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The Unified Valuation System: An Update

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Panelists: JAMES F. REISKYTL
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Summary: Panelists provide a brief history of the "unified valuation system" concept, including objectives, and discuss intended users of the output from the system. A progress report on the proposed valuation law is also presented.

Mr. John F. Gies: This session is about a new unified valuation system (UVS). I work in the Connecticut Department of Insurance, and have been there for six years. Prior to that I was employed with Connecticut Mutual Life in Hartford, which was merged out of existence a year or two ago, one year shy of it's 150th anniversary. The reason I mention this is to emphasize the notion of change, which is the underlying theme of our presentation today: We want to understand the need for change, the inevitability of change, and the appropriate amount of change.

We are privileged to have two well-known people to discuss the topic this morning. Jim Reiskytl is vice president, tax and financial planning at Northwestern Mutual. He has been on numerous SOA and AAA committees and is chair of the AAA's Qualifications Committee. He is a technical adviser to the NAIC, where he is active in the risk based capital (RBC) and Interest Maintenance Reserve discussions. He also oversees the development of the Society's *Handbook for Dynamic Financial Condition Analysis*.

We are also privileged to have Bob Wilcox on the panel. Bob is national director of regulatory consulting with Deloitte & Touche. Many of you recognize him as the former Commissioner of the State of Utah. He also has been a participant on numerous Society and Academy committees. He chaired the development of the

Note: The chart referred to in the text can be found at the end of the manuscript.

Life Insurance Illustration Regulation for the NAIC, and he currently is chair of AAA's Valuation Task Force (VTF), which developed the proposal that you're going to hear more about today.

This is an interesting subject that can be approached from many different perspectives. A brief introduction from a regulatory perspective may be a useful backdrop.

The statutory framework currently consists of prescribed rules for the valuation of liabilities—bright lines, if you will. The bright line prescriptive rules are supported by two elements: cash-flow testing, and an aggregate cash surrender value floor or minimum. In no circumstance may the liabilities otherwise determined be less than the liabilities in the amount of these two aggregate fail-safes. The point is that cash-flow testing, in the current valuation system, doesn't act as a substitute for the prescribed rules, but is simply a supportive element of otherwise determined minimum reserves. Notwithstanding this circumstance, if one were to closely review the standard valuation law (SVL), one would find many areas where lack of specific guidance hampers uniform interpretation of its provisions. Consider, for example, guarantees funded through separate accounts with respect to individual products. Then also consider the equity-indexed annuity, which is a general account product with equity-like features. Contrast this with a variable annuity with a guarantee of principal in certain circumstances. The two products seem very similar and yet a struggle occurs when trying to fit each within a different regulatory framework.

Further examples of awkward application of existing prescriptive rules include variable annuities with guaranteed living benefits, and also guaranteed minimum death benefits. Commissioners Annuity Reserve Valuation Method (CARVM) procedures tend to be utilized in valuing these liabilities. However, a plain reading of the SVL describes CARVM in terms of present value of guaranteed benefits. This is an awkward fit for a variable annuity contract. Consequently, guidelines are developed to fill in the gaps, but additional problems arise such as, are the integration of benefits to be permitted? or are additional guarantees to be valued in a fashion more consistent with the 1940 SVL? One final example of the strain on the existing regulatory framework involves the simplest of products, term insurance. The amount of discussion that has occurred in terms of developing a reasonable reserving mechanism for term insurance is amazing.

The reason for providing these examples is to emphasize that the system is clearly straining under the weight of current products and the advancement in the way actuaries look at products, price products, assess risk, and otherwise deal with the financial implications of products.

The two gentlemen on the panel have different perspectives about how to approach this changing environment. One might be saying that the proposed system is too risky to pursue. The other might be saying that the existing system is too risky to continue. Both have powerful arguments, but the one thing that is common to their outlooks is that both support a deferral of earnings on the basis of a release from risk accounting mechanism, where the objective is the solvency of the provider, so value can be provided to consumers.

Mr. Robert E. Wilcox: This meeting is described as an open forum. From my perspective, it's an opportunity for a broad discussion of the topic. It's appropriate for us to step back and let some of the fresh eyes in the audience help guide us to the original objective of the VTF project or to what it should be.

In December of 1996, it was determined at the NAIC's Life and Health Actuarial Task Force (LHATF) meeting that we needed to take a fresh look at the valuation process. The task force requested that the Academy reexamine the valuation process with regard to life and health insurance, and to do that without constraint of what currently exists. As a result of that discussion, this task force was described by some as the "clean piece of paper task force," because we were starting all over with a clean piece of paper to determine what the valuation systems for life and health insurance ought to look like.

