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Session 6PD
Statutory Reporting Current National Association of Insurance Commissioners Developments

Track: Financial Reporting

Moderator: SHELDON D. SUMMERS
Panelists: DONNA R. CLAIRE
JOHN A. HARTNEDY
STEPHEN K. NEILL
Recorder: SHELDON D. SUMMERS

Summary: This session provides a brief overview and status of a variety of recent National Association of Insurance Commissioners statutory financial reporting developments, including:

- *New Standard Valuation Law Project*
- *Revisions to Actuarial Opinion and Memorandum Regulation*
- *Variable Annuities with Guaranteed Living Benefit Reserves*
- *Reserves for GICs with Rating Downgrades*
- *Reserves for Equity-Indexed Universal Life (Draft Actuarial Guideline ZZZZ)*
- *Health Reserve Guidance Manual*
- *Implementation of Actuarial Guidelines XXXIII,XXXIV, XXXV*
- *Implementation of Revised Regulation XXX*
- *Valuation Mortality and Morbidity Table Update*
- *NAIC Risk-Based Capital Developments, including C-3 Risk Project Update*
- *NAIC Codification Project Update*

Mr. Sheldon D. Summers: Donna R. Claire is an FSA, a Member of the AAA (MAAA), a CLU, a chartered financial consultant, and a Fellow of the Life Management Institute. Donna is president of Claire Thinking, Inc. She engages in general insurance consulting, with a focus on asset, liability, and risk management regulatory matters. Miss Claire has spent over 25 years working in a variety of positions with insurance companies and as a consultant. As a consultant she has worked on behalf of several state insurance departments. She is vice chair of the AAA Life Practice Council and has chaired or participated in several industry advisory groups, including the AAA Liquidity Working Group and the Life Practice Notes Committee. She has authored a number of papers on insurance issues and has been a frequent speaker at professional meetings.

Stephen Neill is a senior actuary with the Texas Department of Insurance. He is been with the department for nine years. Most of his duties relate to solvency issues, with an emphasis on HMOs, nationally significant companies, and nontraditional investments.

John Hartnedy is Deputy Commissioner and Life Health Actuary of the Arkansas Insurance Department. He has 39 years of insurance experience—the last 3 ½ years in insurance regulation. Mr. Hartnedy is an FSA and an MAAA.

Mr. Stephen K. Neill: Our first topic is codification, which is perhaps the largest NAIC initiative in at least a number of years, if not the largest ever. And I'm not sure if anybody really remembers when it started, but it's been a number of years in the making. It's going to be effective January 1, 2001, which means the first time you'll actually use it is in the March 2001 statement. It's basically a rewrite of the *Accounting Practices and Procedures Manual*. As such it has what's called Statements of Statutory Accounting Principles (SSAPs) in it. There are 73 of them.

There are also what's called issue papers. There are 101 issue papers, which give background to back up what's in the SSAPs. And there are also references in it to GAAP Guidance.

A number of states, I think about 20, actually refer to the Accounting Practices and Procedures Manual in their laws. For those states it would just automatically become adopted without any particular action on their part.

For other states it will take an affirmative action to actually adopt the manual. As we understand it a number of the states will make some changes in it when they adopt it. But we expect pretty much uniformity with it. There are Actuarial Guidelines in it, and because some states adopt things like the Accounting Practices and Procedures Manual as of a specific date, meaning the version that's in effect on that date, some states will have all the actuarial guidelines adopted while some of them won't. So you'll have to be aware of that.

In Texas we've had a series of meetings with industry advisory groups this spring to go over what's in codification. It's not really intended to change a whole lot. It's really intended to just pull together the guidance that was out there. But in the process there are some changes in it.

Texas will do a formal adoption process, probably starting mid to late summer, so that well before January 2001 we should have our adoption process completed.

Donna, do you want to comment on recent activity with the NAIC in connection with this?

Ms. Donna R. Claire: The adoption date is January 1, 2001, so if you have not yet purchased the Accounting Practices and Procedures Manual I strongly recommend you to do so. It is two big green binders. This edition may be in-force for a while, since they do not want to have it changed in certain states in the middle of adopting it. But it is going to be an active document. For example, in codification, the appendices do include Actuarial Guidelines.

However, it only has Actuarial Guidelines through 35 in the current book. There was an Actuarial Guideline adopted this year on equity-indexed life insurance, but this one is not in the current manual. So there will be a slight disconnect, perhaps between codification and what a state is insisting be followed. Also, there are certain states that do have strong opinions on certain things, specifically on certain Actuarial Guidelines, for example.

So just because it is in codification doesn't necessarily mean that the state has automatically adopted it. Each state can make any changes that they want to. For example, in New York, which will actually not adopt the manual this year simply because it didn't get out of committee, there are differences between the New York version and the NAIC version.

In general this will be effective January 1, 2001, so you really should be ready to have all your statements prepared on that date on a codification basis.

Mr. Summers: Are there any questions from the audience before we move on to the next topic?

Mr. Charles D. Friedstat: What differences might there be in adopting some of these new standards? The Actuarial Guidelines are pretty much, with the exceptions that you mentioned, going to be in place. But what changes might a company expect to have to make? Are there things that we might have to do differently from what we have done before?

Ms. Claire: That's why I'm strongly recommending somebody in your company look at the entire thing. For example, for specific asset types there is now a specific way that it is going to be valued. Some companies were probably doing it that way, but not every company calculated the assets the same way. So there are a number of items, in fact virtually the entire annual statement, where there is a possibility that the way your company is traditionally doing it is not the way that is going to be done under codification.

