joking. Nevertheless, the committee decided that instead of using the Becker Table, we would express the Becker Table as a percentage of 80CSO and only use it for the first 25 years. In other words, turn it into a 25-year select table. After 25 years the mortality jumps to the 80CSO. Why did we use 25 years? It's alleged that the SOA 85/90 table would have a 25-year selection, so we decided that we could use 25 years. Of course, this does shut down 30-year guaranteed level terms. So if you're planning to sell that, it may be very difficult if this proposal is adopted.

We also stuck in other margins. A lot of them are my fault I have to admit. I thought the mortality table was a bit light and I mentioned this to somebody else. My company works in mortality and he agreed with me. So I wrote a letter to Rob Foster at CNA, who was heading the committee on the mortality table. Unfortunately, this letter also got into the hands of some regulators. Essentially, I was a little concerned that perhaps selection does wear off before 25 years. We didn't really take care of that directly. But we had the table graded to 80CSO between the ages of 75 and 85, so if you wanted to sell a 25-year term plan starting at age 60, you wouldn't get that much benefit from this new table.

We also decided that for smokers rather, than using 80–120%, we would use 90–110%. In other words, the numerical difference rather than the percentage difference is the same for smokers as for nonsmokers. Those were the margins we added. We didn't add any explicit margins. We felt that this table itself was

adequate for reserving. However, there are a lot of implicit margins in this table. For example, as usual under statutory valuations, no lapses are assumed when you do the reserve. We did not project past the year 2000, even though this table will be used for several years into the future. The table does go to 80CSO after year 25. The reserve is subject to a gross premium reserve test. The reserve must be greater or equal to half CX, under an 80CSO or an 80CSO 10-year select factor, so this new regulation will not under any circumstances lower your reserve to the lower of CX.

Finally, we only allow use of the table for fully underwritten business. Now what's fully underwritten business? Well, one definition would be blood testing. We felt that this definition was a bit too strict. As Tom Foley was saying, we decided to include bodily fluids to the actual wording. Saliva testing alone would not be sufficient. Saliva testing currently can detect cotinine, cocaine, and HIV, but it can't detect more sophisticated things like blood lipids or things like that. For the meantime, we felt that we could not sell it to regulators if we allowed use of saliva testing alone to allow these tables. We felt, in theory, that if saliva testing gets better you may use these tables. That's why we didn't insist on blood testing. On the other hand, we felt we couldn't really allow use of these tables with only saliva testing at the current stage of technology.

How about deficiency reserves? Actually, before I get to deficiency reserves, I have a couple of comments on these mortality rates. What I tried to do was to use the logarithm of the mortality. First are male nonsmokers with 10-year selection, 80CSO 15-year selection, *XXX* 15-year selection, 25-year selection using preferred table, and 25-year selection using the standard table. There's a significant drop in the mortality using the two new tables, which, however, merges at between ages 75 and 85 due to the methods we use. Also, at ages below 15 and at duration 15 and duration 25, we didn't change the table. Of course, at duration 25, 10- or 15-year select factors don't get you anything, but these factors get you some lower mortality.

There are some basic reserve comparisons. For 10-year term reserves, I would think that the most important numbers would be the 25-year selection factors preferred mortality, since that is the lowest possible mortality rate under this regulation. For 10-year factors I have to admit that this proposal isn't much more than a half CX. However, this proposal does lead to a decent comeback reserve for longer 20-year term products. It goes up to as high as $18 at duration 14. So, for that $2 premium, you'd still be setting aside a good deal of money for the reserves. This is by no means a very liberal proposal. According to our calculations this reserve is about twice as high as the GAAP reserve, so it's a nice reserve. Admittedly, it's not as high as those huge 80CSO lines. But it's a decent reserve.

The 25-year term is the longest possible period that you can use as a select factor. Once again, the new reserves give you a lot of relief, although they do get up to about $40 or so. For a 30-year term, of course, it gives you no relief at all. It's only good for 25 years, so this proposal would not help you if you're in the 30-year term market.

