RECORD, Volume 28, No. 1*

Colorado Springs Spring Meeting
May 30-31, 2002

Session 17OF
Financial Management Through Hard Times

Track: Financial Reporting

Moderator: FREDERICK W. JACKSON
Panelists: FREDERICK W. JACKSON
DAVID A. RAINS
ANDREW D. RALLIS

Summary: The year 2001 displayed an economic environment unlike that of any year since the 1960s—a time period that is outside the range of experience of many actuaries in practice today. With interest rates at historical lows, the stock market indices declining by 20+ percent, the terrorists strikes, and the beginning of a war, the year provided a true test of an insurance company's financial resources. Issues related to the financial management of an insurance company during times of stress are discussed.

MR. FREDERICK W. JACKSON: I was with Scudder Investments for nine years, working with asset management products from the Zurich Group. I spent my first 25-26 years as an actuary doing pricing work, then doing financial management work, mainly asset-liability management projections. Seven of my nine years with Scudder were as an investment actuary acting as an interface between the investment department and senior management of the insurance companies that we manage assets for.

In the last year and a half I've been in charge of numerous relationships with insurance companies. We've acted as the investment department for 12 to 13 different insurance companies. I've been very much involved, on a day-to-day basis, with the investment management. I have the background of having worked as an actuary and with actuaries, but my perspective is from the investment side.

*Copyright © 2002, Society of Actuaries

Let's look at investment risk issues during the hard times of 2001 and 2002. The first is that insurance companies are taking a more active role in the management of their investment portfolios because it's a much higher risk than it has been in the past. A lot of companies are looking at their investment portfolio as really being a real drag on their A. M. Best rating. They're having to go to A. M. Best meetings to defend the fact that they have significant double B, triple B exposure, collateralized debt obligations (CDOs). It's much more of an influence these past couple of years than it has been in the past.

The second issue is the specific implications for CDOs—collateralized bond applications or collateralized mortgage obligations—that whole class of security where you package mortgages and bonds together. They were very big sellers in the late '90s. Depending on the year of issue and the quality of the bonds that were put in there, some of these CDOs have not performed very well in some companies who have some very large positions in the CDOs. Several of my insurance clients have CDOs, and we do some extensive work in trying to evaluate what might otherwise be a very mysterious structure.

The third issue is investment strategy effect of investing in a business-as-usual mode. A few of our clients are able to treat their investments on a business-as-usual mode. They're having to look at reducing the lower credit quality portfolio additions where they could get a lot of additional yield before that would support their yield-oriented products. They have investment guidelines that say you can't be more than 15 percent or 20 percent in triple B exposure, and they're at those limits or above those limits.

We tell them that if you're going to manage risk appropriately, you're going to have to get those positions down, sell those positions at a loss. At the very least, they should not consider adding additional exposure, which means that they will be buying lower-yielding securities and, therefore, not have the same spread that they have to earn in crediting interest-sensitive products.

There are a lot of problems still with the accounting issues, with Wall Street pushing positions on companies that are questionable. We're really, really struggling to come out of this economic slowdown or recession.

In this period, what kinds of investment strategies make sense with respect to overall credit quality, CDOs, and high-yield securities? And how does this perception affect total business risk? We're not really seeing the investment risk come down yet at this point. How does the prospect of rising interest rates affect interest-sensitive new sales and management of in-force business? These are the items that I would be able to comment on if you have an interest in these areas.

MR. ANDREW D. RALLIS: I'm an actuary at Metropolitan Life Insurance Company. I've been there 18 years, and big chunks of that career were on the financial side, valuation actuary-types of roles. For the last few years, I've been in

charge of asset liability management and risk management for individual business life and annuity portfolios. That's the perspective I'm going to bring to this discussion.

Met is a large formerly mutual insurance company. Probably the biggest thing to happen to us was two years ago when we demutualized and became a stock company. We're still coming to grips with the change and learning how to manage in that environment. Met has also gone through a number of acquisitions. About five years ago we merged with The New England, now called New England Financial, and a couple of years ago we acquired General American as a result of the trouble that they got into over their funding agreements.

Not only have we gone public, but we've struggled to bring all of these entities together into a common framework. The current financial situation has not made it any easier. Not only are markets volatile, but interest rates are low, and that's been a challenge. And the stock market has not been performing well for the last couple of years, and that's been a challenge.

Since we've been public, the biggest driver to the way we've adapted to being a public company has been to adopt a risk management framework based on economic capital. We have a strong centralized corporate risk management function now. That extends down into positions like mine, which are in the lines of business to support that corporate risk management function. Corporate risk management has responsibility for assessing all types of risks throughout the company and also assessing, with input from us, how much capital we should be holding to support those risks. Essentially, we have our own capital formula that's driving our decision-making.