Mr. Friedstat: Are there any things that are coming up in the reserve area that are going to have more than one company effect on certain things that people should watch out for, but maybe they're not?

Ms. Claire: The question was, in the reserving area is there anything coming up that people should watch out for that maybe they're not? For smaller companies a lot of times traditionally you may have a certain method of doing certain things that may no longer be acceptable, especially for the one- or two-state companies.

John, do you want to comment on what Arkansas is going to be doing on this one?

Mr. John A. Hartnedy: We haven't even discussed it yet. We have a number of small companies, and if we have to do special things for them we're going to have to look at it very carefully. I don't know what we're going to do about it at this point. But I have to admit I hadn't thought of the impact until you asked. And I'm glad you asked because now I'm going to look into it.

Mr. Neill: Texas has gone through it pretty thoroughly and I think what we see, and not so much just in Texas, but in general, is where you've had choices in the past of doing things one way or another, sometimes the choices are a little broader in Codification than what Texas had. Sometimes they're a little narrower. But we have yet to find an area where Codification says you've got choice one, two, and three, and none of those choices were the choices available in the past.

There are some specific differences, but they're more in the accounting area than they are in the reserving area.

Mr. Randal J. Freitag: How heavily is the NAIC leaning on its membership for its uniform adoption of codification?

Mr. Hartnedy: I was at an NAIC commissioners' meeting in Arizona, and having spent most of my career on the industry side I've found that the regulators usually have great difficulty getting it together. I was struck by the commissioners getting behind the uniform adoption. I mean they are almost to a person 100% behind uniform adoption. I would say that that means there is an excellent chance, which I wouldn't have said before that meeting, that we're going to pull off something, for example under Gramm-Leach-Bliley (GLB) in connection with getting uniform agents licensing done.

Right now I would bet you that we're going to get it done. And this will carry over into the codification. Now where the commissioners are going to have problems is with us people who are in the ranks. Because if you listen to us talk, and you go to NAIC meetings, it's like we haven't even heard about the idea that there has' to be uniformity all across the country. We have' to be doing things to commence that.

I really think, though, that the commissioners' leverage is going to prevail, and you're going to see an awful lot more uniformity than you've ever seen before. I don't know what Donna's impression of that is, but that's mine. And I'm really surprised at how the commissioners have gotten behind this concept of uniformity. They're really pushing it, and they're pushing it mighty hard.

Mr. Summers: We'll take one more question and then we'll move on to the next topic.

Mr. Stanton L. Cole: There is a panel discussion tomorrow on codification, San Diego Session 60 "Pain, but What Gain? State Variation Under Codification". As a moderator I have three experts there who will be able to answer a lot of these questions. On uniform adoption, my understanding is that most of the states are coming along, and I specifically leave New York out of that comment.

Ms. Claire: The next topic is what we've known as Variable Annuities with Guaranteed Living Benefits (VAGLBs). We are having a major problem with GLB, because every time we say GLB we think it means guaranteed living benefits, and everybody else thinks it's a silly thing like a law. VAGLBs is one of the products that was mentioned by the keynote speaker this morning. It is a variable annuity (VA) but what it is doing is adding another benefit on top of it. You can either be guaranteeing that in ten years you'll get your premium back or you'll get your premium back accumulated at 5% or in ten years or some other period you'll have a guaranteed payout. There is an AAA work group chaired by Tom Campbell and Stephen Preston. The group's report is available from the Academy.

The product is complex. The Academy group is trying to develop some simplified methods that would work for reserving for certain products. What you will see in the Academy report is something called a keel method that assumes equity rates go down a ways and then go up and figures out what type of reserve you would need for that type of benefit.

An interesting sideline on this one is what happens with reinsurance, because a lot of people are reinsuring this type of benefit and the coordination between the reinsurer and the ceding company is important. The Academy group is trying to have a draft actuarial guideline, possibly available in September and almost definitely available by the end of the year.

One concern on VAGLBs is in the absence of this guideline. What are companies doing? If you are big into this market, there are several regulators who would like you to actually speak to your local regulator and discuss what the methods currently being used are.

Typically, the reserves for this are not necessarily that big in the beginning and they can get bigger as time goes on. Right now I think it is up to the actuarial profession to make sure that it feels comfortable that the reserves are adequate. As to the Valuation Actuary Symposium, this issue will be discussed further. One suggestion of Tom Foley's, Chair of the Life and Health Actuarial Task Force (LHATF) of the NAIC, is to get the Academy report. Even though it's not final or approved, as least it gives you some guidance as to how reserves should be set out.

Mr. Summers: Are there any questions on this topic?

From the Floor: I was just wondering what the date on that report was. Is there one that's been out since December?

Ms. Claire: Yes. They basically issue one quarterly. This one was issued for the June NAIC meeting. If you call the Academy, ask for the June one and you'll get it.

Mr. Summers: In California the department is currently working on enabling legislation that would allow these types of contracts to be written in California. And until there's an actuarial guideline that provides direction as to how to reserve for these products, the department will probably require that companies use what's currently in the report.

Ms. Claire: The next topic is Actuarial Guideline ZZZZ. This one is the equity-indexed universal life (UL) reserving guideline. It is officially Actuarial Guideline 36. It will be effective December 2000.

This had been passed earlier from the LHATF, but went back so that the task force could come up with a method that was sort of in between a book-value method and a market-value method, and that method has been included.

The concept is similar to equity-indexed annuities (EIAs). If you want to use book value and if you are close to matched, you can use some sort of averaging technique. This work was done in conjunction with an Academy group.