For deficiency reserves, we felt that it was reasonable to develop a basis that virtually eliminated deficiencies. However, one problem was that we could not change the standard valuation law. The standard valuation law requires deficiency reserves. So what we did was create a table that had very low mortality. We decided to use 40% of the basic table—the basic table being defined as the table of 25-year selection factors.

However, in order to use this table you have to have an actuarial opinion that the mortality rates you are using are reasonable based on the company's experience. You can also use percentages higher than 40% and multiples of 10%. Use 50%, 60%, or 70%, whatever you feel represents the mortality of your company. You can eliminate the deficiency reserves as long as your pricing is at least as high as 40% of the basic mortality, and you could find that this was a reasonable rate of reserving.

Now I have a couple of examples of what the net premiums are under this method. Let me first give you some idea of what the net premiums would be for 10-year term, if you used 40%,60%, and/or 80%, because those are 25-year select factors. We also decided to allow 40%, 60%, and/or 80% 15-year select factors. If you didn't qualify for the 25-year select factors, I'll get to that momentarily. For age 45, a premium of $1 would not be deficient if you could use 40% or 60% of the mortality. A 25-year term product premium of $2.50 for your superpreferred class would also not be deficient.

So far I haven't really spoken about how small companies should feel about this. I guess I'm from a large company, so I don't have a good feeling for small companies' needs. But let me tell you what the committee did, especially for small companies. Number one was the fact that we didn't insist on blood testing. We kept open a possibility of saliva testing in the future if the technology improves. But we felt a lot of small companies don't do blood testing. Another thing we did for small companies, which I alluded to just a minute ago, if you do not qualify for these tables because you did not do this underwriting, you then have to hold the *XXX* 15-year select factor reserves. However, for deficiency reserve purposes you may still use 40% of the *XXX* factors if you can opine on the mortality on that basis. So even

if you do not do the full underwriting, you can still lower your deficiency reserves significantly under this proposal.

That's the industry proposal. I just want to update you as to what happened since the April 2 meeting or since we came to this conclusion. Even before the June 3 Life and Health Technical Task Force (LHATF) meeting, I found out that this problem that Bill Shriner mentioned about 80CSO was not a joke. Just before that meeting some of the large permanent insurance writers all came in and said, "No way, we're going to allow this to get through." Why not? "Well, there's a little tax problem." I wrote it out here, although I don't think I'll read this since it's the usual tax code gibberish. It's Section 8 of 7D. The prevailing mortality table is defined as the table that generally yields the lower reserves whenever there's a choice of two or more tables. Now since preliminary testing, the 25-year select table, while it does raise reserves for whole life products past the 25th year, it lowers reserve products before the 25th year. Does this generally lead to lower reserves? Well, if you're a company that's not growing and has a lot of business in later durations perhaps it doesn't lead to lower reserves. But for most companies that are growing or that have significant amounts of business in the first 25 years, use of these tables would generally lead to lower reserves. Once these tables got adopted by 26 states they would become the prevailing tables. That lowers your tax reserves, but so what? Don't expect all this reserve relief for free.

The problem is that Section 7702, which defines life insurance, says, that for the purpose of the cash-value accumulation test, which is used by all permanent products, the mortality charts cannot exceed the prevailing table in Section 807. Here you would be stuck in a bind. On one hand, the cash values on these products have to be held based on 80CSO because that's what the states require. On the other hand, they cannot be on the 80CSO basis, since they would not be defined as life insurance in that case. The only way out of this is stopping the sale of these products altogether or at least not underwriting them. Obviously that was not acceptable to these companies. So in order to get around this problem, limiting the new regulation to plans not having a cash value. In other words, you could use universal life secondary guarantees, but could not use these revised rules for universal life basic reserves.