One of the things I want to discuss is the impact of the environment on product design: life and annuities, the guaranteed minimum income benefits (GMIBs), the guaranteed minimum death benefits (GMDBs), market value adjustments, and secondary guarantees in universal life (UL) design. I also want to talk about what's going on legislatively with the standard non-forfeiture law, particularly annuities, trying to get legislative support for moving the guaranteed rates down. The third thing I want to talk about is risk management and some of the activities we've taken now that we understand how to manage the risks a little bit better. Also, now that we're a public company, I want to talk about the stability of our GAAP earnings and some of what the volatile environment is bringing toward that. GAAP unlocking is one example, but also FAS 133 and FAS 142.

MR. DAVID A. RAINS: I am with Transamerica Reinsurance. I've been in the insurance business for 15 years, with the last 10 of those in reinsurance. Before that, I worked with missile contractors, working on Patriot missiles, and that's where I learned some of the things that are in the back of my head when I think about contingency planning and what can go wrong. It can be a lot worse than being in insurance business.

I'm in life reinsurance right now. I partner with direct writers and so a lot of my risk is their risk, and I want to touch on that a little bit more. We see a lot of new risks that people start to get into as they're expanding their markets. One of my roles is to think a lot about the difference between exposure and diversification when taking on more risk.

Part of my message is about communication and educating your audience. You need to set yourself up to manage well through hard times. By the way, you manage well through easy times when things are good. You have to think about what might happen and what might turn things from being really good to not so good.

Profit measurement is important. It tells people what we're going to do or what we have done. I can tell you what I've just made or I can tell you the amount of money I expect to make on either the business that I have or the activities that I'm engaged in right now. Those are pretty well connected in our business, in that what I made last week reflects a lot of the future. We're a little different from other businesses in that way.

When we tell people what money we're going to make or have made, do we talk to them also about the events that might not enable us to make that kind of money or might even enable us to make more? Do we appropriately couch our presentations in terms of the risks involved for all of our profit measurements? Our communications usually just show a number: here's what we're going to make, we're going to be making a 12 percent return, and we're going to be sending this much per share back to policyholders.

Maybe that's okay, but I think we do it because we expect that they understand risk and they understand what's going on. We expect that rating agencies, our board, senior management, middle management, our employees, our customers, our stockholders and our policyholders really all get that there is risk behind these numbers. I would suggest that maybe they don't. Maybe that's because we have a hard time explaining it, and maybe we even have a hard time thinking about it that way ourselves.

When someone asks me what I think a particular arrangement or deal is going to produce, I tell them it will produce this return. If I have enough time, I'll talk about the top three risks I see in the deal, but I don't really get into a lot of specifics.

I don't think a lot of people think about risk that way. We don't really walk around with random variables in our head, but instead we try to translate things into a path of events that we expect to happen. I was with a reinsurer at one point. Within about six months after writing a pretty large deal, we had our largest claim, something like $3 million. And you've never seen such commotion in your lives over that. We had just written this, and everyone thought it was great. But when there was an immediate claim, which we knew was well within the realm of possibility, we

had to explain it to people who never cared before. How on earth could this happen? Did we guess wrong? Was that a fluctuation or did we misestimate the path of future events?

We could have had those conversations a lot earlier and probably should have. We should think about keeping those people educated that way. But that question, "Is it a fluctuation or is it a difference?" is a huge question. And, does it matter? I got to learn more as these people kept talking about how they don't really think in terms of risk. We didn't even know if it was a fluctuation or if we were wrong.

People want to believe that it's a fluctuation. And what goes up must come down, so there will be periods of future prosperity that will offset this loss.

My initial response was that that sounds good, but when I really stopped to think about it a little bit more, I realized that I was wrong. Suppose I flip a quarter a couple of hundred times, and I've gotten 120 heads and 80 tails. As I keep flipping, what is my ratio of heads to tails going to converge to? I would say one.

I might have wondered if it was a poorly manufactured quarter that would really turn up heads most of the time. If it really is fair, it will converge to one. But what will the difference, in absolute terms, of heads and tails converge to? Some people would say zero. The truth is it won't. If the difference was 40, I just plug that in right now, and moving forward, I'd expect them to be the same. I can write my 40 in the book and go home. I've lost $40.00 or $3 million or whatever.

But it's hard to get people thinking in that way, and I don't think we do a good enough job of educating people how they should think about things. These hard times that we go through are a good example of that. A lot of things that have happened over the last year did not happen for the first time. Of course, the mortality events and the huge P&C events and human events of September 11 were new, but they weren't completely unforetold. There has been a lot of speculation that something like that could happen. How much scenario testing and thinking about that sort of thing does anybody really ever do? I would think not a lot.