The Academy report, which goes into a lot more detail, is available from the Academy, and on the Academy Web site, which is www.actuary.org. I think it is a good idea because in the Academy report there is more detail as to how to calculate reserves. So instead of just the guideline you can have a little bit more background as to how you get around to calculating these reserves.

Mr. Roy C. Olson: Effective December 2000, does that mean that it applies to all business in-force on December 31, 2000?

Ms. Claire: Both Actuarial Guidelines, ZZZ, which is the old EIA one and this one, the equity-indexed life guideline, even though they have a certain effective date, apply to all business, including in-force business. If the guideline causes trouble with any particular company, the commissioner always has the option of perhaps allowing a grade-in. It is a guideline that applies to all in-force business.

Mr. Summers: Are there any other questions?

Ms. Claire: The next topic is the valuation table update. The annuity tables were adopted several years ago. They are in effect in over 26 states for both group and individual annuity tables. They should be used in cash-flow testing. I recently saw a few companies' actuarial memoranda and not everybody has updated their tables yet. I strongly recommend that you do.

On the disability table front, the basic group data is available on the SOA Web site, and the individual disability table is also available. These are not officially yet adopted, but should be considered.

In the disability tables, the incidents of disability have gone up. The industry went to the regulators and said the current table is not adequate. So that is why a new one was developed.

On the life table, you will probably hear about this more. The SOA is heavily involved in what we call CSO 2000. It will not actually be available at least until 2001, but at least it's close. The basic industry data, the base experience study data, is available from the SOA Web site. This is the 1990–95 experience. It is expected that the SOA will deliver in the first quarter of 2001 the basic table information. That will not necessarily be the valuation table at that point. There is an Academy group that will also be looking at the data.

At this point there is strong consideration of there being a basic table, but like XXX, perhaps having companies' experience overlaying that for reserving purposes. So there is an Academy group with both industry and regulatory members that is looking at all the valuation questions relating to an updated table. And they are numerous.

The basic work is proceeding on track, but at this point it is looking for all the questions that it should be addressing from the Academy's point of view as to what a new valuation table will mean to the products, to taxation, and to reserving.

Ms. Claire: Moving on to the next topic: XXX update. There was a XXX seminar yesterday for all of you in the term market. One thing the SOA has been doing is making the handouts available, probably for a fee. I would recommend you getting it because it will be a binder with all the information that you need for XXX in one place. New York, in general, really is trying to be more consistent.

The new commissioner does believe that consistency is good. Having said that, New York is different. Their XXX regulation is called Regulation 147. They had this in place since 1994. What they're doing is updating it and adopting virtually everything in XXX, plus a little bit. For example, New York does include variable products in 147, which means you can both use the X factor when calculating reserves, and, also, if you have a secondary guarantee, you have to follow the segmentation approach of XXX.

Another thing to point out in the New York regulation is that it does require reserving for UL, assuming an endowment at age 100. This is the only state that has this. This specifically addresses extended maturity options, which a number of companies have in UL products at this point. It is still only an emergency regulation. It's planned to be released on July 5 for a 45-day exposure period. So, all in all, it will probably be the end of the year before a final one gets released.

Another XXX or term insurance update. At the NAIC meeting in Orlando a couple weeks ago there was a spirited debate on UL with secondary guarantees. Mr. Robert Potter of North Carolina has proposed an actuarial guideline that will treat UL with secondary guarantees as whole life insurance for reserving.

The issue at the NAIC meeting was for these products—shouldn't they also have nonforfeiture benefits? I would say the regulators almost unanimously thought they should, and the industry was split between those who actually wanted to sell a product and those who thought if it looked like a whole life product, it really should have benefits like a whole life product.

So again, XXX has passed in a number of states, including California effective July 1. It has now passed in 33 states. And most other states are at least considering it.

There are only two states that have said definitely no. Considering XXX has a major impact, both Steve and John want to make some comment on this one.

Mr. Hartnedy: Arkansas has passed XXX. The primary reason that we passed this version was to make sure that companies would have a tax deduction for it. I think by the time we passed it there were around 26 companies which had done so. We at least wanted to lower the impact of the cost. When I was in the industry I had trouble with the idea of states adopting XXX.

I have only been in Arkansas for 3 1/2 years as a regulator. We did not pass the first version of XXX. I couldn't see the sense of raising premiums that much, and I was not personally familiar with a term insurance company that had ever gone insolvent. So I questioned the whole idea.

If we had a big term writer in Arkansas, it's possible we may have not passed this version. But we don't, so we passed it basically to keep prices down. I put a lot more stock in the Actuarial Opinion and Memorandum Regulation (AOMR) and the responsibility that actuaries take to do proper reserves. I'm one of the few regulators who are wondering why we are going ahead with the XXX regulation. If actuaries are doing a good job with AOMR, I don't need this. And personally, when I'm reviewing annual statements and AOMR opinions in Arkansas, which I review carefully by the way, I don't really pay any attention to this. I'm probably in the minority, so don't take that as an easy way to get around XXX. There were criticisms of the AOMR work done by actuaries half a dozen years ago, but the work I'm seeing now is good. And that's why I'm not putting my stock in what I'll call the minor things. The good thing is that it's probably the best thing we can do for job security for actuaries.

Mr. Neill: Yes, I'd say Texas has taken a different orientation. I think we're the ones who helped get the new version going and getting serious interest in getting it going and getting it adopted in at least the vast majority of states.

I personally think the reserving for term life insurance hasn't been what it should be for a good number of years both regarding the uniformity and the typical level of reserves we were seeing. So in Texas we'll 'be looking carefully at the companies that use a factor with their mortality and will want it similar to what Larry Gorski talks about in Illinois. We're going to want to see some rigor associated with the development of the factors.