This proposal was not acceptable, though, to the term writers because a lot of term products have cash values also. So far this problem has not been resolved, and it is a problem. That brings us up to the June 3 meeting. I think this would make a great question for an actuarial exam by the way. I have a list of outstanding issues and questions here. I wanted to be up-to-date for this meeting, I wasn't at the NAIC meeting myself, so I called Steve Smith, who made a presentation and I asked him

how it went. He said, "Well, I have 37 questions on outstanding issues." The next day, Tom Foley said there were 33 questions on outstanding issues. I have the documents here, and there are 34 questions!

In all justice to Tom Foley, though, I don't really think question 31 is a question. Question 31 is needed to resolve other critical issues. But there's one question for small companies that you may want to think about—Question 13: Is the gross premium valuation requirement acceptable to the smaller companies? Why? This question means that small companies may not be able to afford a gross premium valuation. This means that you'll need more actuarial consulting talent to form this valuation. While this regulation may help the large term writers, it will not help the small term writers. Therefore, it will not represent the industry consensus, which means that there will be companies lobbying against this if it gets adopted.

That's the way it stands right now. If any of you have any solutions to these problems, or would like to know what the other questions are, please talk to me privately and I'll e-mail you a copy.

Mr. Scott Harrison: Somebody thinks that I know more about accounting than law. That tells me they don't think I know very much about law. I'm not even allowed to touch the family checkbook at home.

Let me tell you a little bit about my background and why I'm semi-qualified to talk on this issue. In addition to being a lawyer in private practice representing companies, I have done two terms as a state regulator. I was the deputy commissioner of the Delaware Insurance Department. I was the deputy superintendent in the New York Insurance Department until about a year ago, when I left regulation for the second time and joined Peterson Consulting, where I now consult with insurance companies on a variety of regulatory issues, principally compliance, mergers and acquisitions, and work like that. We also do exam work for states with compliance and financial exam work.

But my first introduction to codification was when I was in the New York Insurance Department as a deputy. Governor Pataki asked us to do a lot in the way of reforming the way the business was regulated in the state of New York. We came in with a very full agenda. We got a call one day in July or August. Within a week we got two calls from representatives of two of our largest life companies. They called the department superintendent and said, "We need to come to see you." So the superintendent said, "Great, come on in." He had an open-door policy . So they came in, we met with each of them in the space of a couple of days. Both of them said, "We need to talk to you about codification." "What's the problem?"

"Well, if such and such an issue is adopted the way it is in codification, it's going to put us under about a 120 risk-based capital (RBC) level. One of our big life companies is going to go to the action level. This is not good." We said, "We'll talk about the issue." It turns out one of our colleagues in the department was very actively involved in the codification project. We found out that the codification process was taking place almost in a vacuum. This would have been in the summer of 1996. Very little information at that time was being disseminated to the industry. Now it would be unfair to say that no information was being disseminated. But it had just been some months before that, as a result of industry demands, that the work, methods, and progress of the working group was even being disclosed to the companies.

The result was that the larger companies, because they frankly have the bodies to begin to look at these issues, began to realize that there were some very significant issues, such as changes to statutory accounting, that were being proposed that would have a very significant impact on their surplus. The one case I mentioned was the treatment of mortgages. Because of the proposed changes and the way those would be accounted for, it would have, in my view, a disproportionate impact on a company that had a high concentration of mortgages, no matter what the quality.

To rewind very quickly, the bottom line and promise of the codification project was to be surplus neutral. All we're going to do, the world was told, is codify current practices. That's all we're going to do. Well, in practice, they would look at a statutory accounting principle for a particular issue. If they didn't like that, they would look at GAAP. And they would take the most conservative one. If they didn't like either one of them they made up their own. What you had growing was, in essence, a lot of current practice being written down, but there were instances where things were changed. There were some fundamental changes that were taking place in accounting treatment. Obviously, as I said, I'm not an accountant. And there are a lot of people more qualified to talk about the nuances of this. But my message to smaller companies is a wake-up call, now that codification has been passed. You people need to figure out how it's going to impact your company.

