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New AOMR Requirements–Burden or Opportunity?

Track: Smaller Insurance Company

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Summary: Recent changes in the requirements of the Actuarial Opinion and Memorandum Regulation (AOMR) may be a burden or an opportunity for smaller companies. Attendees gain a better understanding of the changes in AOMR, the ways in which the new requirements can be fulfilled, and the use of asset-adequacy analysis in other areas of the company.

MR. KEITH A. DALL: This morning, we're going to give you some of the history behind why we have a revised Actuarial Opinion and Memorandum Regulation (AOMR) and then we're going to talk about the different methodologies that can be used within AOMR.

I'll follow up by discussing some of the management reports that you can create after the two- or three-month process of putting the model together. Let me introduce the speakers in reverse order. I'm Keith Dall with Milliman USA, Indianapolis.

Our second speaker will be Norma Christopher. Ms. Christopher is the vice president & life actuary for Cotton States Life Insurance Company, Atlanta. Cotton States Life markets individual life and annuity products throughout the Southeast. She is also the appointed actuary and the illustration actuary for Cotton States Life.

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Mike Batte will be the first speaker. He is the chief life-and-health actuary for the New Mexico Division of Insurance. His 30 years of actuarial experience includes consulting for an international actuarial consulting firm. Mr. Batte currently chairs the NAIC life-and-health actuarial task force.

MR. MICHAEL C. BATTE: The burden that we're going to talk about is the model AOMR that was adopted by the NAIC last year. I'll be talking, in general, about the development of model laws and actuarial opinions before and after AOMR. Then I'm going to go into a project history. Finally, time permitting, I want to talk a little bit about the future of valuation and the future of AOMR.

Model laws and regulations are developed by the NAIC through a structure of committees and a public hearing process. I want to explain more about the NAIC, and specifically the life-and-health actuarial task force (LHATF), which is the task force that was responsible for developing the AOMR, as well as the recent revisions to AOMR.

State regulators formed the NAIC in 1871 to address the need to coordinate the regulations of multi-state insurance companies. The first major step in that process was the development of uniform financial reporting by insurance companies. The NAIC, which was incorporated in March 2001, is the regulatory organization of insurance regulators from the 50 states, the District of Columbia, and the four U.S. territories. It has offices in Kansas City, New York and Washington, D.C. And those offices provide substantial services to the insurance commissioners of the various regulatory bodies.

Briefly, the mission of the NAIC is to assist insurance regulators, individually and collectively, in serving the public interest and in achieving fundamental insurance regulatory goals in a responsive, efficient and cost-effective manner, consistent with the wishes of its members.

Its goals are to protect the public interest; promote competitive markets; facilitate the fair and equitable treatment of insurance consumers; promote the reliability, solvency and financial solidity of insurance institutions; and support and improve state regulation of insurance.

The committee structure of the NAIC consists of the plenary, the executive committee, standing committees, task forces and working groups.

The plenary is a body composed of all the members of the NAIC—the commissioners of the 50 states, District of Columbia, and the four U.S. territories. The executive committee is a committee composed of the officers of the NAIC, plus the officers of each of the four regional zones. In addition to this fifteen-member body, there are eight standing committees, 'A' through 'H.' The 'A' committee covers life and annuity issues. The '"B"' committee covers health insurance. The 'C' committee covers property and casualty. Other committees include marketing and

regulation of consumer affairs, financial conditions, financial-regulation standards and accreditation, special insurance issues and national insurance issues.

There are a number of task forces that report directly to these committees, each one dealing with specific issues. The process is a public hearing process. The NAIC has four national meetings each year. The meetings are primarily a series of committee and sub-committee sessions, much like the legislative hearings of your state legislature, or even congress.

The committee system directs regulatory issues to expert groups for review, before being discussed by the membership as a whole. Reports and recommendations are initiated at the working-group and task-force level, with further review by parent committees or sub-committees, and final approval by the executive committee on the plenary.

At NAIC meetings, these committees listen to the testimony of insurance departments, legislatures, other government officials, consumers, insurance-industry representatives and other interested parties.

The committees also receive written statements and research documents, developed both within state governments and by advisory groups that are composed of consumer-industry representatives. Each committee produces minutes describing the issues discussed and the actions taken. The LHATF is a technical task force that reports to both the 'A' committee (the life insurance and annuity committee) and the 'B' committee (the health insurance and managed care committee).

