SESSION 6A

MEET THE STATE REGULATORS

(OPEN FORUM)

MR. ARNOLD A. DICKE: We have a very distinguished panel this morning of actuaries representing three state insurance departments: John O. Montgomery from California, Ted Becker from Texas, and Robert J. Callahan from New York. We're also joined by Edward A. Johnston who is the government actuary in the United Kingdom who will make some remarks at the end of the session. This session was based on presubmitted questions. I will go through some of them, and we'll get the answers from you.

The first question is: Given a family of a parent life or property casualty company with subsidiary life companies and subsidiary property casualty companies, under what circumstances can or should the subsidiaries be independently valued from the parent, and in which case would the parent seemingly be viewing the sub as perhaps just another investment?

MR. JOHN O. MONTGOMERY: Whether any member of the family has stock ownership or debt vehicles in another depends on the relationships among the affiliates with respect to reinsurance. All these things have to be examined. So, it depends on the circumstances.

MR. ROBERT J. CALLAHAN: I agree that it does depend on the circumstances. However, there's a great deal of game playing going on out there right now.

You can take a parent and create a subsidiary, and infuse capital into that subsidiary without it affecting the surplus of the parent, and then, creating surplus in the subsidiary such that you could have the example of one giant insurance company with a 1% surplus of creating nine subsidiaries, and through the use of reinsurance into the subsidiaries and the infusion of assets into the subsidiaries, you could end up with 10 companies, each showing separately 10% surplus. I think there's a serious question as to whether those 10 companies should be looked on as independent, each showing 10% surplus, or consolidated, each showing 1% surplus.

MR. MONTGOMERY: Primarily because of this problem, the financial reporting working group of the NAIC is studying a consolidated life blank possibility. Opinions still differ among the regulators.

MR. CALLAHAN: That's right, Mr. Montgomery, there is a vast difference of opinion among the regulators and among the organizations out there that are rating the insurance companies. A lot of those organizations are taking the MSVR, adding it to capital and surplus, and getting their company a top rating if they can get 10%.

MR. MONTGOMERY: We found in the Insurance Regulatory Information System (IRIS) tests that 1987 was probably the most chaotic year for test results since we started the IRIS tests, primarily because of all this shifting around, having satellite insurance companies or "pups" and transferring lines of business. Some major insurance companies have three or more unusual values. This indicates that a great deal of change is going on in the industry.

MR. CALLAHAN: I understand the IRIS ratios are still in the experimental stage and are subject to being substantiated by subsequent experience as to whether they are true indicators. The current IRIS ratios can give some misleading impressions to some of those raters, even though they do not get the results of the IRIS runs directly from the NAIC central office, they do have the database, and perform their runs.

MR. CALLAHAN: I just think we'd want to look at each company and each insurance company individually, and we'd also want to look at it as part of a group.

MR. DICKE: The next question in the same series is: Shouldn't a subsidiary that is going to require a continuing schedule of infusion of funds from its parent be considered as just a source of additional lines of business for the parent as far as the valuation actuary for these companies is concerned?

MR. MONTGOMERY: It's possible. It depends on the circumstances. Such actions could be subject to some regulatory action under the

Holding Company Act.

MR. CALLAHAN: I agree, it does depend upon the circumstances, and I have traced the history of a certain New York domestic company for about the past 5 years and found that each year it received an infusion of surplus from its parent. It was really, in a sense, a source of losses rather than gains, the way things were proceeding.

MR. DICKE: The final question in this series is: Is it correct to say that the answers to the foregoing do not depend on whether either party, parent or subsidiary, is a property casualty or a life company?

MR. MONTGOMERY: Yes.

MR. CALLAHAN: Agreed.

MR. DICKE: Quick answer. There's another question here from the same source. Will regulators be looking for evidence of how the valuation actuary fits into the organizational structure of the company so as to see if such structure lends itself to the valuation actuary's access to company developments.

MR. MONTGOMERY: Well, the answer is a "yes, but," and, "yes, but" many companies are decentralizing their activities and spreading the duties of a valuation actuary among several different lines of business. We need some sort of organization whereby one actuary is responsible for the entire company. This has to be worked out, but I'm not quite sure how.

MR. CALLAHAN: With our Regulation 126, right now we are addressing annuities, annuity benefits and guaranteed interest contracts, and we'll soon add in the single premium whole life insurance. Under that regulation we do require that the board of directors appoint the actuary. We put in that requirement to try to show the importance that we place upon the valuation actuary.

In our regulation we call that actuary "the qualified actuary" rather than "the valuation actuary" inasmuch as he makes an opinion only on a piece of the business. Nevertheless, we do expect this regulation to expand into all of the areas until finally all the insurance products are covered; however, because of the importance we place on it, we expect to monitor whether the role he plays does have an impact upon the board of directors.