It's not too late in your state perhaps to impact some change on codification as it's going to be applied by your state insurance department. That depends on the law in your state. We'll get to that issue in a minute.

Approximately 100 issue papers were developed and disseminated among the regulators. They would meet, debate, and talk about them, and then they would be adopted. There were a lot of very controversial issues. Again, another reason why

they wanted to do this was to create uniformity. The state regulators, on the financial side, were very unhappy with CPAs having qualified opinions. Because of a permitted practice in a state or whatever, there was a lack of uniformity from state to state. And it was bothersome to people. So the goal was to create a uniform system of accounting that every state would be required to use and eliminate state-permitted practices. That was a fundamental tenet. The working group said, "We want to take away from the states the right to recognize alternative accounting practices." That created a lot of concern with organizations like the National Conference of Insurance Legislators (NCOIL), particularly in my state, which has done battle with the NAIC over the issue of state sovereignty.

One of the reasons New York still is not accredited is that the legislature insists that we are going to determine how, along with the superintendent of the governor's office, insurance is regulated in this state. We are not going to bow to the NAIC. We're not going to pass model laws simply because some unaccountable, unelected bureaucrat in Kansas City says that I have to do it. Period. This is another instance. Codification comes down the pike, and NCOIL again becomes very concerned. What's going on here? What do you mean? Now we have accounting principles. They will be imposed on the states in total. Take it or leave it.

There was a lot of discussion between the NAIC and NCOIL over this. I don't think anybody has sat down and smoked a peace pipe, but I think that NCOIL recognizes to a certain extent the need for uniformity. But at the same time, NCOIL is very diligent in protecting its interest in what it views as its sovereignty in regulating the industry.

Parenthetically, I think it's interesting for an organization of state regulatory groups to insist on the preservation of state regulation. I'm not here advocating for or against federal regulations. But, insisting on the sovereignty and the importance of state regulation was like the 11th Commandment being brought down from the mountain. Yet, at the same time, with the state, the effort is to create this seamless uniform system from state to state so that the characteristics of regulation between New York, California, Rhode Island, and Delaware are gone. The nuances of regulation are now viewed with suspicion. They are viewed as something that is an impediment to good state regulation. I think codification is an issue, or just an example of the rush to ward off federal regulation. What you're doing is creating a federal system. You're creating a unified system of regulation, so it doesn't matter except on the things that really count—form filing, licensing of agents, and things that are directly relevant to your business.

You are creating this uniform system. What does that have to do with codification? Well, once things began to be disseminated and the industry began to wake up a little bit, the industry demanded a survey. The NAIC commissioned a very expensive survey to be done in late 1996. The results that came back indicated that, under the current issue papers, the life industry experienced an aggregate 13% reduction in surplus. On the P&C side it was 8%. Now mind you this is in the aggregate, so there are going to be winners and losers here. From the regulators' view, I frankly was not that concerned about companies that would see an increase in surplus. The last thing I wanted to see was a company rendered insolvent or in trouble because of a change in accounting principles.

As a result of that initial survey, changes were made. There was a second survey done that was released in March or September 1997 in which the accountants stood up and announced that it was surplus neutral. They claimed to have fixed all the problems. But again, you have winners and losers. This was an issue principally for small companies because the impact can be much greater. Percentage-wise an impact on your surplus can have a much greater impact on your company than for the likes of Guardian, New York Life, or other bigger companies. They have a greater cushion.

I was very troubled a couple of years ago at a conference in California. I was asked to speak to the ACIC in California about codification. All of a sudden I was getting these blank stares, including from some people from larger companies. So I said, "Who here knows what I'm talking about?" Three or four hands went up. The people who were mostly in smaller companies had no idea this process was ongoing. They had absolutely no idea that somebody was out there. There was an effort being led by the chief examiner in their own state to rewrite statutory accounting principles, which, in 1998 or 1999, would have a direct impact on their financial statement. They had absolutely no idea. I don't mean this in a pejorative sense, but the greatest threat to smaller companies is ignorance of the process and unfamiliarity with the process. The codification was approved in March 1998.