These two committees use this task force to address technical actuarial issues. Membership at the task-force level is in the name of the commissioner or the superintendent or director of that insurance department. The actual participants on the actuarial task force are all actuaries.

The task force refers all accident and health-insurance issues to its accident-and-health-insurance working group. Probably, the recent accomplishment of this task force that you would most recognize would be XXX, the valuation of insurance policies regulation. That was accomplished by this task force, which went through this project over an extended period of time and developed two models. The first wasn't adopted by many states at all. The second one has been adopted by most states.

The task force hopes to get an actuarial guideline on XXX out this year. One of the more recent accomplishments of the accident-and health-working group is their input on modifications to the long-term care regulation, particularly as it related to rate stability in that product market.

Its current membership includes actuaries from the departments of insurance of the

states of New Mexico (which chairs it), Arkansas (which is the vice chair), California, Connecticut, Florida, Illinois, Michigan Minnesota, Nebraska, New York, Pennsylvania, Oklahoma, Texas, Utah and Washington.

The task force adopts a work plan every year that is referred to as charges, and that work plan is approved by the NAIC. You can find these charges published on the NAIC Web site. And for the LHATF, the current year, those charges range from providing assistance to other committees and task forces, to developing new model laws and regulations in specific areas.

I want to briefly look at what actuarial opinions were like before AOMR. How many of you have ever signed the Jurat page as actuary? We quit doing that in the late '70s. At one time, for many years, the signature on the Jurat page meant that the actuary was signing off on the reserves.

In the mid- to late- '70s, we developed an actuarial opinion, and I'm going to read the version of the actuarial opinion from 1990. We actually began using it in the late '70s. This actuarial opinion was the one that was primarily used throughout the decade of the '80s, up until the early part of the '90s.

In my opinion, the amounts carried in the balance sheet, on account of the actuarial items listed above are computed in accordance with commonly accepted actuarial standards consistently applied and are fairly stated in accordance with sound actuarial principles. They are based on actuarial assumptions, which are in accordance with, or stronger than those called for in the policy provisions, meeting the requirements of the insurance laws of the state of domicile. They make a good and sufficient provision for all unmatured obligations of the company, guaranteed under the terms of its policies, are computed on bases of assumptions consistent with those used in computing the corresponding items in the annual statement of the preceding year's end, and include provisions for all actuarial reserves and related statement items, which ought to be established.

The two significant things about this opinion versus AOMR are the state of domicile, and the 'good and sufficient' provision.

So let's talk about the AOMR. It was adopted by the NAIC in 1991, and it adopted a two-tier system. For one of those tiers, the companies with assets exceeding $500 million were required to conduct sufficient tests, such that they could certify that their assets make adequate provision for their liabilities. This is known as the 'section eight' opinion.

The actuaries were required to perform asset-adequacy analysis, and provide a supporting memorandum. Under certain conditions, companies with assets falling below $500 million are exempt from this requirement and need only certify that their reserves have been computed in accordance with the formulas specified in the

law. We call this the 'section seven' opinion.

The requirement that the opinion include a statement concerning 'good and sufficient provision,' obviously, is gone. And I guess the basic difference between the section-seven and the section-eight opinion is that one says that the reserves are adequate or meet some standards besides provisions and law, and the other one doesn't.

So, we've seen a transition from a signature on the Jurat page to a formal actuarial opinion, and then the development of regulation requiring some companies to perform an asset-adequacy analysis. With that as the background, let's look at the new AOMR requirements.

Briefly, I'm going to review the project's history from the LHATF point of view. We're going to look at the issues, talk about the development, the controversies that we ran into, and the implications of the revisions.

There were four issues that the task force looked into. One, should small companies be exempt from performing an asset-adequacy analysis? Two, what flexibility should be provided to the commissioner accepting actuarial opinions based on foreign states' laws? Remember, we went from a state of domicile to a state of filing when we went to AOMR. Third, should additional information be required to be included in the actuarial memorandum, or should a confidential summary of the assumptions and results be prepared and submitted to the commission?

In the 18 months subsequent to the adoption of the AOMR, there were a limited number of revisions made and included, mostly technical corrections and clarifications. Since that time, since '93, discussions of the above issues have been an ongoing project of the LHATF. The task force included interested parties in these discussions, in addition to open sessions at the quarterly meetings of the NAIC. Numerous conference calls were held over the last several years to discuss the various drafts of the revised model.