Right after that, as I stepped down from being Commissioner at the end of the year, and the request came for the Academy to pursue this task, I was asked by the Academy to take on the chairmanship of the task force to look at this issue. We started in the early part of 1997 to go down this course.

Jack described some of the strains on the current system, and if you've been involved in the policy development side of the valuation system, I think you have to agree that there are genuine problems. But for those of you with little prior experience or awareness of this project, for the next few minutes you can become the chair of the task force. How would you approach this task of re-addressing the valuation process for life and health insurance with a clean piece of paper? Let's get some discussion going for a few minutes about how you would approach the topic. What are the problems you'd face? What sort of research would you do? How would you launch a project to reexamine the valuation process? I could mention a few things to start your motor running. However, I genuinely want your input, so please give us your thoughts.

From the Floor: One of the things I might do is look at what other countries are doing in this regard. I think the United States is unique in having specific laws that complement an actuary's experience, knowledge, and training to determine whether adequate assets are available to pay future claims.

Mr. Wilcox: As a matter of fact, we did that. Shirley Shao from Prudential chaired a subgroup that looked at what's going on in other countries. Some of the things that it discovered were three kinds of predominant reserve requirements. There were prescribed methods and assumptions like we have in the United States. There were net premiums with discretion on assumption, and there were gross premium-based valuations. It was useful to find out that people were performing valuations in a different way.

We also found a definite trend toward actuarial judgment, as opposed to prescribed formulas. That was important information and something that we have used considerably in the development of the new approach. There was emphasis on capital adequacy and financial condition, and integration of that piece into the valuation system was an important part.

We found that a single report system dominated in most foreign jurisdictions, as opposed to our statutory valuation system, GAAP valuation system, and tax valuation system. We have more systems than anyone else. Then we also determined that most places in the world valued assets and liabilities consistently, and that there were problems when that didn't occur. Most countries have moved to a system that values assets and liabilities in a consistent fashion.

There was a requirement for flexibility to adapt to market changes, and that's where we saw a developing trend as other countries were revising their system. Another aspect that I think stands out in importance where the valuation system works well, is the existence of a strong working relationship between actuaries and accountants.

In summary, one of the things that the project did right up front was to look at what other countries have done. The VTF subgroup identified a number of countries that represented different sizes, different cultures, different economies. and different parts of the world as giving us a representative sample without looking at every country. We had the east, west, north, south, developed countries, developing countries, and a whole range of outlooks and insurance products. If you're interested in how these insurance activities are performed in other countries, I would recommend it to you because it's a great piece that's been added to actuarial literature.

Mr. Bill Higgins: There's so many things that we do that seem to have the same objective, such as statutory, GAAP, tax reserve, cash-flow testing, projections for GAAP, and other activities. If you were an outsider looking at this, you'd probably ask why we are doing all these things.

Mr. Wilcox: That is a good insight.

Mr. Steven L. Kossman: I think I would look at those companies that went into receivership, or maybe were problematic, and take a look at what the reasons were. Were there loopholes in the current valuation law? Would some of these proposals be helpful and have prevented those problems?

Mr. Wilcox: In that regard, we were able to take advantage some other Academy task forces and committees that had already done a lot of the work, and also review the SOA and Casualty Actuarial Society research into failed companies. Also, there was a task force that had started a year or two ahead of what we were doing with the assignment to look at the solvency of insurance companies. The report began by saying that the task force had been given the wrong assignment and it looked at the solvency of insurance companies, instead of the viability of insurance companies. The report said that, if you wait until solvency is the question, you've already passed the point at which it's reasonable to deal with the problems. The important thing is the company's ability to carry out its business plan and remain viable. The VTF considered that and determined it was an appropriate aspect to build into the valuation system in terms of the things that we needed to do.

Mr. Gary Corbett: I would use a two-tier system with a basic reserve system that's very close to best estimates for earnings, with a required surplus that's more than required surplus. It would be absolutely segregated as a form of liability obligation on the balance sheet, an element of working capital to provide for the necessary solvency.

Mr. Wilcox: So, you point out that there are really two purposes. Even though we're trying to get to a UVS, we need to be able to carry out the current business of the company. We need a balance sheet and an income statement because we have to know what our earnings are, but that balance sheet by itself is insufficient to tell us that we have the resources to remain viable and solvent.

Mr. Charles Linn: Adapting to market changes is important because you can't predict everything that's going to be coming down that road. It would be preferable to have that flexibility and not prescribe too much that locks in and stifles innovation.