I'll lay out a few things to think about, and you can tell me if you think they're harder now than ever before or if we're just more aware of them than ever before. They are not the same things. What kind of risks are we talking about? Well, the big one that actuaries are good at is product development. One question is whether guaranteed elements in the policy are going to keep me from realizing my profit objectives. Actuaries do a real good job of saying, "Here are the scenarios that are good and here are the ones that are bad." When we're putting those scenarios together, we try to be reasonable within the realm of our experience, but our experience isn't everything, so we should think about that a little bit too.

Then we ask, "What about the indeterminate elements?" I would suggest that we

can't really manage all the things we think we can manage because we won't be willing to make those decisions when the time comes. Does anybody think about that and communicate it at the same time? Are we really going to change premiums or cost of insurance charges (COIs)? What is the cost of that decision? And has anybody thought about that today as opposed to when somebody is stressed about it?

What about embedded options? I don't just mean policyholder ones. You can write a product, then have a powerful agent or agent group convince you to do something different from what you originally planned to do. Can you price for any of these things? Can anything be priced? I would suggest no, but I've certainly heard my management say, "Just price it; you can price for anything." I disagree.

The last thing I wanted to mention is the hard times that we're having and the risks that we're talking about. You might say, as I hope that you would say, that you've reinsured a lot of risk. But are you confident your reinsurer is making good decisions, and they're going to follow through on their promises to you? Because that's a risk that you've assumed when you've reinsured the other ones away.

And that's true with everybody that you're financially involved with. What are your affiliates doing? That might be an important thing for you to pay attention to one of these days. What about your reinsurers and your joint venture partners? What about your customers? What about your competitors? Can your competitors do something that will have a material impact on your results? You have to pay attention to those. They can be subtle or not.

A great example from the past is non-smoker discounts. If you had ignored that development when your competitors all did it, what a mess that would have been. So a lot of things can happen that can be hard for you that are affected by other people. To reiterate, an important part of managing through hard times is how we manage through easy times. When things are profitable and life is good, let's make sure that we continue to set expectations and hold provisions for adverse deviation and provisions for loss. Present profits in a risk-adjusted way, which involves a lot of education.

Make sure that you are involved in the events around you. Do rather than just be done unto. We have a lot of things that we rely on to help us: the NAIC, the ACLI, Congress, the government. But how many of us spend time volunteering in these organizations? I think we probably should.

In real life, we have the police and the fire department to help us, but we can also put fire alarms in our own homes and be part of a neighborhood watch where we care about each other, not just overselves.

MR. ROSS JAMES STARFELDT: You had mentioned that you have your own risk capital definitions of the capital you set aside. I'm wondering how you went about

defining that. The risk-based capital formula is obviously an industry standard. It sounds like you're moving away from it or creating your own definition.

A big question as we talk about managing through hard times is: How much capital should we have behind any of these risks? And I'd be interested in how your organization went about looking at that risk, how you defined it, or how you came up with the measure to see how much capital you need to put behind these risks.

MR. RALLIS: Yes, that is a huge question. We've been working on our internal formula for three or four years now, and it's really just stabilizing in the last year or two. So I can speak to it with some confidence.

It's essentially put in a fair value context. Fair value has a different meaning for different people, and we know that the international standards are pushing it. About three or four years ago, we decided that the real risk in our balance sheet was in fluctuations of the fair value of things. So assets are evaluated in terms of their volatility of total returns. We have a historical value-at-risk model with all of the data series for different asset classes and so forth over, I think, a 12-year period right now.

That's a matter of debate, but that's what we settled on. Asset default risk is probably the biggest risk that our company holds. But it was also necessary to develop that same type of framework for liabilities. So we've essentially developed a fair value framework for the liabilities and are looking at the volatility of the change in fair value of the liabilities and the correlation with that of the assets as a measure of risk. We look at a particular multiple of that volatility to come up with the capital. I don't want to disclose the multiple. So we're not looking at the tail as much as we are looking at the fluctuations.

There are other types of risks that were very hard to quantify. The biggest of those for us was operational risk. For operational risk, we had to actually bring in an outside consulting firm to assess how much operational risk a company of our scope and magnitude should be holding. It turned out to be a large number, much larger than we had guesstimated internally.

In terms of obvious things, mortality risk turns out not to be a big risk for our company, mostly because most of our life insurance is in par blocks or blocks where the COIs are indeterminate. Even if that's not the case, we've reinsured out a lot of our mortality risk. If anything, we have a capacity to take on more mortality risk. That's something the internal formula revealed to us.

One of the affiliates of General American when we acquired them was Reinsurance Group of America. That was fortuitous to us because that brought in some more mortality risk that we were missing, and we have correlation offsets among these things. It has really become a very well developed formula. We debate the particulars, but the key, now that we know what the number is for the whole

company, is driving that down into decision making.