Notices of these conference calls were published on the NAIC Web site and e-mailed to approximately 150 interested parties, including representatives of the American Council of Life Insurance, the National Association of Life Companies and the National Fraternal Congress of America. Additionally, representatives of the American Academy of Actuaries and the Actuarial Standards Board provided significant input on this matter.

There were only two controversial issues, whether or not small companies should be exempt, and the state of filing versus state of domicile continues to be an issue.

I remember, in the early '90s, at one of the first Valuation Actuary Symposiums that I attended, I went to a small-company session. At the small-company session, one of the focuses was on the state-of-filing issue. At that time, I was the valuation

actuary for a health-insurance holding-company system. We were licensed to write health insurance in about 34 different states.

In the early '90s, there might have been five states that had consistent valuation laws for accident and health insurance. So, the state-of-filing requirement that appeared as a result of the AOMR caused me a lot of trouble, and probably still causes a lot of problems for companies that write in those sorts of product lines.

This topic was on the program as a small-company issue. So I'm going to focus a little bit on the small-company exemption. Should small companies be exempt from the asset-adequacy analysis? We've already discussed the two-tier system, the section-eight versus section-seven opinions.

The major justification for developing this system was the expense of asset-adequacy analysis in the early '90s. At the time we developed this two-tier system—this testing consisted of multi-interest-rate-scenario testing—there was very little software and hardware available to accomplish the task. If you will, think of your desktop personal computer in 1990, and compare it to what your home computer looks like today.

The process for doing cash-flow testing on interest-sensitive products dominated our whole discussion on asset-adequacy analysis. And it was deemed that the expense of that process would far outweigh any benefit that a small company could get from that process.

The industry representatives continue to support that small-company exemption, primarily because of this expense issue. The National Association of Life Companies has gone on record before the LHATF, and before the full body of the NAIC, indicating that they don't believe the cost of the additional testing is justified by the benefit.

Secondly, they're still asking about what harm we are trying to avoid. What problems are we having with small companies that require that we tighten this issue up? Those are two pretty strong objections coming from the National Association of Life Companies.

The National Fraternal Congress of America, which generally represents fraternals in many cases doing business in one state or a small geographical area, also is opposed to this, on the basis of expense.

This opposition not withstanding, the task force recommended the removal of the small-company exemption, thereby requiring all companies to demonstrate the adequacy of their reserves. The task force is basically agreeing with a recommendation that was made by the state variation-in-valuation laws task force of the American Academy of Actuaries.

A recommendation the American Academy of Actuaries made back in 1996, was that the AOMR model regulation section six and seven should be deleted completely. Their rationale was that uniform actuarial opinions are important, both in terms of policyholder protection and the integrity of the statutory accounting system. Secondly, there is no precedence in GAAP, risk-based capital requirements, and other things, for different standards, based on size. Third, formula reserves alone may not be sufficient. And fourth, foreign states are more likely to accept a domicilary state AOMR if the reserves are tested for adequacy. Again, from the Academy's point of view, there's an interplay between state of filing versus state of domicile.

The task force did recognize that the issue of expense was a legitimate concern. During the project, the task force received the assistance of the Actuarial Standards Board, which has developed, in response to working with the task force, revised standards of practice relative to this matter.

These revised standards base the amount of testing on the degree of risk inherent in the contracts being sold. Necessary testing will vary very little from complete multi-interest-rate-scenario cash-flow testing, depending on each company's business and the risk exposed.

The other controversial issue was the state of filing versus state of domicile. The standard valuation law requires that the filing of an actuarial opinion that states that the reserves and related actuarial items comply with the applicable laws of the state of filing.

The original AOMR mirrored that by requiring a statement to the effect that the reserves and related items meet the requirements of the insurance laws and regulations of this state or of the state of domicile, and are at least as great as the minimum aggregate amounts required by the state in which the statement is filed.

Again, this has been a problem for actuaries signing opinions in companies that are licensed in multiple states. I guess the controversy over this issue can be stated pretty simply. The industry would prefer a state-of-domicile opinion. The regulators probably prefer a state-of-filing opinion.