Mr. Wilcox: This builds off of the concept of giving the actuary the responsibility to do the job, rather than prescribing precisely how to do it.

From the Floor: Also, in the sense of the unifying approach, do you also envision, for example, cooperation with other countries? For example, under the current conditions of globalization, we have European countries that are subsidiaries here and vice versa.

Mr. Wilcox: Certainly, we're aware of the work that is going on internationally in response to the convergence that you refer to. In fact, international accountants are trying to redefine the way we're going to account for the insurance business, and the actuarial profession is involved in that in much more significant ways than in the past. We're trying to make sure that we're feeding into that process. Obviously, you get into a different political process, where we're dealing with the NAIC and the financial accounting standards board and so forth, but as those things change, we think it's important to be doing research in the United States. We have a role to play in how that's done, because, ultimately, it will not be possible to continue to operate on a global basis when financial reporting is done in separate and distinct ways. We've been limited in terms of how much we can do at this point, but it's an excellent point to keep in mind.

Mr. David Huff: As I thought back to the blank sheet of paper, I thought we might be going back to basic definitions. What are the contingencies that we're concerned with to attempt to make our work as all-encompassing as possible. And, then, within the type of contingencies, we can think of payments that occur due to living or dying or morbidity. We would want to try to address environments that would cause deterioration or acceleration of payments within each of those areas. This is more of a microquestion, rather than the macroquestion we're addressing, but some of the research that's being done is touching on these areas. I don't know how long it will be before we think we have our arms around the deterioration that might occur because of forces beyond the company's control. In other words, the actions of the policyholders or marketplace need to be addressed in light of how they might work to undermine what we think is an adequate reserve system calculation.

Mr. Wilcox: That's an excellent observation. We must ascertain that it's within the scope of the actuary's responsibility to look at all contingencies and not have anything pulled out and taken off the table so to speak.

Mr. Joseph L. Murdzek: When we're looking at something for the first time, we also have to acknowledge certain constraints, that is, the FASB and the IRS. Even if we come up with something good, it remains to be seen whether it will be acceptable in their eyes.

Mr. Wilcox: That's an excellent point and one that we discussed early on. We had to recognize that our various audiences had constraints on them. We identified all of the audiences that need the information we produce and what they do with it. We recognized, in the process, that they do different things and have different constraints. The people who use our work product to collect taxes have a different view from other people who use the information. Consequently, we made a fairly long list of the people who use the information and, at the conclusion, had about eight or ten different categories. It helped us identify entities like FASB and the American Institute of Certified Public Accountants (AICPA) that are interested in what we do. We have reached out to them. We've met with the FASB a couple of times to talk about our work, what we're doing, and how we're doing it, so they could understand us and we could understand the concerns they might have. We have not gone to the IRS, only because we're cowards. We need to have a much greater consensus and be much further down the road before we tackle that one. But that is an audience that we need to be concerned about.

Mr. Kossman: It would be worthwhile looking at other financial institutions. The blending between different financial institutions and financial competitors has potential to put insurers at a competitive disadvantage.

Mr. Wilcox: That's an important point. We've done some of that analysis, but probably not as much as we need to.

As we're winding through the time, let me move on and show you some of the things that the VTF did. We listed the advantages and disadvantages of the current formula reserves. While that was going on, the primary thrust of the task force was to try to set some general broad parameters, a framework, on which to base a system that could be evaluated by whether or not it would meet the objectives that we identified along the way. We identified that it had to be a system that would provide information to policyholders, regulators, and others to assist them in making informed judgments about the insurer's financial condition. It needed to support financial analysis, both at points in time and over time—that is, it should be a continuous rather than a discrete function. We also said that it should address overall solvency; not just contract reserves. In particular, it should address resources consistently with obligations.

In the final analysis, we may not achieve every step in this framework, but the goal is to address each of these as well as we can and still have a system that is practical and achievable. It should produce auditable and verifiable results that incorporate an actuarial feedback loop in which assumptions and projected results are compared to emerging experience. For those of you who are familiar with the *Casualty Statutory Yellow Book*, a predictor/corrector approach or a Schedule H reserve development approach on a broader scale is envisioned. If we're going to rely on actuarial judgment, we need to analyze how actuarial judgment changes over time and ascertain that there is accountability for estimates.

The system should cover all insurance activities and be holistic (consider the entire enterprise), rather than merely representing some of the independent parts. It should provide for covariance of risk. That does not necessarily mean that we always know everything we ought to know about covariance, or that we know how to use the covariance in the results. But the system should not preclude us from using all of the covariance that we can identify and that we know how to apply.