One of the unusual aspects of my job is that I'm actually in the product development side, even though I'm involved in asset liability management and risk management. That's because my customers, the people I work with, are the pricing actuaries who are the decision-makers for a lot of what goes on. We try to address risk ahead of actually putting it on the books.

When we develop a new product, we go through the same steps we did in evaluating the company's total position. We'll go through those same steps for each product and try to evaluate how much capital we think we need for that product variation.

MR. CLINTON J. THOMPSON: I'd like Mr. Rains to spend a little bit more time talking about why he thinks some risks can't be priced for. How do you account for those sorts of risks?

MR. RAINS: We just talked about an option that is occurring in some reinsurance contracts, at least some that I see proposed to me by my clients. Historically, reinsurance was from companies who were laying off risk that they weren't willing to hold. A lot of reinsurance lately has been what I would call an arbitrage of expectations of mortality, where people are coinsuring up to 90 percent of their business, first dollar.

Some companies have said they would like to take all that back themselves after, say, 10 years. I've found, looking at the rate scales for that kind of business, that in maybe 10 percent of those deals I was comfortable that I could accurately predict something that would happen and I could put a price on it that I felt good about.

Ten years probably is enough time to determine the difference between random fluctuations and a difference in the mortality versus price. What is it really going to be? I'm just suggesting that 10 years might be long enough for it to happen.

I'm going to propose that if all the people I do business with have that option, they will select, in their own best interests, whether to recapture or not. If it turns out that mortality is better than the premiums that they're paying, they'll take it back. If it turns out that their premiums are lower than their mortality, they will leave it with me. So going forward, I will be left with all the losers, if you will, of the bets I've taken. I can't tell you up front which ones are losers and which ones are winners.

I also know that I will be left with any random fluctuations that might have occurred in the meantime. The negative fluctuations happen a lot faster than the positive ones. Positive takes a while, so you have to go a long time with little claims to make up for one big claim. So that's an option that is embedded in some reinsurance contracts that I find unpriceable. It's hard to know what to do. You

have to sort of manage that through your total business management.

Another example is if I were to reinsure direct writer A's secondary guarantee risk. If the business goes into a secondary guarantee state, I get my income limited to that premium paid rather than my increasing YRT scale.

But it seems reasonable, and I could probably do quite a bit of pricing around it. I could do some stochastic analysis and that would be good. Maybe I could satisfy myself, but I'm not sure because that is also a client that has policyholders and agents that pay attention to crediting rates and things like that. They have the ability to affect whether or not that benefit is in the money for me, and their best interests may not be mine.

A lot of these situations involve what I would call an option that someone else has to do something in the future that I can't predict today.

MR. LANCE E. SCHULZ: I have a couple of questions. Rick touched on the idea that we're going to be having some increase in interest rates, but obviously we haven't seen much. I was wondering what makes you think it is going to come and how long you think it's going to take.

Andrew mentioned purchases you had made on acquisitions. I wonder if you could talk about how the current environment has impacted your ability to consolidate those acquisitions.

MR. JACKSON: I'll look in my crystal ball and tell you that it's going to be the fall when the Fed increases interest rates. The Fed decreased Fed fund rates the most in history last year. They basically can't go any further. There's no more powder to help put in place that element of helping the economic recovery take place. The short-term interest rates are as low as they can go, so there's really no more powder there.

We saw a very strong fourth quarter. We thought we'd have a second negative gross domestic product growth quarter that would cause us to put the label "recession" on the last two quarters of the year. It didn't happen. It was actually positive. And then we saw a huge first quarter burst, but a lot of that was inventory that had been drawn down being built back up. Now we're seeing the stock market going back and forth and we're seeing these other issues that have come up: the accounting considerations, the Enrons, and all the other companies that were taking very aggressive accounting stances. That's a major issue. If you really look closely, you have to see that there's a strong conflict of interest for Wall Street analysts who have been recommending positions in telecoms and others. How could there be memos going back and forth within the firm saying this piece is a dog and then they give the stock a buy recommendation? That has to be cleaned up. Also, there's the overhang of the threats over Memorial Day depressing the stock market. There are some real issues out there that keep this recovery from taking

place.

But the fundamentals are there, and we think that the recovery will take place. We had predicted at the end of 2001 that it was going to be toward the end of the first quarter or in the second quarter, and now it's being pushed out to later this year. But we expect that there's only one way for interest rates to go—up. We're well below normal levels, and we see the economy stabilizing. You don't have companies like Home Depot have a tremendous first quarter and be afraid to raise their expectations going forward.