I don't know whether the task force cut the baby in half or what, but we did come up with a method that will permit a state to accept a company's state-of-domicile opinion. It's sort of a three-option approach. I can tell you that the ACLI opposed this part of the model, primarily because they don't think this will lead to uniformity. What they would like to see is a uniform state-of-domicile opinion. They feel this could create multiple options, depending on how your state exercises and they have opposed this change on that basis.

We have codification that we are trying to move toward more uniform standards, which recommends a change in the standard-valuation law. The 'A' committee has

a charge to that effect and is looking into that issue.

The LHATF and the life-practice council of the American Academy of Actuaries have spent an inordinate amount of time dealing with the formula reserves specified by the standard valuation law (SVL). Typical projects involve looking at a newly designed product or a new feature in an existing product, in an attempt to determine a commissioners-reserve valuation compliant method, so that we can issue an actuarial guideline or develop a regulation covering this new product or new product feature.

I guess the shining example of our work is XXX. It took over seven years of work to come out with a model, and we no sooner got the model out and got commitments from the states to adopt it, than we had to develop a guideline. We're in our second or third year of working on a guideline to interpret XXX.

Capital adequacy, risk-based capital, along with the modeling capability that we have today, makes much more sense than the formula reserves of yesterday. That's my personal opinion; I'm not speaking on behalf of the task force. But we've got to find some ways to change this process. Otherwise while we try to draw the line tighter and tighter, actuaries will continue to be creative when developing new products and new methods, and it's a waste of our efforts.

On a second front, if the SVL were amended to a state of domicile, the AOMR would obviously be changed in that respect.

MS. NORMA Y. CHRISTOPHER: I am Norma Christopher and I'm the actuary for a small company. I wear all the hats. I have one assistant, who's not even an associate. So I'm in the same boat that most of you are in.

What I'm going to talk about are the two new standards of practice that came out in the fall, Actuarial Standards of Practice (ASOP) No. 22 and No. 7. And I have these numerically backwards, because No. 22 really tells you when you need to do cash-flow testing, and when it's permitted for you to do other forms of asset analysis.

You don't always have to do cash-flow testing. I think that's one of the big things that small companies are thinking, "Well, I can't afford to do cash flow testing. I don't have the equipment to do cash-flow testing." You don't really have to do it. ASOP No. 22 tells you when you need to do cash-flow testing, and when you can do something else. It is effective now.

There are several main steps in doing the asset analysis. First of all you have to select the assets that are going to back your reserves. If you don't feel that you have enough assets to back those reserves, you're going to have to set up an additional liability, so that you can pull those assets over.

You're going to have to use your own judgment in deciding what form of asset analysis you need to do. One thing that keeps driving me crazy is that they call it asset-adequacy analysis, and to me it's really more determining whether the number set aside as a liability is big enough. Do I really need more assets to support that business?

You don't have to use the same method for everything. Maybe there's one block that you have to do cash-flow testing on, but not the rest. So you can use different techniques for different blocks of business.

Cash-flow testing is the most often used. We do use cash-flow testing at Cotton States, but I don't personally do it. I had a consultant come in to help set up the first model. We keep the model on our premises. We modify the model as we add new products. Since we use the same software to do product development, by the time we've finished the new product, the model is basically done. So once it's built, it's not that difficult to maintain.

Then during year-end, since my assistant and I are pretty busy putting the statement together, I hire a consultant just to run the model. I'm still the appointed actuary, and I make all the decisions as far as the assumptions and what has to be done, but I'm not mechanically running it because of time constraints.

It does not cost that much money to do it that way. I think a lot of people don't realize that you can hire a consultant just to do the mechanical part, without paying him to sign the statement. That's what they really charge you a lot for, taking that responsibility.

Gross-premium reserve testing is another option that may satisfy the requirements. When I looked at it myself, I felt it was just as much work to do a gross-premium test as it is to set up a cash-flow model. You get a lot more credit from the rating agencies, risk-based capital ratios, and other things, from doing the cash-flow testing.

If you are going to do as much work as you have to do to run those gross-premium tests, you might as well go ahead and do the cash-flow testing. If you are a small company, like we are, there are not that many assets that you have to key in.

If you have really simple, plain-vanilla product, you can just demonstrate how conservative your reserves are. If you have a four percent 1980 CSO reserve, and you know that you can show that your mortality is much lower than that, and the interest rates that you are earning on your assets are much higher, that may be a sufficient demonstration that you are conservative.