The system should balance practicality, cost, and resource effectiveness in relation to the value of the information to the audience. If it isn't practical, it won't work. If it costs more to do than the results are worth, it's not going to work. It should be consistent for all companies and among regulatory jurisdictions. If there's an aspect that we may have difficulty achieving, that could certainly be it. Anecdotally, in a meeting here in New York a couple of days ago, the subject came up about the problems that a committee was having getting all five of the actuarial bodies to agree to do things in the same way in an area where it was important to do things in the same way. Because each of the actuarial organizations have different boards of directors, it was very difficult to get that consistency. The thought went through my mind, "If we can't do it with five actuarial organizations, how in the world can we do it with 50 states plus the district, with all of the states having two houses of the legislation except one." Obviously things are going to come out differently when you have that much opportunity for variation, but it is important that we get all of the consistency that we can possibly get.

The system should be flexible and accommodate unidentified future needs. It should be the kind of system that allows an innovative company to come up with an innovative product, and allows it to introduce and market that product without having to spend months, if not years, getting enough support from the industry to develop a valuation system. Similarly, the system should not present impediments to the regulators, so they get embroiled in process before a product can come on the market. Equity-indexed products are an example of that. It is difficult to scoop the market with a great idea if you need to get the synergy of enough companies to develop a valuation system that is acceptable on a prescribed methods and assumptions basis before proceeding.

A key part of the VTF proposal is use of actuarial judgment in the development and interpretation of results, in preference to compliance with prescribed methods and assumptions. At first blush, this sounds really exciting. The more you go home and think about it, the more challenging, difficult, and maybe even scary that becomes, because along with the opportunity to use actuarial judgment is a great deal of responsibility.

Such a system should accommodate materiality issues. I should note that when materiality came up, we said we don't know what materiality is, but the accountants must know what it is because they use it all the time. However, the accountants say they don't know what it means, either.

Then there were three objectives that came along as well—the layers that a prior commentator was talking about. We're starting at the far end of the spectrum relative to what we do now, by stating that the system should evaluate the ability of a company to execute various business alternatives. Who needs to know that? It is primarily management and the board of directors, not the regulator nor the creditor. The board of directors sets the business plan and has the responsibility to know that it can be executed and carried out.

The system should evaluate the adequacy of resources relative to obligations. Now we're getting into a regulatory area. Regulators need to know when to "pull the trigger." When a company can no longer carry out its public responsibilities, this evaluation of adequacy of resources is necessary to perform that step. And finally, earnings and the balance sheets are necessary to measure changes in resources relative to obligations.

The 10 elements of the framework, together with these three objectives, were necessary first steps to define what we were going to try to accomplish. Chart 1 is central to many of the things we've been talking about. Consider a company's current operations. On this graph, the horizontal axis shows resources relative to obligations. The vertical axis shows the probability of survival for the company. Somewhere near the middle of the chart, you see the indicator that points to statutory liabilities. If a company were to have assets only equal to its statutory liabilities, under the current system, it would have some ability to survive, if only because of the redundancy in the statutory liabilities. I'm taking out of the equation for a minute the fact that, if the company had assets exactly equal to the statutory liabilities, regulators would come in and take it over anyway, because that would not be a good enough protection for the public.

However, as additional assets are added, in addition to the assets equal to statutory liabilities, total assets might be enough to get the company, for example, up to the company action level of RBC. The company would have a much higher probability of being able to survive long enough to meet all obligations in that circumstance. That's the fundamental purpose of RBC. It increases a company's probability of survival to the point that the regulators can permit the company to operate without having to intercede to protect the public. If one were to assign survival probabilities to that level, maybe the company action level would be the 95th, 96th, or 97th percentile. The point is, a probability of survival that's associated with RBC equal to the company action level exists. Subsequently, as one comes down to the other indicated levels, there's a lower and lower probability of survival, until one gets to the mandatory control level. That's where a regulator steps in with the statutory authority to go to court, get a seizure order and change the locks.

This describes the framework that currently exists. But, instead of having a prescribed method and set of assumptions in determining that statutory liability level, if one defines it as a point on the survival curve, one will have delegated the actuary the responsibility to set that complying asset level wherever it needs to be—at the 50th, 60th, or 70th percentile. However, given that the point is established, the actuary has the responsibility to identify all of the contingencies and use best judgment to select the assumptions to estimate impact of the contingencies in assessing company survival. That is, if a company has a certain amount of resources, then it has at least this level of probability of success in meeting all of its obligations.

Not only can statutory liabilities be defined that way, but it is also possible to move up the scale and define each of the other control levels that the regulators need. We can use this curve as the integrating foundation for building valuation systems.