Once we get back in a little bit more of a settled economic environment, we believe interest rates have to go up. It could be 100 basis points or it could be more like 150 to 300 basis points over the next couple of years. We are taking the position where we thought we'd be buying some longer corporate bonds right now. We're buying some mortgages that will have cash flow throw-offs. That was a little bit of a give-up in yield right now, but we expect that the interest rate increases are going to come.

There will be structures out there that will provide good returns for those products that need those high interest rates to support their products. We think it's going to be more like third quarter, but we do expect that the Fed has to go up as soon as it gets enough positive information. The market forces are going to push interest rates up. There's only one way to go at this point, unless we're facing a deflation situation, as Japan has.

MR. RALLIS: I'm going to comment on interest rates a little bit too. We have our own forecast that is not dissimilar with that forecast, but one thing we haven't talked about yet is the steepness of the yield curve. It's extraordinarily steep, and depending on your product, that can have an impact, depending on what your strategies are. So we also see the yield curve rising but flattening with the short end coming up more. When that takes place it probably will be tied to whenever this recovery gains some steam.

In terms of the acquisitions, it's hard to do them at any time. In hard times, it's probably just a little bit harder. But with acquisitions, you have different cultures. Met's philosophy has been to view itself as an integrator when we acquire companies that have strong brand names.

We feel like New England had a very strong brand name; General American had a strong brand name. They had reputations in the industry, and they had distribution tied to those reputations. We've taken a position that we want to keep that brand name intact, but at the same time we need to realize the economies of scale. So there's been a lot of effort and expense in bringing together all of the back office-types of functions so that we can realize those economies of scale and yet keep the distribution distinct.

In the last couple of years, we've moved everybody to a common ledger. We're moving to common administrative platforms, one for universal life products and one for annuity products. We have the philosophy that the products themselves will be distinct in support of each brand. At the core of all this is that we would price similarly so that you wouldn't have one group of actuaries in one entity pricing differently, with a completely different view of the world than another group of actuaries. So pricing has been integrated, although distribution hasn't. That's the way that we've tried to deal with it.

MR. JACKSON: Have you seen anything happen differently because of the hard times?

MR. RALLIS: When we do these acquisitions, we have to look at the fact that the risk tolerance might have been very different prior to the merger or the acquisition into Met. With annuities, I'm seeing that a lot of the blocks of business we acquired had four percent guarantees in the contracts, which is something we were never comfortable with. Met's in-force is dominated by three percent guarantees, and our new products have been priced with three percent guarantees.

I could say the same thing about some of the GMDBs and benefits like that, where the companies we've acquired have had more aggressive product features than we might be willing to have developed ourselves. When you do the capital calculations, that shows through because those features do show up as more risky and demanding of more capital.

There's nothing in our proposition that says we can't have those features. It's just that if we have them, we have to be able to charge for them. We can't just bake them in there for free. But that's about the best I could offer for you because some of those guarantees are more in the money today than they were three years ago.

FROM THE FLOOR: I have a question with respect to risk-based capital. Andy said that the asset default risk is the biggest risk for Met right now. I would hazard a guess that that's probably a new situation. Companies may not have viewed that as the biggest risk before.

And what I've seen in the last two years is that asset volatility has increased tremendously across the board. The S&P and the market and the rating agencies in general have really punished firms much, much more than they had two or three years ago.

The clients that we manage money for are reacting to a significant increase in risk on the investment side of the business that wasn't there two years ago. It's the rare company that hasn't experienced that. My clients are coming to me saying, "Well, let's revise our guidelines so that we don't have a single issuer triple B that used to be at one percent." You could have a single issuer on a $2 billion insurer that had a $20 million position in WorldCom. WorldCom goes in the tank, goes to

50 cents on the dollar, and they take a huge hit on their surplus.

We're now talking about reducing single issuer limits from, say, 1 percent to ½ percent on triple Bs. I'm seeing that with all my companies, both P&C and life companies, on a different level. What I'm curious about, based on this discussion, is whether you are also seeing this increased investment risk. If so, how are you factoring it in? If all else were equal, which it isn't, it's just a general increase in risk on the investment side. What are you doing if you take David Becker's theory that the companies are just huge CMOs with a lot of different moving parts, asset parts and liability parts?

What are your companies doing to manage the overall risk, given this ramping up of risk on the asset side, the investment side?

MR. RALLIS: I'll just speak from the position of a very big company with a very large general account. Our issuer concentration limits haven't changed, but they were pretty low, about one percent to begin with. But we've managed lower issuer concentration guidelines than that. We have slightly higher limits in some of the subsidiaries we've acquired, just because they're so small in terms of the overall percentage of a general account that we can't invest efficiently. We're looking for chunks in the $5 million, $10 million range.

If we stayed with single issuer constraints of even one percent, we couldn't handle the volume of transactions we'd have to do. So for the main Met Life general account, we're at around one percent. But we're very well diversified. We've taken our Enron hits and our telecom hits, but it hasn't been overwhelming. We didn't have that kind of concentration to throw us into changing our strategy very much. But I imagine some companies might have had more concentration than we do.