If you don't have much variation by economic scenarios, you can demonstrate that. In our products, we sell through what we call 'Wal-Mart America' and most of our policies are on bank drafts. We do not have any fluctuation in premium receipts

based on what the interest rates are. These people just buy from their local agent, and they don't change their behavior. We can demonstrate that.

Loss ratios are also pretty obvious. Those are basically the same as showing conservatism; you can show that the amount that you've lost from claims, is less than what you've assumed in your reserve.

If you're going to do the cash-flow testing, ASOP No. 7 gives you guidance on how to do it. And it's going to tell you about some things that you have to set aside. Just use that as a guideline, and the regulation gives you an outline for an actual opinion and what the words have to be.

Once you go through it the first time and set everything up, it's really not that difficult to do it every year. It's just the unknown of getting it started the first time that's difficult.

You do have to do cash-flow testing if you have a significant asset risk, if you have liability cash flows that go way out into the future, a new and rapidly growing book of business, etc. The guideline lists different kinds of scenarios in which you do need to do cash-flow testing.

You do not have to do cash-flow testing if you have short-term liabilities or short-term assets, if you have a block of business that's not sensitive to the economic scenarios, or if you're really looking at a risk that's not sensitive to economic scenarios, such as AIDS, or asbestos, or just excess mortality.

So if you decide that you need cash-flow testing when you go through that list, then ASOP No. 7 offers guidance on exactly how to do cash-flow testing. But I think that you'll find in No. 22 that you might not have to. Most of the business that small companies transact does not demand cash-flow testing.

In fact, I've heard some discussion by larger companies saying, "Well, now that they've changed some of these guidelines, we don't have to do cash-flow for some of our blocks of business." They felt that they could demonstrate conservatism, show a loss ratio, or whatever. They are going to cut back on some of their cash-flow testing. So that's going to be interesting to see if the regulations might have the reverse effect of what was anticipated.

MR. DALL: Mr. Batte and Ms. Christopher covered the burden of the asset-adequacy testing. I'm going to try to explain some of the opportunities that there are within cash-flow testing.

In fact, what I would like is for you to not look at this whole process as a regulatory requirement, but rather as an opportunity to set up an excellent management tool for a variety of strategic uses. One of the side benefits of this whole process is that you fulfill the regulatory needs. I think a lot of companies look at this and just

assume that they're looking at it from a regulatory standpoint, wanting to fulfill that particular obligation. And once they're done, they put it away until next year.

Actually, when they're done, they have this wonderful model built. They've spent two or three months on this whole process, and they've got this opportunity to be able to share with management a lot of quality information—the value of the business, emerging profits, and so on. I'm going to try to cover those particular items today.

The key to all of this is communication and what I want to cover involves visual reports. Management does not have the time to go through the three-inch-thick actuarial memorandum. They simply don't have the time to try to cover all of the details. So the key is to summarize those results, try to make some assumptions, try to create a nice management tool out of it.

For example, when I was working at a prior company, we used to put together a sales and in-force report. We had just started selling work-site marketing cases, so we added some work-site marketing information, regarding how much we were selling, along with our targets. It was all numbers; it had percentage growth and a few other items.

I would distribute that to all the other managers, and we would put it on the bulletin boards around the office. We'd have monthly management meetings, and I was always surprised that that report never came up in any of those management meetings. Every once in a while, people would ask how work-site marketing sales were going. And I would simply pull that sheet out.

One day, we decided that we would change that report drastically. We made it into a visual report. Rather than putting numbers on it, we made graphs. We sent it out to the same people, put it on the bulletin boards again.

It was amazing to me that everybody at the next staff meeting had that report with them. They could understand exactly what was going on with the growth of the company, the growth in the work-site marketing sales, the decrease in some of the other lines that we were looking at. They had questions regarding those particular issues.

It was as simple as changing it from a page of numbers to a nice visual. That's part of communication; that's part of what we need to do as actuaries to communicate better to our managers.