And I'm personally happy that we have 32 or 33 states that have approved the new version. So, we have two-thirds'' of the states on board now, and I think some more coming fairly quickly. There are two sessions here on XXX—one today and one tomorrow. 42IF X(XX) Marks the Spot and a Workshop 87WS Regulatory Update on X

Mr. Summers: I'd like to make a comment on the bulletin that California recently sent out. On the front page it says it is effective July 1, 2000. There is an error in

Section 8 of the bulletin where it says the effective date is January 1, 2000. The correct date is July 1, 2000.

Donna, regarding the work done by Bob Potter, was he only addressing the types of secondary guarantees that are referred to as either phantom accounts or shadow accounts? This type does not explicitly state what premium is necessary to keep the policy from expiring. Instead, the policy is guaranteed to stay in-force as long as an account value based on a different set of cost of insurance charges, interest credits, and expense charges remains positive.

Ms. Claire: For some reason, regulators actually don't like the creativity of what is called shadow accounts. In effect, as he said, it does not have a stated premium for the secondary guarantee. But it states this phantom account will have stated COI expense and interest rates. However, at this point they sort of have learned that if you specify one thing, somebody will come up with something a little bit different and maybe get around the Actuarial Guidelines.

So what they are doing, and Mr. Potter is trying to figure out exactly how to word this, is coming up with a guideline that will conceptually handle all sorts of secondary guarantees of life insurance in a UL product. And the basic concept is that the reserve should be the present value of benefits less the present value of premiums. The premiums under most UL policies are flexible, so the assumed future premiums can wind up increasing in future years. You can still wind up with zero reserves, but you do have to do this calculation on a seriatim basis. The guideline Mr. Potter proposed will be discussed in a conference call within a month or so of the LHATF.

Mr. Summers: I have one other question. XXX has something called an X factor, which is based on actuarial judgment and is used to determine the mortality assumptions for calculating deficiency reserves. There's been a little discussion here about the AOMR. Does the use of an X factor less than 100% affect what a company must do with regard to the actuarial opinion?

Ms. Claire: Yes. If you've ever used under 100% you do have to have an actuarial certification. Even if you're a Type 7 company you do have to do an actuarial certification. So, effectively, anybody in the term insurance market, if you are using term rates and you want to use the X factor, will have to certify as an actuary that these make sense. As was pointed out at the seminar yesterday, it can't automatically be assumed that the X factor can be whatever you need it to be in order for the deficiency reserves to be zero.

In fact one of the speakers yesterday was a major reinsurer, and he has commented that there are still going to be deficiency reserves, even for 15- and 20-year products. For the 30-year product, deficiency reserves actually can be pretty high. The regulator is going to look real closely at the X-factor assumption. As Larry Gorski pointed out, hand waving is not an acceptable answer to how to come up with an X factor. Saying 20% because that's what the pricing people want is probably also a pretty bad way to keep your job.

Mr. Summers: Are there any questions from the audience?

Mr. David E. Scherr: Just a question on XXX and the CSL 2000 table. Do you think that the 2000 table, when it's approved, will be retroactive for XXX products?

Ms. Claire: No. And my guess is, even when it is approved, the table is not going to handle things like super preferred, at least not in the table itself. I have a feeling XXX will have to be revisited.

My guess, and I think Steve disagrees with me on this one, is there is still going to be a XXX type of regulation out there.

Mr. Neill: Yes, I think there will still be a need for something like XXX, but depending on what happens after they develop the basic table and what the work looks like on the modifications you use for your super preferred and things of that nature, I could easily see where XXX would need to be revised again. I think whatever is developed at that point, my expectation is it would be on a go-forward basis.

Mr. Hartnedy: And that's probably the likely scenario, but if the Unified Valuation System (UVS) happens to come to pass, maybe XXX and some of these other things will completely go away. So we have to think about what your position is going to be on UVS.

Mr. Summers: Is the reason for the question that it would be hard for existing policies to compete with new policies?

Mr. Hartnedy: I don't mean to indicate there couldn't or wouldn't be a consideration of offering CSO 2000 to go back and pick up the policy since January 1, 2000. I don't personally look for that, but if the work on the modifications is good, then that's a possibility. And to the extent the industry feels that that would be desirable as the work goes along, if you'll make your views known, I'm sure there will be interest among regulators on that. And I will say I do hope that CSO 2000 enables us to simplify the process of reserves on term insurance.

Mr. Summers: OK, we'll move on to the next topic.

Mr. Hartnedy: We're going to spend a little time on risk-based capital (RBC). There have been comments about the C-3 risk, which has to do with the interest-rate risk, particularly regarding interest-sensitive type products. In the past the C-3 risk was a percentage of reserves. Now it is going to be subject to cash-flow testing with maybe up to, or even more than, 50 interest-rate scenarios. This is a much more rational approach, but it certainly replaces a very simple approach with a very complex approach.

Now would you necessarily consider doing all these tests? It could reduce your C-3 risk by up to, or even more than, possibly a third. So you need to consider the size of your C-3 risk. There's a whole session on this, Session 41, The RBC C-3

(Interest Rate) Project that will specifically address just this subject. So I'm going to take a little time here to just give a little bit of background on how C-3 fits in the whole RBC structure. I expect, if this is going to impact you, you're probably already very aware of what has happened with regard to C-3 risk in far more detail than I will gave you.

Let me tell you a little bit about the impact of RBC. Of course, that measures your size and your risk. You still need minimal capital and surplus requirements in the state, since really RBC is more applicable and appropriate for the larger companies.