We also recognize the fact that there could be several actuaries, each for a different piece of the current annuities, annuity benefits or guaranteed interest contracts, and that most of the companies have appointed a single qualified actuary. Although there are a handful of companies that have appointed four or five qualified actuaries, each for a different segment, our regulation requires that one of the individuals be designated as a coordinating actuary.

MR. TED BECKER: I agree there should only be one actuary with the primary responsibility.

MR. DICKE: The next question: How will state regulators monitor the proposed health benefit ratio reserve if companies can manipulate the anticipated loss ratio?

MR. CALLAHAN: I think that this is an experimental area toward which we're moving. It ties in the reserves with the rate fillings and the anticipated loss ratios. Companies could file a higher anticipated loss ratio than the minimum required by the state. It's also possible, under a given set of circumstances, that a company could file a lower loss ratio for the first few durations rather than for later durations but in the aggregate that they would meet the minimum loss ratio. If we find that there is manipulation, we will have to address that point as the experience develops.

MR. DICKE: And the same general area: Is age an acceptable classification under community rating, and would the resulting aggregate premium be considered as a leveling premium?

MR. MONTGOMERY: No.

MR. CALLAHAN: No to both parts of that question. The age is not, and also it wouldn't be considered a leveling premium.

MR. BECKER: I wanted to emphasize that right now we have nothing more than a proposal, and it may not be in its final form.

MR. CALLAHAN: Maybe I'm not familiar enough with the community rating, but I thought that there were certain broad age groupings, such as senior citizens, that they frequently put into their own category, but that the principle was that basically there was no underwriting of the individuals wherein the experience in the early durations could be expected to be less than the expected experience.

MR. DICKE: We have a series of questions now on Regulation 126 in New York. How many companies submitting memoranda under Regulation 126 were unable to demonstrate an adequate level of asset liability matching?

MR. CALLAHAN: Most of the companies that did not submit an actuarial opinion in memorandum for 1986 had not submitted actuarial opinions and memoranda for 1985 and earlier business. They generally used the lower valuation interest rates in earlier years, had some conservative valuations, and as such the regulation really only applied to 1986 new issues and changes in fund.

Very frequently those companies had a conservative block or a block of annuity business valued so conservatively that they could afford to take the penalty reserves for 1986. Perhaps 40% of the companies chose that route during 1986. Of those that submitted actuarial opinions and memoranda, we rejected perhaps 4 or 5. As for some of the companies we rejected, it was a case of the memorandum being incomplete. They did not do the sufficient analysis. In some of these cases they ended up taking the penalty reserve as an indication that they had enough other business valued conservatively. In several cases they did submit a revised actuarial opinion and memorandum. In the one case we rejected the actuarial opinion and memorandum for about 5 or 6 different reasons, and we just got the revised opinion and memorandum back in. I have a couple of individuals going over the opinion and memorandum. At this point we are not set to say that we are satisfied with that opinion and memorandum. As a matter of fact, if anything, we are not satisfied. They did use a different procedure. They used a procedure by one of the various consulting actuaries that has software, but there are various assumptions that they use of which we are highly critical. So, basically we have a problem with one company, and we also had perhaps two or three companies which were accredited reinsurers withdrawing from New York as accredited reinsurers. In one or two of the cases they withdrew because they did not want to go into the work at this time. In the other case I feel there is a serious question as to whether that company could have satisfied our requirements if they had submitted the actuarial opinion and memorandum.

MR. DICKE: Another 126 question: Does the New York Department plan to amend Regulation 126 to reflect changes made by New York S4587B regarding McCauley duration? I might say, Mr. Callahan, that in answering that you might take into account that at this Symposium something was said about 1989 being the year that those changes would occur, and that there were some questions about what the penalty reserves would be for the next several years.

MR. CALLAHAN: The reference to the McCauley duration was stricken from the law. It appeared in that place in the law where duration is defined as the number of years from issue that the guaranteed interest rate exceeds the valuation rate for life insurance for more than 20 durations. In cases of most of your SPDAs, that duration would be one year or less. When we began writing the regulation we realized that the duration had to be the remaining duration, and if we took into account persistency, we could get just about any result that we wanted. We found out that we had mixed apples and oranges, so we decided to delete the McCauley duration from the law. It will take a while to get the changes into the regulation, even though we were to agree on the changes today. The mechanics of going through changing the regulation is such that it would be early next year before any such changes would be affected in final form. In the meantime we would expect to go in accordance with the law and ignore that part of the regulation which reflects, or which is based on the law, which was just deleted.

MR. DICKE: So, would the penalty reserves be 15% or 20%, then?