One concern or question is whether the professionals have the ability to understand this likelihood well enough to figure out where a company is on the curves. The probability curve exists. The only issue is whether it is understood well enough by our profession to be administrated. If it is, this seems like a logical way to go through the valuation process. We arrive at a unified valuation concept by integrating related financial concepts off of this same probability S-curve

Ms. Faye Albert: I can understand the theoretical possibility of determining the probability of survival of an insurance company and saying that actuaries are smart enough to figure out the probability distribution. But, are you expecting the regulators to accept, say, 5% of our companies going broke just as a matter of course, because that's the way that we're setting our standards?

Mr. Wilcox: I talked about this in a session yesterday. A company's right to succeed includes the right to fail, and the regulators' responsibility is not to prevent failure, but to intercede before policyholders are injured by the failure. In that context, perhaps the regulators aren't happy if they have to intercede 1 out of 20 times, either. However, note that we're not suggesting where on that curve the acceptable survivability point ought to be, but rather defining the process. Subsequently, the regulators will say, this is how much we're willing to accept in terms of a company action level.

If a company is at the company action level point (i.e., the 95th percentile), then in 19 out of 20 times, they'll be able to meet their obligations, and 1 out of 20 they won't. But if, at that point, you can change the business plan, you're not broke, and you have the opportunity to identify a problem. You can do the things necessary, whether it's of hedging risks to reduce the risks, adding capital, or whatever, to remedy the problem. That's why that company action level exists. It is the point at which the regulator gets involved. The regulator may want to see your business plan, how you're going to work your way out of the problem, and changes in the business plan that will remedy the problem. Otherwise, you're on that slippery slope that may get worse. The existing system is similar to that, and the current RBC level at the company action level is probably no better than a 95th percentile statutory benchmark.

We were asked by the NAIC to put these concepts in the form of a draft model law because it was a better way to identify all the flaws. That will be in a final form to present to them in December. We've tried to embed in the model the controls that regulators need. The model includes independent actuarial reviews and definitions of reporting structures.

Next, Jim Reisktyl will present his perspective and give you a different viewpoint on what we've been doing.

Mr. James Reiskytl: It's interesting to comment on something that hasn't been described to you other than conceptually. I strongly encourage you to get the document that Bob's team has prepared and to review the discussion the two of us had in Hawaii. In that one, Bob went into much greater depth about what the system is. As it is, you'll have to imagine that you know what the system is and put my comments into context. One of the reasons I'm here is to give you some other things to think about as you review the proposal, and although one individual did refer to process of constraints, I intend to develop the topic more fully.

Arguably, the UVS exists today. We have a GAAP system, a tax system, and an RBC system. And we have, underneath it all, an S-curve concept, so arguably we're done. Why this discussion?

Furthermore, consider what the standard is that you as valuation actuaries purport to establish reserves at? I'd say the answer is "mush." And I helped develop that mushy standard because I was one of the original team that put together the valuation actuary concept. It's deliberately mush because the profession wasn't ready to move much beyond that.

I think the profession has made progress. It now understands what cash-flow testing is and what it isn't. We are knowledgeable enough to make sure we don't exactly match assets and liabilities, so we can take some prudent risk. That's what we're all about, and I think we're making a lot of progress from where we were when the valuation actuary concept was developed. But, if I were to ask you what the current reserve standard is for your company, I suspect you wouldn't know. If anybody feels that they do have that answer, I'd like them to stand up. We read all the various laws the states provide, and frankly they do not provide much in the terms of standards.

I will make three basic points. The first is, what's the objective? Tom Foley, the chairman of Life and Health Actuarial Technical Task Force, looked at a clean sheet of paper and put down what a valuation system ought to do. That means it may be implemented in three years or in 20 years, who knows. Second, it's an SVL; it doesn't say anything about RBC or GAAP. It could be that the accountants are waiting for us to revise their world. Bob has done a nice job talking to them, but they may or may not be receptive to redoing the GAAP system. If they are, terrific, I would like to see the actuaries redesign the GAAP system. It truly needs some work.

I'd also comment about the notion of one consistent system. That's a great concept. But the bottom line is that, when you try to serve more than one master, you often fail. I would submit that one of the problems with GAAP today is that it tries to serve too many masters and is technically failing. Some view GAAP as an income standard. Some view GAAP as the financial standard. Returning to the definition and events that we are going to describe as a statutory valuation system, I suspect Bob and I would come up with the same answers, and regulators might even agree. But the remaining question is, are we trying to design a statutory valuation system, or are we trying to redo the world?