At least there's a covariance, so it basically states not everything bad will happen at the same time. It's not likely that if your house is under 50 feet of water that it will also burn down. That's kind of how I describe covariance. Needless to say, the NAIC has not used my definition.

In 1999 so far, when this report came out, there were a little over 800 life companies that had reported their RBC information to the NAIC. Of those 818, 19 were at some action level. Only one of those was at a mandatory control level. That 19 is 2.3% of the total. So that you life actuaries can feel proud of the work you do, 2.6% of the property & casualty companies, or 42 of them, were at an action level, and 16 of those were at mandatory control level. Regarding HMOs, 64, or 25% of them, were at an action level, 7 of them at mandatory control level. And if you do any work in the health insurance business you're probably not be the least bit surprised.

In 1998, of 1,334 companies that reported to the NAIC, 98.4% reported no action level. Now in 1997 there were 30 of them that had some action level. Of those 30, 25 also reported in 1998. There would be consolidations; probably some of them did go out of business. But out of those 25 at various action levels there were only 7 from 1997 to 1998 that were still at an action level. I would use that as at least mild evidence that the concept of RBC is working. You people are looking at it. You're using it as a measure of the capital and surplus levels and success of your companies.

Now, very specifically, what impacts RBC? The major impact is the C-1 or asset risk. Excluding the asset risk for affiliates, C-1 accounted for 48% of RBC. Now that's only 20% in the small companies and up to 60% in the big companies. The asset risk for affiliates accounted for 18.4%. That's almost down to 0% in your small companies. It's largest in the companies that are $100-250 million in assets. It's up to 30%, then it tails back down in your large companies to 10%.

C-2, or your insurance risk—this is health insurance premiums, health insurance reserves, net amount at risk, that type of thing—is 18.2% of your RBC requirement. But it's 75% of the RBC requirement in your small companies, and as small as 10% in your large companies. The C-3 risk is' 11.3%. It's negligible in the small companies. In other words, apparently they're not doing a lot of the intra-sensitive equity-indexed- type products, not surprisingly. But it gets up to as much as 15% in your larger companies. So when you look at this change in C-3 , you're going to look at the size of your company and how big the C-3 part is of your RBC. If it's 3-4%, the fact if you run all these scenarios you can reduce it by a third may be almost meaningless to you because you'll only be reducing your C-3 risk by that amount.

Total business risk, C–4, is 3.9%. The adjusted capital as a ratio to RBC minimum requirements is 256% in the life insurance industry. I think it was a very good change. At least as a regulator it is one of the things that I look at very carefully. And it influences how hard we go and look at the companies. We'll question it because we kind of want to know what you're doing. But as to the action we take, if you're solid in your RBC you're going to have an easy time with us.

Ms. Claire: Regarding the scenarios that John was talking about, some companies pushed for an exemption saying, "Well we don't have to do it if our interest sensitive business is no more than x%". The industry was sort of pushing it to be an optional provision. The regulators said, "Fine, you can have the exemption, but anyone who qualified for the exemption gets the exemption." You don't have a choice in the matter, simply because they figure the good companies are the ones that are going to do the test no matter what. And it is the other companies that are going to be in the situation of not qualifying for the exemption; therefore, a quick accounting is that probably about 90–95% of you will probably be exempt from it.

However, for the 5–10% of you that are not exempt from the test, you really should be prepared by the end of this year to do the test because it will be required for the annual statement for this year-end.

Another major project that the Academy's RBC group is going to be working on is equity scenarios. Variable products are becoming a much more important part of most life insurance companies. The Academy RBC group has just barely started this work, so I don't expect anything to happen very quickly on the matter. It is something that you should follow, especially if you are in the variable market, simply because the work that it is doing has been generating the equity scenarios that can be used in your cash-flow testing.

Mr. Summers: Are there any questions from the audience?

Ms. Marsha Wallace[±]**:** I have a question about this equity project. Do you know whether there's going to be any consideration given to the fact that interest rates and equities sometimes move together so the covariance between equities and the interest rates in those scenarios is considered?

Ms. Claire: Yes. But as I know you know, there is no one answer to this question. A lot of research has to be done. The equity subgroup of the Academy's RBC group includes a number of industry representatives who are working very hard on this

[±] Ms. Wallace is not a member of the sponsoring organizations, is Vice President Asset Liability Management at Transamerica/AEGON in Los Angeles, CA issue. Yes, the interaction is one thing that has to be considered. No, at this point they don't know really how they are going to do it.

From the Floor: I might make a suggestion there. Some of the people who are working in that area now who have models are developing the models to take that into consideration. So you might want to look into that.

Mr. Neill: The next topic is GICs with ratings downgrade termination provisions and the liquidity associated with that. This is a subject that the LHATF started looking into in late 1998. The focus then was specifically on GICs with termination provisions where you could get an early cash-out if there was a ratings downgrade of the company. There were basically three concerns that motivated the task force to start looking at the issue.

One, this was looked upon as preferential treatment for a particular group of policyholders to be able to cash out and leave less liquid assets for everybody else. The second overall issue was the possibility of a run on the bank; the company is history before the regulators have any opportunity to do rehabilitation work on it. Third, when you have this kind of provision, what are the valuation issues? What reserves should you be holding in light of that? Approximately three or four months later we got the General American surprise that got everybody's attention. There was much greater awareness. It was looked upon as a much larger, more complex issue than what we thought going in.

The response is that there's now a separate task force within the NAIC looking at the issues. New York has its Circular Letter 35, through which it is seeking information, and for several months now there's been an Academy group looking at it. Fortunately, Donna is the head of that group. So why don't I turn it over to you, Donna.