MR. CALLAHAN: I would have to go back and check. Off-hand, I think we would be talking in terms of 15% rather than the 20%. But that is one of the things we have to discuss with the advisory group. It hasn't yet been ironed out.

MR. DICKE: Two questions from the same source. When do you think New York or any other states will adopt a regulation similar to 126 which will apply to all intrasensitive products or, in fact, all products? I guess the question should be: Do you expect it to happen? And if so, when?

MR. CALLAHAN: I think we're going about it piecemeal, right now. In the past year, legislation was enacted requiring the actuarial opinion and memorandum for 1982 and later business. I think it will be a few more years before the requirements are extended to premium paying business. By the same token, the timetable you heard about during this Symposium that the advisory group has in mind is entirely too optimistic. There are serious questions surrounding the actuarial opinion and memorandum, and there are serious questions that regard retaining a statutory formula type of reserve. These questions need to be ironed out.

Now, I have circulated comments to the advisory group to the effect that right now, unless something is done about the accounting procedures for reinsurance in unauthorized companies and the use of letters and credit, it makes a mockery out of the efforts of the group to establish sound reserves because through the accounting procedures they can cut the bottom right out of the bag. Right now, in New York we are working on some revisions with respect to the reinsurance credit. We are working with an advisory group, but the problem area involves the letter of credit with which the unauthorized companies under current accounting procedures are allowed to use to substantiate the reserve credit taken.

MR. DICKE: What about the other states? Would you care to make some comments, Mr. Becker?

MR. TED BECKER: In Texas we have the December 1980 version of the Standard Valuation Law, and there are several questions as to whether we could adopt anything like Regulation 126 without any reference in our statute at all along those lines. Of course we're following the events in New York as closely as we can and trying to monitor it as a state and through the life and health actuarial task force.

MR. MONTGOMERY: In California there was some legislation proposed this year to allow funding arrangements which would have allowed us to go the New York route with respect to 126. However, it got tangled up with arguments about premium taxes on such agreements, and as a result, it didn't get through the legislature. Until that matter gets resolved, we probably won't have any form of regulation in California. However, it's possible that some compromise may be reached on this. Anyway, we are planning to come out with a regulation along those lines as soon as we have the legislation allowing us to do so.

MR. CALLAHAN: I am also of the opinion that the annual statement requirement that's been there since 1975 for an actuarial opinion and memorandum that includes the statement that the reserves make good and sufficient provision for the future obligations, is not being properly adhered to by many of the actuaries signing the statement. That places a responsibility on the actuary in certain companies where certain products that are very definitely interest-sensitive to do cash flow testing. Also, I believe that the basis of the NAIC guideline is that any state regulator can require cash flow testing of a company; but also I believe that now the obligation already lies on a valuation actuary in the companies now in signing the actuarial opinion to the current annual statement.

MR. MONTGOMERY: Mr. Callahan, I agree. For that reason the report would be more valuable. And Mr. Callahan and I disagree on that point. He still thinks a statement of opinion's more useful if it's supported by a report.

MR. CALLAHAN: Yes, I would require a report, but I would also require that the actuary have the guts to express an opinion. No one is better qualified to make that statement of opinion than the actuary.

MR. MONTGOMERY: I think that's where the problem is a fact of legal liability on such statements. It's going to be very difficult for actuaries to make those statements if they're taken to court.

MR. CALLAHAN: Then maybe the actuary will do a conscientious job, and if he's put under pressure by the president or the chairman of the board to certify to a given set of figures and cannot in good conscience do so, then maybe that actuary ought to seek employment elsewhere.

MR. MONTGOMERY: The report should specify the limitations and assumptions that were made in formulating such a statement of opinion if that's required. If conditions change from what the assumptions really were originally assumed to be by the actuary, he should not be held liable. We're going to have to look at the wording of the opinion and the report and perhaps combine them somehow so that more protection is afforded the actuary in the event that conditions change after he's made such a statement. Right now you're hanging him out to be shot at by every trial lawyer.

MR. CALLAHAN: That problem has been discussed over the past several years. Many of the proponents of the valuation actuary feel that this is a responsibility that the actuary should undertake, and, if necessary, get the liability insurance. Part of the reason the current actuarial opinion to the current annual statement has become perfunctory is that in many cases the regulators have not been reviewing this opinion.

In New York, when we put out the requirements for the actuarial opinion back beginning with the 1982 valuation under law, really with the 1980 and 1981 valuations under a circular letter, we in turn did review these opinions and memoranda and did comment on them. For 1982 I personally reviewed all of those submitted to justify the use of higher valuation interest rate. For 1983 I reviewed about half of them. I have sought to get additional help in reviewing. However, I am thoroughly convinced that, unless the regulators review these opinions, it becomes just a matter of appearance with companies saying that they are doing this cash flow analysis and that they are submitting these opinions and memoranda to the regulators, and that they haven't found any problems. If the reason they haven't found any problems is that the regulators haven't had the staff to review them, then we have just the appearance of regulation.