It's law as far as the NAIC is concerned. There are a couple of issues that are still being worked out. There was an attempt to codify the model investment law. The pigeonhole approach, in effect, makes it an accreditation standard by incorporating it into codification. That effort was largely frustrated. There were some other issues over confidentiality investments. Those issues are currently being worked out. But it has now been passed to the state. There's a permanent ad hoc working group at the NAIC on codification which will remain as a standing committee. The purpose of that working group will be to continue to tweak the system and identify or respond to problems as they crop up.

But the issue for your companies is, what is your state going to do? What is your commissioner going to do? There are a couple of scenarios here. If your statute says, that your commissioner has the power to determine the accounting principles under which you'll be examined, then all that some states require is for the commissioner to say, "Yes we're going to do it." Very likely, in that state, your commissioner doesn't need to do anything. He or she could just adopt the codification adopted in whole or in part as he or she deems necessary.

Some states will require legislative action. In some states the legislature has retained to itself the right to determine what the accounting principles will be. I think in those states and in states where it needs to be done by regulation, public hearings maybe required. There will be battles on these issues. You'll have companies coming forward, lobbying the legislature and the department saying, "Look, this is going to be the impact on us. You need to recognize or permit a practice." Once that happens, you're moving back to where we were before, which is, generally recognizing the number of accepted or permitted practices. We've clarified some other things but don't have complete uniformity. But I'll tell you there's not a commissioner in office right now in my view who is going to say their codification legislature is so important we need to pass it. "That's OK if it's going to take down one or two of our companies, or if it's going to significantly impair the surplus with one or two of our companies." There's not a commissioner that's going to let that happen.

So what's the future of codification? I think that there will be a lot of pressure on the states to adopt it in toto. I think that pressure ultimately will be resisted because politics, as someone said, "is all local." I'd rather deal with the bureaucrats in Kansas City on these issues than have to answer to the press as to why I now have to take down a company and trigger a loss of jobs and an impairment of the guarantee fund. There's a whole panoply of bad things that happen when you have to take a company down.

I think that over time there will continue to be efforts to reform and revise what we currently have to try to work these things out. So maybe over time we'll get to something that everybody can live with. But you people need to find out. You need to talk to your accounting people and your outside accountants. If you're using a Big Six firm, those people should already be talking to you, consulting and advising with you, and telling you what the impact of the changes in accounting will be on your company. You should already know that. If you haven't heard that, you need to go to them and make sure that you know, so you can begin now to

protect yourself. Because these things will begin to take effect very quickly. With that I'm going to stop, and we should have a little bit of time for questions.

From the Floor: From the speaking end, as a lawyer, you certainly address the accounting issues very well.

Ms. Julia T. Phillips: In all honesty, I have primarily worked in the area of health insurance. But I have found myself getting involved in life insurance. Since I joined the Minnesota Department of Commerce, which is the insurance department in Minnesota, about three years ago, I found myself for the first time in an environment with very few actuaries. We have one life actuary, one health actuary, one P&C actuary, and a student. So the life actuary and I have actually been doing quite a bit of cross training, because if that person is out, there's nobody to answer questions or do stuff. So I have been dabbling in life insurance.

When I started going to the NAIC, I got interested in some of these issues and I started going to the LHATF. What I thought I would talk about a little bit is something that I have gotten involved with quite a bit in my regulatory work, which is the actuarial opinion and memorandum. I was a valuation actuary for a couple of years, and I didn't even realize that there was a Section 7 opinion because we were a big company and we just did a Section 8 opinion. Now I read hundreds of actuarial opinions every year, because we track them in Minnesota, and determine whether it should have been a Section 8 and whether the actuary was appointed. So I thought I would talk very briefly about the difference between a Section 7 and a Section 8 opinion. Also, some of the NAIC's proposed changes have not yet come to a final form. In fact, they've kind of been bouncing around.