We also have large positions in private deals, private placement bonds, commercial mortgages and even agricultural mortgages. So we're diversified into a lot of asset categories that might be harder for other companies to get involved in.

MS. DANA N. HUNT: Can you speak to any management of the risk that you take on as a reinsurer because direct writers are sending away 90 percent of their business? How do you manage that moral hazard or the potential for it?

MR. RAINS: Let me talk about the difference in what I've been calling moral hazard and what I would call morale hazard. I borrowed the term "morale hazard" from the P&C line. Moral hazard, of course, would be if you buy reinsurance or insurance in the interest ahead of time of making a gain on it. The party you're buying it from wouldn't know anything about it if you lied on your application, or something like that.

The other kind of risk that I'm talking about is morale risk. Suppose that a tree crashes through your window, and you know you have insurance, so you just leave

it. Then a huge thunderstorm comes by and floods your house. Rain comes in, ruins your carpet, and ruins your hardwood floors. If you had been trying to take care of what's yours and covered that hole, that damage wouldn't have happened. But if you decided not to worry about it because you're insured, the company won't cover that loss. The proximate cause provision keeps it from having to pay those kinds of claims.

In this business, it's a lot easier to make a decision if you have 10 percent versus 90 percent of the risk to pay. What you're referring to is a lot of people are 90-10 coinsured, particularly with the mortality risk.

So that puts reinsurers at an interesting risk with respect to public opinion. If something bad happens and there are questionable claims that an insurer would be within its rights to decline, it certainly would be possible for it to agree to pay and to try to bind its reinsurers to its decision without having to spend a little time talking to them ahead of time. That can absolutely happen.

But that's sort of an "event" thing. We worry about it, but the worst thing is the trends that can happen in the slow erosion in mortality experience over time. It can result from making some underwriting exceptions or from loosening your claims review process.

I have a couple of hundred clients. These clients are all in the insurance business. They're in the risk-taking business, with mortality being the fundamental part of what they try to project.

A lot of these companies have made the decision over the last several years that when they're allocating resources and time, they should spend more on product development or on recruiting brokers and much less time on studying cause and effect of mortality. There are a whole lot of companies out there who are in the mortality business, but if you ask for a mortality study, they don't have one. It's been on their project books for five or six years, and they'll get around to it when they can. I understand it, but it makes me really nervous.

I talked before about the idea of secondary guarantees. If I were reinsuring someone's secondary guarantees, that to me is a huge morale risk in that we might have an agreement right now as to what it is. But once I take on that risk and they no longer have it, it doesn't affect their COIs and their crediting strategies. They just get their money if they want it, and I am on the hook for the risk as it comes up later.

It's very difficult to manage that. We do whatever we can by trying to nail down today's situation in our contracts and treaties as much as possible. That includes such things as the underwriting that was being used at the time and the claims review practices being used today. The problem, of course, is that these treaties last a long time, and it's very difficult to anticipate the future. The reinsurer/insurer

relationship for years and years has been very gentlemanly: we all agree with this, so let's just proceed.

That's wonderful, except that the decisions are between parties that know each other now, but in 10 years, they'll be between parties that do not know each other and possibly never met. And 20 years from now, there will be a lot of business possibly still on the books, and who knows what the relationship between the two companies will be? So we try as hard as possible to define the state of business that we are taking on so that if there are changes going forward, we can map to that. That is the risk that keeps me up at night more than any other in my business.

MS. TERESA N. CARNAZZO: I have a question on stability of earnings, particularly with respect to fixed expenses when you have decreases in revenues both because of sales and policy charges. Any thoughts you have on managing that risk?

MR. RALLIS: I guess at some level, no expenses are really fixed. A few years ago, Met experienced an operational risk when we got in trouble for our sales practices. You saw our field force decline from 14,000 reps down to in the neighborhood of 6,500 reps. That was a huge pressure on fixed expenses, and it took a while to catch up.

The specific point that I was making was that with the stock market declines, you have a loss in mortality and expense (M&E) revenue, which was somewhat unforeseen. But that was compounded by the deferred acquisition cost (DAC) unlocking, where you're projecting forward the M&E revenue that you're going to receive on a much smaller base of assets. It results in a large DAC write-off. What we were seeing was that the DAC unlocking was actually swamping the current period effect of having lower M&E revenue. So we took some steps to modify the way we were doing DAC unlocking to stabilize things. It was reviewed, and our auditors opined that it was okay. There's essentially a type of mean reversion assumption where we would assume that if we had a big decline in the stock market, it was likely to be followed by bigger-than-normal increases in the stock market.