Now, there are a lot of possible uses from the cash-flow testing—or the gross-premium valuation, method that Ms. Christopher covered—including GAAP projections and asset liability management. Those two particular items, I'm not going to cover here. I want to talk about other items from a pure management-reporting standpoint, strategic uses. Some of the strategic uses include valuing the

block of business, financial projections, risk management and new regulations. If you're actually going to sell your company or a block of business, the first thing that the consultant is going to do is create, from a statutory basis, the present value of profits. That's exactly what happens during an appraisal, so that's what you already have accomplished in cash-flow testing and gross-premium valuation work. You have those future profits out there, you get the present value of those profits and that's a big piece of the value of the company.

Financial projections can be used to monitor your pricing assumptions versus your actual experience. I'm sure a lot of you not only are the appointed actuary, but you're also the pricing actuary. So you know exactly what kinds of assumptions you put into these models two years ago, three years ago, whatever it is. And now you know the assumptions that you're putting in the cash-flow model. It is now easy enough to change those assumptions and compare the impact of when you priced it, how profitable it was, to how it looks under the current assumptions that you're using., You can evaluate the possibility of needing to make changes in your product design.

"Enterprise Risk management" is the new, trendy phrase that's getting a lot of publicity right now. There were two excellent meetings yesterday afternoon on risk management. I'm going to cover again today some of those risk-management items. It may not be the really technical analysis behind the scenes, but you can start to point out some of the risks that you have within the company. Then management will start to ask questions, and you can start going back and doing all the detailed work later on along with more complex statistical analysis.

Another benefit of setting up this model is that you can adjust it to include any new regulation and measure the financial impact.

If nothing else interests you, you can certainly get interested in the management-compensation angle. If you're going to create this nice model, show the present value of profits by line and in aggregate. It might become a tool for management compensation or management bonuses, to see the increase in the present value of profits from year to year.

Milliman did a survey of larger companies with at least $1 billion in assets. There were about 67 respondents, in total. The question was asked, '"How do you use cash-flow testing, beyond just for regulatory means?'" Over 60 percent said that they use it to derive liability durations for investment policies and asset-liability matching.

The item that ranked third is rating-agency presentations, and I'm sure most of you helped management put that particular presentation together. Again, if you're going to spend two to three months putting this model together, you've got the perfect tool to try to get a lot of information for rating agencies. Risk assessment, again, is the key to strategic business planning. So you can see, even the larger companies

out there are not using the model to its fullest advantage.

Now, I'll cover the items for which they use it even less frequently. As actuaries building these models, we can certainly work with the accountants and do a lot more from a budget-planning standpoint. We can help them understand what will go on in the next year, and what to expect, as far as the number of sales, or the number of profits by product line.

You can also help management understand the emergence of earnings, and where profits actually are coming from within the company. Again, it's very easy to do if you're going to go through the effort of doing the cash-flow testing or gross-premium valuation.

Whatever model you end up with, you can use it to understand what the growth and the value of the business is from year to year. Certainly you're going to have to add a few items. If you want the value of the total business, you're going to have to add the capital and surplus, asset-valuation reserve, interest-maintenance reserve, and those types of items. You may have to change some of the assumptions for these other purposes. A lot of companies that we work with end up using fairly conservative assumptions for AOMR, because they know that they're going to pass the asset adequacy testing. I don't particularly care to do that, because I think that once you start doing that, it takes away from this management tool that you have. If you are doing that, then you're going to have to modify some of the assumptions.

At some point, you are going to want to distribute the earnings, rather than retain them. If you wanted to add new business projections, you certainly could. However, you might just want to go ahead and leave the new business out for this particular purpose. If you're pricing at 12 percent internal rate of return, and your hurdle rate or discount rate is 12 percent, there's probably not going to be much, if any, new-business value out there anyway.

When management sees a typical report with just numbers, they get all glossy-eyed, and they're not going to take the time to understand it or have any interest in looking at it. But if you create a nice chart, you have the same information, and when management looks at it, they're going to remember it. When they start to see these types of reports, there are going to be more questions and discussions about the financial state of the company.

It's good for management to understand that even though they may be selling a lot of variable annuities, the value of the company may be leaning toward the life-insurance products that they have, the old, traditional products, and some of the universal-life policies that they're currently selling.

In fact, we just did an appraisal on a company that claimed to be just a variable-annuity company, because those premiums far outweighed any other premiums in

any other line. But when you actually looked at the value of the company, there wasn't a lot of value in the variable-annuity business. The variable annuities only made up about 40 percent of the value of the company. So again, these reports are a good tool for management to use when deciding what product lines they need to push their distribution toward. Certainly, they'll start to ask a lot of questions when they see these reports.