Ms. Claire: The keynote speaker really tied into a lot of what's going on here. The important thing is how are actuaries going to address it with management? Liquidity is one form of risk. And it is going to be the first one we are addressing simply because of the concerns, especially after the General American situation.

There are a number of different groups looking at similar-type topics. This includes UVS, which we will talk about a little later, and the work of Terri Vaughan, who is an actuary, and Commissioner of Iowa, who is heading up a financial reporting rewrite that is looking into the risk management.

This group, headed by Neil Vance of New Jersey, is looking specifically first at liquidity risk management, but then will move onto other areas. The NAIC and New York are coordinating very closely on what's happening in this arena.

New York expects to have a revision of Circular Letter 35 out soon. They will be releasing a draft. The way that they're approaching it, and the other regulators are following what New York is doing, is coming up with sort of a Q&A for asking some questions of the companies to determine which companies they should ask more questions of.

Instead of doing a strict formulaic approach, the theory is, let's ask the questions. What are the liquidity risks of the companies, and, second, are the companies managing these liquidity risks? The intention is, if a state has further questions, there may be a second round or a third round of more detailed questions. Some insurance departments may invite you in to discuss this.

In New York they did have one round of questions on Circular Letter 35, and, depending on the answers, there were a specific number of companies where the appointed actuary was asked a second set of questions. And when that did not work out that well for certain companies, the chief financial officer, the chief actuary, and the CEO of the company were invited in to talk to the New York Insurance Department. So part of it was a learning experience.

This is a growing field for actuaries, so I think it's one that we really should follow. The Academy group is doing a primer to explain what the liquidity risks are both on the asset and the liability side. We are not going to say a particular product is good, bad, or indifferent. We are saying this product has embedded options, or this asset has embedded options, and you have to consider them. There are various ways to consider them, and what we are trying to come up with is industry best practices in terms of liquidity, plans, policies, procedures, and models. We expect this report to address a lot of the actuarial inputs that can be given to this.

We will have a draft available for the September NAIC meeting. It is a work in progress. This Academy group has 10-20 people representing all forms of the industry, regulators, etc. It is work that I think the actuary really has to focus on, head on, so we can get to the point where the actuaries are considered the risk managers of the companies.

From the Floor: I have a question on the liquidity issue. When you talk about it and you talk about product options, my concern is that all the attention seems to be focused on what happens in an up-rate scenario, where there's not enough liquidity. But you can have the same products and the same assets and get a down scenario where there's effectively too much liquidity and have a problem too. And the solution won't be the same in both cases. Are you dealing with that?

Ms. Claire: Yes. Every time we try to come up with certain statements everyone points out that there is something else you have to consider. And we we've sort of come up with two different types of liquidity.

One is your day-to-day-type management of liquidity. One is what happens in a catastrophe scenario. In effect, over-liquidity may be just as big a risk to your profit as under-liquidity is if something bad does happen. The Academy report is going to be balanced in terms of explaining both sides of the coin. I think it will probably be released soon as a draft. There are a lot of opinions out there and we definitely would like to hear them.

Mr. Donald J. Golightly: Obviously the rating agencies are very interested in liquidity issues right now too. Standard & Poor's (S&P) has a liquidity model. Do you see the Academy or the NAIC recommending some sort of liquidity model to measure companies' liquidity levels?

Ms. Claire: Actually, the version of Circular Letter 35, the rewrite, which was originally suggested by the Life Insurance Companies of New York (an industry advisory group) sort of copied S&P without saying that. The Academy group had trouble saying that that was a correct approach, simply because the S&P can quickly change the factors they add and subtract. If you codify something like that, it is really hard to change. So we recommended against the factor approach, at least in a codification. We did not say the regulators may not ask you for that type of information on a one-to-one basis, but we did not want it codified.

Mr. Golightly: That sounds good.

Mr. Hartnedy: AOMR. I'll comment, since we're talking about liquidity, that in the process of reviewing the actuarial opinion and memorandum, the *Actuarial Standards of Practice* (*ASOPs*) *22* and *7* are being revised to support some potential changes here. *ASOP 14* will be dropped. Now *ASOP 7* very specifically excludes assets supporting capital and surplus and extremes. So full liquidity is not analyzed. It points out the importance of what Donna is talking about because, strictly speaking, full liquidity is not addressed in an AOMR.

I for one think it's definitely the responsibility of the actuaries, and it needs to be addressed. As long as I'm in the ASOPs though, I'll make also a comment on *ASOP 22*. This seems to me to be a very flexible ASOP. Now that's important because what is considered to be changed is the dropping of Section 7 opinions and requiring all companies to do what we now know as a Section 8 opinion. The Academy supports this.

Large companies see it as a level playing field. Small companies are strongly objecting, seeing a cost factor and very little benefits since they will have to use industry or standard assumptions. It will drain or strain actuarial resources, and actuaries to avoid liability will tend to overanalyze the small company and drive up cost. I do have to say, if I were a small company I would probably join ranks with the small companies and object to this.

In our state we have a number of small companies, and we have been able to be, I think, flexible well within the requirements of the existing ASOPs, let alone what is proposed with the proposed *ASOP 22*. For example, let's say I have a company that's in a credit insurance runoff situation and its assets are in Treasuries. And, by the way, capital and surplus exceeds the face amount of the credit insurance. Reserves released, over the last few years, have exceeded the death claims. The company has generally been profitable. I can see the company giving me a Section 8 opinion that I would consider satisfactory under the proposals. And that could be on one page, at most two pages, with comments on the assets, with some comments on the mortality experience in that company and the trend of their profits. And that should be enough. I would be satisfied with that.