You might not find the evidence in the historical data that would justify it totally, but it's a reasonable type of assumption. We did put in barriers so that the unlocking wouldn't get too far away from reality. But there is tremendous earnings pressure on Met, and I'm sure on other publicly traded companies. We're looking under every nook and cranny for earnings. Also, stability of earnings is very important. Nobody wants to see earnings fluctuate, even for something that's out of control like the M&E revenue stream. We can't cut fixed expenses rapidly enough to accommodate, so earnings would fluctuate.

MR. GARY J. STRUNK: With the events of September 11, have you seen any impact on the cost or the availability of catastrophe coverage? If so, what options

or strategies does a company have to deal with it?

MR. RALLIS: There is very little of it out there. First of all, most companies that would have considered writing it before or wrote quite a bit of it, won't now. The risks aren't any different today than they were a year ago, but they've been made more real to us, and a lot of companies are feeling that. And they're just not going to write it.

People can cobble together some catastrophe coverage at higher attachment points than you would have liked previously, and to have a total amount they're willing to pay that's less than you might have liked. They'll pay a smaller corridor at more money than you'd like.

But that's going to include some overseas reinsurers, and some overseas insurers working together to make it happen, and there's not enough out there for everybody. When I say more money than you would like, I mean probably three to five times what you were paying before. And that's a pretty good deal if you can find it. Most companies are running naked. It's scary, but that's what a lot of them are doing.

Some of them though had decided that catastrophe coverage was expensive a year ago and had already begun to run naked, because their assessment was that nothing like this could probably happen. There was a little bit more pain in the market than they might have thought.

The same thing is true with the GMDB risk. It's very hard to find anybody to take any substantive amount of that, and certain kinds of products can't seem to sell without the feature.

MR. JACKSON: We've seen some of our P&C insurers take the hit early and then try to institute price increases. One reinsurer had some significant payments to make for September 11 and has instituted increases. We've also seen Bermuda insurers being set up. It's an opportunity to set up a separate company and reach for the higher prices that should have been there before.

MR. RAINS: I don't have any specific comments about catastrophe coverage, but I have a comment on a related thing on the interest rate side. We've seen derivatives prices rise dramatically for some of the things that I would say we buy for catastrophic movements in interest rates. It may be related to September 11. But the general level of interest rate volatility is much higher than it has been, which has doubled the cost of some of the protections that we were trying to buy before. And there are fewer counterparties willing to write far out of the money options, as well. So not P&C catastrophe coverage, but related.

MR. JAMES TODD DANIELS: With respect to GMDB statutory reserves, how do you handle the risk of fluctuation in reserves due to the current regulations when

you have such fluctuations in the stock market?

MR. RALLIS: From my perspective, it's an issue that the analysts are very interested in, our reserving practices for GMDB. We're largely self-insured. The best protection is to have product features that don't expose you to any unusual level of risk. This gets back to one of the questions about acquisitions. In one of our acquisitions, their GMDB had a six-month ratchet. That kind of feature is almost unpriceable.

Nobody even had monthly models to price the stock market volatility. At this point, we're only offering one-year ratchets. We had a five-year ratchet product, which was a very innocuous design, except that all of our contracts ratcheted on the same date, December 31.

So that's another feature that really exposes you to an unusual risk. It's just whatever happens on that day. The best thing is to make sure that your products don't have anything too funky, but then assuming you have features that you can live with. If you can't get reinsurance coverage, you better be comfortable retaining the risk.

We are comfortable with retaining these kinds of separate account risks because we find them to be a good sort of offset to how much credit risk we have on the asset side. So, at this point, we're comfortable, although we'd like to get reinsurance coverage. It's almost as if analysts want to know that you have reinsurance coverage so they know you can stay in business because they have doubts whether you have capacity.

But if you're pricing it, you should be prepared to keep the risk on the books, if you think it's a good risk to write.

MR. JACKSON: First of all, I completely agree. If you're writing it, you ought to be comfortable with the risk. Your economic reserving methodology ought to include that, and it should probably not fluctuate wildly.

You have different kinds of reserves there are the statutory ones and the economic ones. Certainly, there's the ability to write and/or reinsure to another jurisdiction with different statutory rules, but that ought to still be limited to a real economic reserve. The only thing that you would save would be any redundancy in the statutory requirements.

I'm not sure that I could tell you how much of it is redundant because of the volatility of events these days, so I guess it's sort of two pieces. There are ways to help with that, but getting to the real issue is where I think the questions are. You have to be very comfortable with what you're doing and that's in the economic reserves that you hold on your books.