Financial projections—the first thing you're going to want to do for financial projections is add new business using the marketing department's sales projections. Adding the new business really isn't as difficult as you may think, because if you're doing the cash-flow testing, you've already put in all the product information that you need. It's simply a matter of running out some additional sales into the future for those products that you're currently selling.

Again, you're going to want to modify the assumptions. But some of the benefit of doing this is the ability to see the emergence of earnings, which is critical from a management standpoint. Do some budget planning, capital allocation, to know how far your surplus is going down or up.

It gives management an idea of where to emphasize their management time, their distribution activities, or maybe where to change agent commissions. You don't want to add too many projection years. If you stay within the two- or three-year period, you can probably still have management buy into your assumptions.

Another item you will need to add in is acquisition expenses. You may have to add in more overhead expense into your model, because typically in a run-off mode, you might not have all of your overhead expense in cash-flow testing. Adding those items isn't that difficult, and management gets a wealth of information out of it. They get to see where the expenses have been in the past, and where they will be—or where you think they will be in the future.

You can actually just split out your assumptions by expenses, mortality lapses and investment income. After you do this from year to year, you can go back and look at your last year's model that included the new business that you were expecting. Then you can compare it to what actually happened. Again, a lot of the embedded value type of analysis should be presented from a visual standpoint, so that management can actually understand it and buy into it.

Okay, so now we get into risk management. Obviously, you have to know your risks. Get your earnings by source, whether you're going to use reinsurance or not. You have the model created. If you've included your reinsurance, it's easy enough again to just take out, to see what your present value profits would be without it. Or maybe you want to add more. You want to get a quote from a reinsurer to find out what they would quote on a coinsurance agreement for your term, to see what kind of impact that would have on your profits.

Another use is with divesting and acquiring different blocks of business. Again, once management sees the emergence of earnings, the present value of earnings by product line, they will have a better understanding. If they want to continue in that particular line, then maybe they see the need to divest of one and acquire a block of business in another line because they have more core competencies in that particular product line.

You can evaluate decisions about underwriting. Perhaps your models are showing that the actual mortality is higher than what you were expecting. You could add some underwriting expenses, estimate that you're going to get more selective underwriting, and see what the impact of that would be in the overall picture.

Stochastic pricing is a trend that's coming. It's probably going to come out in the future in new regulatory requirements. You can get a head start by starting to include stochastic analysis in your management reports.

Management should understand all of the company's risks, Everybody here, I'm sure, understands the risks that are involved in interest rates, lapse rates, claim costs and pricing.

You can make graphs that just show the impact of lapse-rate scenarios. In the actuarial memorandum, you would simply list that you have the different sensitivity tests, and you would list the impact that it has, generally, on the surplus, or maybe on the present value of profits. If you graph that information, it shows management exactly what's going on. A lot times management may be surprised that the lapse rate really doesn't have as much impact as what they would have thought that it had. Or maybe it has more, depending on where you are in the surrender-charge patterns.

With mortality scenarios, it is the same sort of thing. Just show management what's going to happen down the road. You could combine this analysis with some sort of expense report, discussing the impact that it would have on more selective underwriting. Increasing your underwriting obviously increases expenses, but then it's going to bring down your mortality, down the road.

Improved investment returns, reducing lapses, increasing sales, or reducing reinsurance are all risk-management items. However, it is really easy for management to see when you use simple graphs instead of talking about standard deviations or covariances, and things of that nature. You should have the statistics in the background, but it doesn't necessarily mean that you need to show that up-front to management. You want that information down the road, if they start asking questions.

As I started out, the key is communication. I didn't discuss anything that you didn't already know or weren't able to do. But I think it's very important to be able to see it. I've seen a lot of the reports from different companies, and if you can make the

reports visual, it certainly allows management to get a better picture of what's going on in the company.

FROM THE FLOOR: The profits you're talking about discounting are present values, statutory profits, I assume?

PANELIST: Yes.

FROM THE FLOOR: I may be crossing over into some other session, but I attended one yesterday on purchase accounting, and they're going to take advertising out of goodwill. I was wondering if you think it's appropriate to use the present value of these statutory profits to show that your present-value of profits exceed the goodwill on your books? Is that an appropriate question for this session?