Bob dreams about that kind of thing. One ought to dream broadly. However, the question is, in whose lifetime? How soon do we wish to accomplish that objective? Another aspect of dreams is that they inflict no constraints. I love dreams. In dreams I am thin and handsome. But when I wake up, I'm still the old fat guy, and not quite so handsome. Dreams are great, but we have to deal with reality.

That brings me to the details. Bob has been very short on details. To Bob's credit, he conducts a very open discussion. He welcomes all opinions and even lets me speak once in a while. However, the bottom line is there's no consensus. We're all over the map. If we went around the room, everyone would have a different idea about what we're doing. Consequently, I want to focus on three things.

First, there is the issue of constraints in a valuation system. International surveys are great. I did a survey once and studied taxes. The trouble is that you look at taxes and come up with one conclusion. But there are more issues. The valuation systems are different, the accounting systems are different, this is different, and that's different. Bob and his team study reserve systems. Terrific! The only trouble is they ignore taxes and a lot of other things. So when you get the answers, be wary. You cannot look at a part of a puzzle and get a good answer. You have to look at the whole picture.

So let's focus on three things: (1) tax constraints, (2) how to measure insolvency, and (3) professional capacity to do these valuations.

Let's start with the fundamental issue of taxes. The government is always looking for more revenue. It does not miss an opportunity to raise some more revenue and believes that reserve deductions are a loophole, pure and simple. Long before the UVS was even considered, the government was attempting to increase our taxes (reducing our tax deductions), as on the present proposal on annuities, on foreign taxes, and so on. Any change in reserves is likely to increase taxes. The bottom line is that tax reserves are built on statutory tables, methods, laws, and regulations. That means that every company in the United States gets the same tax reserve deduction, even though the company experience varies.

If you abandon this structure, you then have to decide what should be deductible, how much to be deductible, and the basis for the deduction. Some might relish the thought of establishing your own assumptions and creating your own tax structure. I see at least a few members from Canada here. It's my understanding they have moved in this direction and have had the opportunity to pay increased taxes as a result of this process. It is my understanding Canadians have moved to a system with more reliance on the actuary. They have also moved from a system where they weren't paying much tax at all, at companies that had some internal taxes, and now they're paying significant taxes. Forewarned is forearmed. Be prepared.

What do we have today? I submit to you that the current linkage between statutory and tax reserve makes sense. The current system produces appropriate reserves through actuarial analysis and due process. More important, we have an independent body making these determinations based on financial solvency, not on revenue needs. If you have a system that's based on your experience, you're going to have to defend every deduction you make. You're going to have to defend every assumption. We already have instances where statutory reserves have been ignored. What happened? Higher taxes!

The applicable federal interest rate is another circumstance where inappropriate use of a tax structure is not consistent with what would be sound from an actuarial structure. Bob is a great ambassador. He may convince the treasury that future revenues should be driven by a better system that produces the same or lower taxes than now, and is based on whatever the actuary assumes is appropriate for reserve deductions. But what if he does not?

Do you realize that 25 sections of the Internal Revenue Code are currently tied to this statutory reserve structure? Bob has his work cut out to rewrite things such as definitions of life insurance, products that we sell, and so on.

Finally, consider also the reserve aspect we currently describe as the cash value floor. If the accounting committee says you don't need cash value floors, and the actuarial committee says you don't need cash value floors, then you might as well open up your pockets to much greater revenue payments for the government.

No life company currently is taxed on GAAP in the United States. In Canada and other parts of the world, it's another situation. Germany, as I understand their GAAP, has a 98% standard. I think that's very appropriate for a tax deduction, too. I'm all for the Germans winning out in this system. I suspect they will not, however. Of course, if we have the best estimate (50%), you're going to see quite a difference in tax results. We surely want to avoid a statutory system based on GAAP, because it could end up being our tax structure.

On another related subject, there are those who naively or incorrectly assume that lowering reserves means you're going to have more capital to work with. That's just a plain incorrect assumption. Unless you also lower RBC, all you've done is lower your tax deduction and create a greater tax inefficiency. You have no more capital that you can do anything with in the marketplace, unless you also lower the RBC level. If you start with the concept that RBC is absolute, which I believe it is, that capital target is unchanged. In this respect, reserves are just a placeholder in the total scheme of required capital.

Another topic I'd like to spend a few minutes on is insolvency. Do you want your company taken over based on independent formulas, or based on your judgment? Wouldn't it be a great world if your assumptions would decide whether you are insolvent. Most of us in this room know that assumptions can be changed enough to ensure solvency for a good long time. When I finally become insolvent, I will be really insolvent because there won't be anything left in the system. I'm not going tell the CEO about negative trends. The dynamic becomes one of, "I think I ought to use this assumption. No, I can use another one. On this one we'd be solvent, and this one we'd be insolvent." You can follow that dream to your heart's content. I'd just as soon avoid it.