MR. RAINS: I'll just add a comment because it wasn't clear in our capital framework. If we develop a product that has statutory reserves in excess of what we think we need to hold, or statutory reserves and capital in excess of what we are holding in terms of GAAP reserves and on economic capital, we will assume that there's a tax on that difference that we'll charge ourselves to, in essence, either raise the statutory capital that we'll need some other way or relieve ourselves of the statutory capital through a reinsurance mechanism.

In a sense, the statutory capital is not our objective; it's just an additional cost. So we won't design a product that revolves around a particular statutory ROI or ROE target.

MR. SCOTT L. FITZPATRICK: How do you think the war exclusion will be applied in future waves of terrorist attacks?

I don't know if companies have already made that decision, but I think there was one company that was dragging its feet on paying life insurance claims on September 11 claims and, about two or three days later, they backed off of it. I think it would be financial suicide for a company because the public opinion would be so against them.

MR. RALLIS: The mortality claims arising out of September 11 were not as catastrophic as the P&C claims, so I don't know if we've had a true test of the war exclusion. There was ambiguity whether it was an act of war. The president used words suggesting that it was, but conventionally there's no declared war.

I can envision other situations where companies might not be so eager to jump to pay claims from a war exclusion, even if public opinion demanded that they pay those kinds of claims. If we had some type of nuclear attack and deaths were in the hundreds of thousands or millions, the insurance industry couldn't pay those claims. That's the whole point of the war exclusion. You're talking about risking the entire industry on perhaps a single event.

MR. RAINS: As a reinsurer, it's an interesting position to be in because you have to spend quite a bit of time talking to all your clients, seeing who is going to make the same decisions and who's going to defend their right to deny a claim. It's a pretty sticky spot to be in. We have a lot of interesting talks with our clients and with our retrocessionaires, and we're certainly not unprotected with the amount of risk that we take.

If there was a second wave or third wave of terrorist attacks, I'm not sure when it would kick in. But at some point there would have to be some real assessment of where we have to draw the line and defend ourselves. You're right that it was ambiguous as to whether a provision like that would have come into play or not. I'm sure we could have spent quite a bit of money on lawsuits, advertising agencies, and all kind of stuff if we had chosen to do it as well.

But public opinion is a powerful thing. It's true that if the insurance industry can't pay, it won't pay. But we see the effect of public opinion on a lot of things even today on other kinds of risks, not just the war exclusion. There seems to be a bit of an attitude or mindset that if the insurance industry can afford to pay, they ought to. That to me is just as dangerous as the idea of being run out of business because it could get there pretty quickly.

I don't know how many of you are thrilled and excited to be supporting industries by writing corporate owned life insurance (COLI) business, but if you read *The Wall Street Journal*, you're the devil. Now I don't think so, and I think it makes plenty of sense.

But when you read articles, it isn't phrased that way. People who don't understand that product really get behind it and make laws that affect us. Public opinion is really just a beginning, and it can translate pretty quickly into legislative action. We have to pay pretty close attention to that and express ourselves and defend ourselves early, by educating people.

MR. JACKSON: On the mortality side, you really have to be looking at something of a nuclear magnitude, and you have to be able to tie a specific country to the event. Then you would look at whether the insurance companies could pay or not. That's when you'd get the companies trying to stay afloat.

MS. CARNAZZO: Does it make financial management sense to create limits for paying death benefits? You could say we'll pay up to $100,000 in the event of this sort of catastrophic terrorist or war-like attack. Or would that be poor for public opinion? Does planning ahead work in this situation?

PANELIST: We've actually engaged a group of people in our corporate risk management area who are working on a project called the Unthinkables Project, which is to do just that. They are to think of whatever outrageous scenarios we might encounter, to develop some type of contingency plans on how the company would react. The plans would exist so that we actually wouldn't have to think right on the spot, but that we might have a game book that we could pull out and say, "It's going to affect this line of business this way, that line of business this way."

I think it's an excellent idea, if you have extra time, to go through an exercise like that for the different types of risks.

MS. JULIE M. BOSWORTH: I'll just add one comment to that. Planning ahead is great, but one of the things that has to be factored into the planning is the regulators. A lot of planning ahead can be done in terms of contingencies. We won't pay under this scenario, or we'll only pay a limited amount under another scenario, but you have to file your policies, and they have to be approved by the states. Whether or not the states are going to go for any sort of war exclusion or terrorism exclusion is another issue.

PANELIST: If it is your company policy, as opposed to an individual policy form, you certainly have to be careful when you're defining policies like that. I don't think you want to have too many of these defined that you wouldn't want the world to know about in advance, because they'll know.

PANELIST: The only thing I'd add there is that in retrospect this kind of thinking should have been done from a P&C perspective before September 11. It wasn't done, and Setpember 11 has changed the way that we think. I'd be surprised if more and more companies aren't going to be doing this kind of thinking. What the unthinkable was is no longer true; there's very little that's unthinkable anymore.