Now these ASOPs are going to provide guidance. And they're going to provide more guidance than you've seen before because the law is going to drop the details. For example, the seven interest scenarios will not be in the proposed law, as is the case now for Section 8 opinions. So there's going to be more responsibility moved to the actuary. I see that as a positive. Again, I'll say what I said earlier—that some years ago we did not have a good reputation as actuaries for the job that we were doing with actuarial opinions. I feel that has definitely changed.

I've talked to all the actuaries I work with in my state. Of course I have' a lot of small companies, so I can call 2 actuaries and cover about 35 companies. But I've talked to each one of them, made just minor suggestions on what they can do, and I've found the actuaries, outside of one, to be very cooperative. When the other one disagreed with me I told him I would discuss it with the Actuarial Board for Counseling and Discipline (ABCD), which I did without using his name. He has now found the ways of cooperativeness. And so we're working this thing out, and the actuaries are basically doing a good job in that area.

When it comes to this Section 8 opinion being required for everybody, I recently suggested in a letter to the Actuarial Task Force at the NAIC that the commissioner be allowed to make single-state, small-company exceptions to detailed analysis. I think that might be helpful, although I have to admit I'm going to ask the actuaries to take a look at the assets. Take a look at the mortality experience and be able to tell me that the company is on a decent track. This is important because you can have unique things going on with small companies.

The small company consortium says they aren't aware that AOMRs have prevented any insolvencies. I can't say that I am either. I have used the leverage under AOMR to require small companies to give me an analysis because they sold stipulated premium products. These are products, at least in our state, that you could sell up to 1968. They were level premium whole life policies with no requirement for cash values or reserves. So basically they got a block of level premium business out there with no reserves on them. And of course the Arkansas' department had never had a Fellow on its staff before. When I came in I told the commissioner that we needed to ask for Section 8 opinions and it was amazing how many companies wanted to meet and visit with our commissioner after that comment came out. But he supported the issue. And it was very interesting.

I was actually a little bit surprised at all of our companies' unrealistic assumptions that they had adequate reserves to cover this product that basically had no reserves. And actually now the companies have come around and they feel a lot better about their operations. They didn't want to spend the money to do it. I don't make them do that detail every year. And I think this very much meets the requirements of the actuarial standards. They can update it with fairly brief comments if nothing material has changed.

Now I think those are good uses of the actuarial opinion, and the memorandum puts a lot of responsibility on your back. One of the main things is allowing the other states to accept a state of domicile opinion. We are not changing the law. I want to be real clear about that. That's why some of that explanation is there. So technically we had to jump through some hoops to basically allow the commissioners to find a way to give them the authority to accept these opinions. So that's why there's a positive action on the commissioner.

I strongly encourage you to go to your commissioner and talk to him or her about accepting this state of domicile accreditation. For one thing, it's good for the commission to meet you, the actuaries. A lot of the actuaries are doing one of these "to the best of my knowledge meets your requirements." So bluntly, they aren't doing it anyway, and I appreciated the frankness of an actuary who told us that at the NAIC. Not that I didn't think there was any other way, but I appreciated him getting up in front of everybody and saying that. I don't expect a lot of you are really studying that in detail anyway.

When I went to the department one of the first projects I did was to do the valuation update that goes in the valuation manual. I spent three to five days doing that. And I don't imagine there's a whole lot of you who spend 3 to 5 days reviewing each of the 50 state's' laws to make sure that you're in compliance with all the latest changes that took place in valuation law. And with accreditation, bluntly, it doesn't make any sense to me that we do anything else but state of domicile opinions. For our reputation, for the chance to meet the commissioners and the staff with a reasonable proposal, I really suggest you strongly support this part about accepting state of domicile signatures when it comes to actuarial work.

We're still working on this. We have some more changes; there will be some technical changes. Again, I'll say this is one of the most important things, I think, that's out there. It's not complete because of the liquidity issue that Donna was talking about. Short of that, RBC, UVS, those are three, I think, very crucial things to the role and the importance of the actuary. You should pay attention to those issues. Do as much as you can to update yourself. And my own suggestion is do as much as you can to support them. Don't neglect to use the ABCD. I don't mean necessarily to turn everybody in, but to ask questions. They are very helpful. And you can go back to your peers if you disagree with what they're doing, and let them know that you've discussed it with the ABCD and what its response is without incriminating anyone.

I think you'll find that most of us are professionals and will accept that kind of help and criticism. Are there any comments or questions on AOMRs?

Ms. Claire: Just a follow-up on what John has said; again, the *ASOPs 7* and *22* are being rewritten to effectively eliminate Section 7 opinions. This will probably go out for comment in September. Those of you who are affected by it may want to look at that very closely. The AOMR is trying to be on track with the ASOPs so it will not be effective immediately, and because it's a regulation it is going to have to go through the states. Right now, the actuaries are still legally liable for trying to answer the question, "Are you following the state laws?"

Mr. Neill: I just want to echo that and say that I think it's worth keeping up with what's going on, both on the ASOPs and on the development of a new AOMR regulation at the NAIC. Texas has a lot of large companies, but also quite a number of small companies that will be impacted by this. We've tried to be very flexible on our smaller, particularly single-state, companies in the past. I would think that would still be our outlook with the changes. But it's something that all of us need to keep familiar with.

Mr. Gregory L. Fitzmaurice: Can you explain a little further this bit about a level playing field for the larger companies against the smaller companies? I really don't understand that. Who are the smaller companies competing with that that are being hurt? Are New York Life, Metropolitan, and Sun being hurt by the smaller companies not doing asset/liability testing? I really don't understand this.