I've been on the LHATF for about three years, and for the entire three years the Section 7 and Section 8 thing is going on. To refresh my memory I called Jim Van Elsen, who is a very faithful attendee at these task force meetings. He's a consultant and does a lot of work with the National Association of Life Companies. The Actuarial Opinion and Memorandum Regulation (AOMR) has just been bouncing around. Back in 1996 it was one thing. Six months later it was something else, and then six months later something else again. It's still in flux.

One of the big issues is that the NAIC is trying to rewrite the AOMR. In preparation for this I printed out a copy. It's 30 pages long. This is the NAIC model law of the AOMR. One thing that I thought was interesting was that the Minnesota law is actually a version back, and we have some different wording in our law. My sense is that, like many other things with the NAIC, the states do reserve the prerogative to

not only do things differently, but also to forget to do things, and to do things slowly, so there is quite a bit of disparity among the 50 states.

But the issue that I first heard a couple of years ago, was that different states have different requirements, and the actuarial opinion is supposed to say that you're "certifying that the reserves are appropriate for your state of domicile, and in aggregate meet the standards of the state in which the statement is filed." It is practically impossible for anybody to certify that reserves meet the standards of all 50 states. What first came up was a discussion of a trade, which made me uncomfortable because I always like to have the illusion that regulators are trying to do the right thing.

But there was a discussion about making a trade where we would exchange allowing actuaries to certify just for the state of domicile, not having to say that the reserves meet the standards of every state in which they're filed. The trade-off would be that every company would have to do a Section 8 opinion. A Section 8 opinion is one that requires asset adequacy analysis, which often involves cash-flow testing, which is very expensive to do. Whether you have in-house people do it or have a consultant do it, it often requires purchasing expensive software and a lot of time. So, there was a great deal of resistance from small companies. Jim Van Elsen got up and was very eloquent about what a hardship this would be, if a small company would have to do the asset adequacy analysis.

In the current incarnation of the AOMR, there are several categories of companies. But in essence, if a company has a small amount of assets there's an asset test as well as some other standards as far as investments, surplus, and so on. That company then does not have to do asset adequacy analysis. The actuarial opinion simply has to certify that the reserves are adequate and all the other wording that has to go into the opinion. This was what was being discussed when I first became involved. The regulators were saying, "We'll give you state of domicile. But you'll have to do a Section 8." The whole thing has just bounced around. Most recently there has been a group of regulators who is trying to work on something called the benchmark. It might use codification as the standard and then say that each state can at least be assured that the reserves meet this benchmark. And then, if the state knows what the benchmark is, the group can determine if it wants to ask for additional reserves from the company or not.

In the meantime, there was a discussion of a central repository where some official agency would keep track of all the valuation laws in all 50 states and the territories. I think that eventually died for lack of somebody willing to do that. The Academy of Actuaries was willing to hold it, but only if it didn't have to check and review

everything. I think it had enough trouble with its valuation manual. It had some experiences with being able to get timely accurate information from the states on that. It was willing to be the repository in the sense that it would maintain it, but as far as checking the accuracy, it really didn't want to do that. Similarly, the NAIC got cold feet at the idea that it was going to have this central repository and all you had to do was check there to find out the valuation law. So it's still going on. The actuaries are working on it and trying to get some consensus. Is a benchmark a good way to go? And if so, what should the benchmark be?

And there are always states, and I think New York is the outstanding example, where the insurance department does not want to be told what to do by the NAIC or anybody else. So, the idea that a state would have to accept another state's valuation standards, and say, "This opinion is acceptable as long as it meets the requirements of your state of domicile" is an unpopular concept with a lot of states.

The NAIC relies tremendously on people in the industry to do the actual work. One thing that is very helpful is that the industry can come forward and have a consensus like Abe was talking about. That's what the NAIC would really like. If the industry would do the work and get a consensus so that everybody in the industry agrees, then the NAIC is fairly likely to be interested in adopting something, relying on the fact that the companies who are willing to work on it are often the companies who are willing to meet the higher standards and put in something that's an effective regulatory mechanism. It's easy to make fun of regulators because we don't do any actual work. We just sit around telling people what they can't do.