There is one area where Bob and I are marching arm to arm and shoulder to shoulder. We call it viability analysis. This viability analysis, which I wholeheartedly endorse, is going to be required only annually. It's hard for me to imagine a well-run company making a substantive change in the enterprise before doing some type of analysis to figure out what will happen financially. However, the committee decided it wasn't necessary to require that. I'm not for a lot of requirements, either, so I endorsed that proposal. We're all on the same page.

Finally, the third focus or concern is the actuarial profession's preparedness to do this. The UVS is a holistic approach. You have to conclude that the concept is absolutely right. How can you determine whether a company is viable unless you look at everything? It is a very interesting concept. I wholeheartedly endorse it because I cannot find fault with a concept that says you must look at everything. I struggle, however, with how to implement it. If you're willing to do that and you somehow figure out how to do it, the next step is, are you willing to accept that responsibility?

Let's assume that we'll be very professional and responsible. The next question I would ask is, do we have the tools? And although I am a proponent , I've also been widely criticized for the fact that I promote the concept of an 85% standard. The critics point out that the standard is very difficult to achieve. And there is also concern about the actuary's legal liability.

I also have to comment on the feedback loop. A feedback loop is a highly desirable process to put in place. The VTF was once considering a Superactuaries Central Review Board. We no longer are, and I think that's good. Now we are considering another system whereby the regulator will hire an actuary to review your actuary and your assumptions. Regulators may have even more stress under this system, if adopted, because they would have to pick between actuarial reports with potentially differing conclusions.

Another fundamental issue is the role of the reviewer. Some say the function is to verify compliance with actuarial standards and verify the completeness of the reports. Others suggest that this reviewing actuary role is to evaluate the assumptions. Are those assumptions reasonable? And yet others suggest the role is limited to verifying compliance with ranges for assumptions, similar to the pension assumptions. That is, the interest rates have to be between X and Y; the mortality has to be between a specific range, and so on. Guess what? You recreated tables—only you didn't call them tables. You called them "acceptable assumptions". The key point is that we need to determine which role is appropriate. The draft as it stands tends to focus on compliance aspects: Did the actuary make a report? Is the report complete? Does the report comply? It focuses less on the validity of the assumptions.

I hope you'll remember three things when you review UVS. First, what are you going to do about taxes? Second, how do you want to measure insolvency? Do you want to do it based on your experience and your own assumptions, or do you want to do it based on some formal independent approach? And finally, do we have the ability as actuaries to carry out this holistic approach?

The current system puts a lot of responsibility on the valuation actuary. The valuation actuary could do a much better job and leave accountants with a lesser role. I submit that, under the dream approach, the accountants will be kings and actuaries will have a much lesser role. Once you accept the idea that you can use assumptions, accountants will say they have as much ability to set assumptions as actuaries do. In fact, they might conclude, from the tax perspective, that they'll create their own structure and have their own accountants design whatever assumptions they should use to determine your tax deductions.

As a result, some comments about developing another alternative to UVS are appropriate. We should look to an approach that mandates that the statutory reserves cover one standard deviation of risk, or 85% of possible risk. It makes sense to build on the current structure and use all these innovative and creative UVS concepts. The actuary must establish the reserves for this. No prescribed tables exist. The actuary must come up with an 85% standard and demonstrate to regulators that the objective can be achieved. Can we agree on and establish what the 85% level is? Keep most of the business where it is, that is, using the tables, markers, and so on. But the markers are not a safe harbor. This would be an attempt to test where the UVS is going. By applying this approach, we can begin to improve our ability as actuaries to meet these criteria. Ultimately, we might get to the UVS, which I think is a worthy dream.

With that I'll throw it open to discussion because you've been kind enough to listen to me this far. What's your opinion?

Mr. Gies: I will recap some of what I heard in these presentations. We need a clean sheet approach, all things considered. I also heard that we ought to work with the current system. The ideas that are being talked about are good, so why can't they be overlaid on the current system?

Mr. William Cook: I have a question for Bob Wilcox. As much as I admire all the work the task force has done, I think it's on the wrong track. How is the task force getting feedback?

The second question is for Jack Gies. At the October Life and Health Actuarial Task Force meeting, support for the UVS was expressed. Everything else the regulators did at that meeting was completely contrary to the principles in the UVS. There was detailed description of prescribed valuation rules and insistence on being able to identify embedded losses on a particular line of business that would not be contemplated under the UVS. My question is, is there a mismatch of feedback from regulators regarding the UVS?