Mr. Hartnedy: To take the second part, they're all subject to the guarantee association. A real value in AOMR is that it provides a more realistic analysis of the reserves than just a Section 7 opinion which simply says, "We followed the law." OK? A lot of times that's not adequate; for instance, if you have structured annuities. I gave you an example of STIP premium, where to say that you followed the law doesn't tell you at all whether you have adequate reserves. Everybody has to contribute to a guarantee association, and if the small companies have weaker rules it's penalizing the large companies.

Understand, I'm not trying to defend this argument, but it's one that I've heard. So the level playing field is, hey wait a minute, if some of us have to make sure that we have adequate assets to cover liabilities, why don't all of us have to? That was the comment on the level playing field that I've heard. There may have been others, but that's the thing I heard, and part of the argument is regarding the guarantee association—why should the rules for reserves be less?

Ms. Claire: When the ASOPs come out, read them. It doesn't make an exception for small companies, but effectively it is saying that if you have assets and liabilities that are not sensitive, then the work you have to do is not nearly as extensive as the cash-flow testing that everybody thinks of. There are other alternatives for coming up with reserve adequacy.

Mr. Summers: OK. We're going to move on to the next topic.

Ms. Claire: The UVS. I will give you a very brief update about this. There is a tremendous amount of work being done by the Academy group chaired by Dave Sandberg. I think it has done a very good job explaining UVS to the regulators. The problem is, I think, the buy-in from the industry, partly because of the feeling that "change is bad." There are some concerns about what effect UVS will have on various products. At this point the Academy UVS group is suggesting to change over to it in steps.

One of the things is to come up with a viability analysis that will allow management to know the company: What are the major risks? Do you have enough capital around? This was more looked at as a management report, not as a regulatory report. There is a lot of work that has been done, but I cannot say that it's moving extraordinarily quickly.

Mr. Neill: The next topic is the Health Reserve Guidance Manual. This is something that's been in process now for about two years. It is developing guidance both for actuaries and for the insurance department personnel who do the triennial exams and other work. It started out with the NAIC asking the Academy to assist in this area. The Academy developed a draft, which came out about a year ago. NAIC regulators have been looking at it since then. There's been a lot of work on this. It gets very detailed.

And there's still quite a bit of industry input, even though it's in the regulators' ballpark at this point. There are four overall areas that are looked at: claim reserves, contract reserves, provider liabilities, and premium deficiency reserves. A lot of good information is being developed, and there may be a lot of people in the room today who have helped with it; if so, we do very much appreciate that. We seem to be close with perhaps a final draft that would then go to the A&H Working Group of the LHATF, and I would expect that would happen sometime later this year.

To wrap up this session we would like to make some comments on *Actuarial Guidelines 33, 34*, and *35*, which are the last 3 that will be in codification or at least the codification as it initially will exist. *Guideline 33* is dealing with the Commissioner's Annuity Reserve Valuation Model (CARVM) for annuities with elective benefits. It responds to design elements that have come in over the last several years, such as annuitization values that are greater than cash values, enhanced death benefits, nursing home benefits, and partial withdrawal benefits.

The thrust of the guideline is that your reserve is the greatest present value of any possible benefit stream that results from that combination of benefits. On the elective benefits you have to make the assumption of incidence rates that will produce the largest value, whereas on nonelective. benefits there are other incidence rates that need to be used. It was effective December 31, 1998 with a 3-year grade-in. It covers any annuities with issue dates since January 1, 1981. This is one that Texas hasn't adopted yet, but I expect we will as part of our adoption of codification.

I don't know if that guideline's been widely adopted by the other states or not. I don't have any information on that.

Ms. Claire: A lot of actuarial guidelines are not necessarily adopted by the states. For example, New York specifically has to adopt. Some states by their law will automatically adopt actuarial guidelines; some use them just for guidance.

Mr. Neill: In Texas we often allow their use even before we adopt them. But with us it's a specific adoption process.

Guideline 34 covers VAs with minimum guaranteed death benefits. You assume an immediate drop in the value of assets and then a recovery rate over a period of time.

There are five assets classes that are identified, and they're identified with very general descriptions. It's' left to the actuary to make sure that the assets of the company are put in the right category. And, again, it applies any time a death benefit can exceed the account value in a VA. But specifically it does not apply to group VAs that are not subject to CARVM.

There are some very specific things you need to do if reinsurance is involved with the VAs. It quite often is on the death benefits. This one too was effective December 31, 1998. There is a possibility for a three-year grade-in. And also it is, once again, for annuities issued since January 1, 1981.

I expect if you're in this market you're familiar with it, and if you're not in the market, there's a fair amount of complexity that you probably don't want to go through until you need to.

The third one is *Guideline 35*. It's CARVM for EIAs. And, again, all three of these are providing guidance on what you need to do under CARVM to be in compliance with the Standard Valuation Law.

If you're not familiar with EIAs, this is a product that provides a minimum guaranteed rate with a chance for a greater rate based on an index, and the index is generally the S&P 500.

As Donna mentioned on another topic, there's a concept of hedged-as-required. If you hedge your assets properly there's one method you can use. If you're not hedged-as-required then there are two other methods you can choose between. And if you are properly hedged and become not properly hedged, then you have' one quarter to get back in line or you have to go to one of the other methods. This guideline applies to all EIAs regardless of when they were issued.

Mr. Summers: Our time's about come to an end. I'd like to thank our panelists for a fine job. And I'd like to remind everybody that a lot of these issues are covered in more detail by other sessions referred to earlier.