PANELIST: It's another way that you can give management some information, if you create the present value of profits, adjust your book value, and everything else that you're going to need to do to get the value of the company so that management understands the value of that company and the relationship of that to goodwill. As to the impact on accounting and how you're running that goodwill off, that's more a question for the accountants.

MR. PAUL PAINCHAUD: I was wondering, for companies licensed in New York, do you have any information on the current status of the small-company exemption on Regulation 126?

PANELIST: I've been told that there are approximately 12 states that will be in a position already to have adopted the revisions to the AOMR. I don't know if New York is one of those states. New York has been an active participant on the LHATF, has had substantial input on the development of this regulation, but I don't know what their position is going to be this year.

Again, in discussions that I've had with people who have asked me when this is going to be applicable for their company, I believe much of it is going to depend on what the NAIC does with respect to these revisions in two areas: one, the accreditation standards that they apply to the various state insurance departments, and the other is codification.

I think many states are waiting to see what will happen there. There are a lot of states in which, if this becomes an accreditation standard and is developed as a codification standard, they won't' even have to do a rule-making hearing or do anything formally to adopt it, because they will adopt it because of codification.

MR. WILLIAM ZEHNER: I have a couple of questions on the actuarial guidelines. Actuarial Guideline 33, regarding valuation of annuities, specifies how to calculate your annuity reserves for deferred annuities. What I've interpreted is, you then go to the state laws to determine whether to apply a continuous or a curtate basis to

it. I believe it's Actuarial Guideline 8 that specifies that you would have to use continuous reserves. It seems that AG 33 supersedes AG 8. I wonder what the panel thinks about whether you should refer to the state laws or refer to AG 8 to determine if you use continuous or curtate.

Another question refers to aggregating reserves in cash-flow testing. For a non-New York company, if you accept the rule to aggregate reserves—I was wondering then why, Ms. Christopher made the comment that if you have sufficient conservatism in reserves, you wouldn't need to put those in your cash-flow testing.

MR. BATTE: Again, there are many actuarial guidelines dealing with reserves that essentially are a part of codification standards. In some cases, specific actuarial guidelines are referenced. That being said, if you're trying to figure out whether or not an actuarial guideline applies, or whether or not a state's interpretation of the law applies, obviously, the state is going to be free to interpret the laws the way it wants to. The actuarial guidelines are there for the states to utilize if they need them.

There are states that do not necessarily follow each particular guideline in giving advice to the examiners that are going into companies and doing the examinations. So in a perfect world, someday we will get to a codification, we will all be using the same accounting standards. All states will be using the same NAIC accounting-practices-and-procedures manual, and insurers will have more uniform guidance for what to do.

But in the meantime, if you have a question, especially if it's on how your state of domicile interprets different laws, address that question to them specifically. And your other comment about New York, again, I would address those comments to the staff there.

MS. CHRISTOPHER: On the question about conservatism, of course you could use those conservative assumptions in your cash-flow testing. But if you're really conservative on your reserve assumptions, you wouldn't have to do the cash-flow testing, if you could show that you were already much lower than those conservative assumptions.

And as far as the aggregate goes, you don't have to segment your assets. You can put everything together. In my company, we don't have any segmented assets; everything is all lumped together. And that's the way I run the cash-flow testing. I do run it separately for my own use, and I use those results for some by-line-of-business reporting. But for the cash-flow testing, I run everything together against the total assets.

FROM THE FLOOR: I have a quick question. Is it safe to say that no states will adopt this for 2002? I know that there are some states that are thinking about adopting it, but I believe the effective date would be 2003.

MR. BATTE: Never say never. I think it's fairly safe to say that, at this point, it will be for future periods of time.

FROM THE FLOOR: I have one more question with regard to the 'A' actuarial memorandum. There was discussion about companies that have better home-loan bank loans on their balance sheets. Are they going to consider including those factors in cash-flow testing in the future? Or is there discussion about excluding the pledged-collateral assets supporting those loans?

PANELIST: I honestly don't know the answer to your question. My assumption about cash-flow testing on assets is, if you're going to do cash-flow testing, if the lines of business that you have require that you do cash-flow testing, you have to pick assets from your portfolio to match the reserves of that product line. If the only assets that you have are mortgage-backed assets, then you're going to have to utilize them in cash-flow testing. I don't know of any exemption, as such.