One problem with regulators is that we tend to get very cynical. We see the worst, you know. If I read 100 actuarial opinions and the first 99 are perfect, I just flip through them. Everything is fine. But I had one that was fairly good and had most of the required wording. It had everything in it except the opinion. One line says, "In my opinion the following,. . . ." That line wasn't there. So we have a tendency to be kind of cynical and suspicious. When we get to that 100th one we say, "Oh gee, how could they have left that out?" and write a letter saying, "Please supply another opinion." We can be difficult to work with partly because of the fact that, like an oncologist who only sees really sick people, we spend most of our time with the things that aren't working out or aren't good.

I think maybe we can throw the floor open for questions at this point. If I've breezed too fast past anything and failed to explain something, feel free to raise your hand and we'll go ahead.

Mr. Jerry Seaman: I haven't heard of any major case for involving the "every state" requirement. Have there been major cases where that has been an issue? Usually, when reserve requirements are onerous, actuaries know about them. When they are subtle, they are usually unimportant. Maybe I'm oversimplifying.

Ms. Phillips: Let me repeat the question for the record. So the question is, have there been any major cases in which the requirement that reserves meet the standards of all states has been an issue?

From the Floor: It seems like more of an intellectual issue than a real one.

Ms. Phillips: I'm not aware of any case where that has generated the issue. Does anybody else on the panel know?

Mr. Weishaus: I think you're right that it's an intellectual issue. But it still has bothered us since we don't want any problems with the regulators. The case that I remember in my company is that we wanted to use smoker and nonsmoker tables. It seems like there are a couple of states like North Carolina, tobacco states, which do not really recognize the smoker/nonsmoker tables. They've never really formally approved them. We wrote a letter to these regulators and they seemed to be willing to accept the use of smoker/nonsmoker tables on one hand. But they don't want you to call them that.

Mr. Harrison: I think it's more of an issue in health insurance, where some states have set minimum standards of gross premium valuation and in the state of domicile, you have tabular reserves. There's where you see more of a problem than in life insurance, where it's pretty standard. That's been my experience. I think it comes up in credit insurance and disability as well.

From the Floor: I have a question on the codification process. It seems like usually when there are changes made, there's a grading period. Is something similar going to be done in the codification process?

Mr. Zeid: Yes, the question was whether there's going to be a grading period or seasoning period for the codification. I think that, in practice, yes. Although I think it's the intention of the NAIC and certainly the intention of the working group to do everything right. Their experience teaches them that the answers that they've come up with are the right answers. But I think as a practical matter it was Glen Pomeroy who supported the notion of the creation of this permanent ad hoc task force on codification. There are going to be issues that come up. There are going to be

problems. There are going to be things that will be missed. Companies will take issue with the language on certain issues, so I think that's a practical matter. This is a work in progress that will continue to be a work in progress.

But in terms of the applicability of it, there will not be a seasoning requirement. The original goal was to have it in place for financial statements or exams for this year. My sense is that since it was approved in March it may not be applicable this year, but certainly in 1999.

Mr. Jerry Davis: Regarding the *XXX* proposal that requires underwriting and examination of bodily fluids, are there any standards being set for what you're supposed to do with the results of such examinations.

Mr. Weishaus: We explicitly tried to avoid doing that since underwriting technology keeps advancing. Anything we write into the law may become obsolete overnight. Our omission of this does bother the regulators. I think in the list of the 34 questions, one of them is that perhaps we should limit this to blood testing. But we tried to avoid that altogether.

Mr. Zeid: I hope that we've informed you about which regulatory projects are on track, and which are sidetracked. I think we'd like them all to be sidetracked but I don't think that's going to happen.

We wanted to make you aware of the special concerns of smaller companies regarding the recent developments. Understanding the issues and the options available to manage them for the success of your company is the goal.