Mr. Wilcox: Let me speak first and I think Jack will have some things to add. Perhaps there's not a right track and a wrong track; there's a bad track, a better track, and a best track. I hope people would feel encouraged to put together alternative approaches and other systems that they think will work better and put them on the table, because this is going to go through a lot of iterations in development before it gets into a final form.

The VTF now is trying, with guidance from the Life and Health Actuarial Task Force, to put together one system that would be consistent within itself, and which could be laid against the approach that Jim told us about. I challenged Jim to take that concept to a more complete or mature conclusion. I would encourage anyone to develop an alternative system. Very likely, after the December meeting of the Life and Health Actuarial Task Force, the Academy's task force will be in a position to take other alternatives and develop those further. I am not suggesting that the approach we're taking is the absolutely correct system. I think there may be better approaches than the one we're working on. Referencing the subject about conflicting views and feedback from the Life and Health Actuarial Task Force, remember that they're working within the current system. It requires details and specificity. That's what is creating the growing understanding that the current system is not sustainable. We need something different.

Mr. Gies: The question from the floor was very insightful, and Bob's comment on it was about right. Regulators are interested in modernizing the SVL in a manner that addresses today's environment. At the same time, they deal with statutes containing prescriptive rules and ongoing modification of prescriptive rules in order to make the existing valuation system work. A huge problem for regulators is whether to administer the current 1940 SVL as it's written, or modify it as we go forward and let these new concepts "seep" into the system.

In the latter circumstance, you begin to have a very inconsistent framework. Certain regulators will develop an opinion and administer the SVL based on a reading and interpretation of it. Other jurisdictions will take an opposite point of view. An increasingly uneven playing field will emerge eventually, unless the clean sheet approach results in a redirection of valuation responsibility into the hands of appointed actuaries or a modified approach, such as alluded to by Jim Reiskytl, is put in place that productively modifies the existing system.

Mr. Morris Chambers: I listened to Jim Reiskytl's presentation. I have known and respected him for a long period of time. However, his presentation was the most complete litany of excuses for lack of progress and lack of responsibility I think I've ever heard. If the actuarial profession in the United States does not move forward in support of what Bob Wilcox is proposing, then I suggest that we will be relegated to the back room, where we will end up being the number-crunchers that many consider accountants to be today.

I would encourage everyone to support the UVS, because I see that as being the future of the actuarial profession here in America. It fits in perfectly with the concerns that others have expressed about the intrusion upon our turf by other experts. What we have to provide to the public is our professionalism, our standards, and our code of conduct. If we put teeth into those and accept responsibility, then we can move into the 21st century.

Mr. Reisktyl: I'm curious how you distinguish UVS as being different from our current valuation actuary system, in which the actuary establishes an "85% criteria". I don't think that the UVS or the alternative system that I suggest are any different in professional terms. My point is, we should move toward achieving the desired goal, but without throwing out everything that currently exists and becoming heavily taxed in the interim. I hope I understand the sense of your comment.

Mr. Chambers: I have a lot of difficulty with designing a system to inform the public about the condition of a company's books and its financial results and performance, primarily based on avoidance of tax.

The other comment I would make is with respect to your reference to 85%. Who knows where it's 85%? When the assumptions are prescribed, for some companies it's going to be 40%; for others it's going to be well over 85%. The point is, it's the actuary who should know what's going on in the company and be in a position to establish assumptions that are appropriate to the company's operation.

I have a comment on the dynamic financial condition analysis. When a company embarks upon on a new direction, you say the actuary should be required to produce a new report with respect to the financial condition. If there is a company in this country that doesn't want its actuary to do that work at that time, I want to know its name. I'm not going to buy any of its policies.

Mr. Reisktyl: I had some trouble hearing what you said. I'm not sure if we're in complete agreement or disagreement. There are some people who incorrectly assume that you can rely on static tables and methods, etc., and not have to meet the standards. That is not my opinion of the valuation actuary's responsibility.

It sounds like we're disagreeing about the standards, because I, for one, agree with what you're saying. I'm all for having the actuarial profession be strong. I think the actuary has to step up and be counted and be willing to express an opinion. I think we can do that in the current structure. I believe we already have a say. What we don't have is a good discipline. From my perspective, you and I are not in disagreement, but I have given you that impression. I'm sorry because that was not what I was trying to accomplish.

Mr. Gies: Unfortunately, we have run out of time. Thank you for your attendance and comments.

CHART 1
A COMPANY'S CURRENT OPERATIONS