MR. MONTGOMERY: I feel that some sort of validation process is necessary on these cash flow projections he's made in the past in order to furnish validations of whether the assumptions he's made in those projections are being borne out by actual experience.

MR. DICKE: Might I ask this of our non-New York panelists? I understand some other states -- some states outside New York -- have requested copies of memoranda that were submitted under Regulation 126 to New York. Would you see that as a possibility?

MR. BECKER: Yes.

MR. DICKE: The other question would be: There are certain issues of confidentiality surrounding parts of the memoranda that can be held confidential. In New York they have the legal status to impose confidentiality. Would that be true if they were submitted to California or Texas?

MR. MONTGOMERY: Well, the working papers on financial examinations are confidential. The examination report is not confidential. I consider such statements as part of the working papers.

MR. CALLAHAN: Our regulation says the company may request confidentiality in accordance with the regulation that governs the access to public records. There are limited reasons for granting that confidentiality. So far we have kept the memoranda confidential, but if someone wanting a given company's memorandum to contest that confidentiality, it could well be that there is no basis for the confidentiality.

MR. BECKER: I think that it would be appropriate to get the information directly from a licensed insurance company, and if we wanted to do that, I think that we could just request it.

MR. DICKE: Would it be confidential, do you think?

MR. BECKER: I would think it would.

MR. MONTGOMERY: In our circumstances we've already requested information from some of the companies we've been examining and gotten the information directly from them on what they reported.

MR. BECKER: I would think it would be just like a regular examination report, as Mr. Montgomery mentioned.

MR. DICKE: Another question: How can a non-FSA actuary receive a qualified actuary designation in New York under Regulation 126?

MR. CALLAHAN: First of all, we initially had the requirements for an actuarial opinion and memorandum which was agreed upon in late 1981 for the use of the higher set of valuation interest rates, and that was enacted into law in 1982. At that time the requirements referred to the American Academy of Actuaries (AAA), but AAA membership was neither a necessary nor sufficient condition under the law. That wording is still in our present law. However, under Regulation 126 we chose to make AAA membership a necessary but not sufficient condition such that, if any individual did not like the AAA for any reason and chose not to become a member even though he could become one, that individual would not be recognized under our Regulation 126.

Now, as far as the AAA goes, when they put out their standards, their suggestions, they allow for a non-AAA actuary to become qualified. Part of the reason for that is the fear of restraint of trade if the AAA were to make that recommendation. But the insurance department is not subject to that requirement regarding restraint of trade, and in our regulation we can require that the individual be an AAA member. Now, we don't want to review everybody's qualifications. So, we felt that, in addition to such a review, being a fellow of the Society of Actuaries and one who has kept abreast of recent valuation procedures was sufficient to qualify one without having to review his individual qualifications. Anyone who is not a fellow of the Society of Actuaries must demonstrate to us that he has acquired the education and experience of the subject matter listed in the AAA's yearbook for someone qualified to sign life annual statements. In addition to that, he must be familiar with the C-3 Risk and cash flow analysis. In some cases it was this last point where the individual failed to demonstrate that he was familiar with the C-3 Risk and the effect of interest rate variations -- and we are still, in some cases, awaiting the demonstration -- that the individual does have this knowledge. If the individual demonstrates that, we will then give him a letter acknowledging that he is considered a qualified actuary under Regulation 126. To date, we have approved approximately four or five individuals who were not fellows of the Society of Actuaries.

MR. DICKE: It might be of interest to people to know that the new flexible syllabus that's being worked on will have a course, as they call it, on the valuation actuary concepts.

What is the definition of <u>annuity</u> under Regulation 126? Specifically, are monies held by insurance companies for retirement benefits and deferred compensation plans for their own employees included?

MR. CALLAHAN: Last night I got out a copy of my Regulation 126 and found that we did not include a definition of annuities under Section 95.3 entitled Annuities. However, we did advise how on certain contracts which consisted of increasing payments and spikes in payments, and how that contract can be broken down as far as determining the valuation interest factors. We do have those guidelines in the later part of our regulation, in particular in Section 95.12, Paragraph E.

Now, as far as the funds are concerned, I would say yes, those funds for the company home office retirement employee are funds which would be subject to Regulation 126. However, there are certain types of products where, due to the nature of the product, the company can demonstrate that cash flow testing is not required. I think the company would have to analyze such funds as to whether those funds do or do not require cash flow testing.

MR. DICKE: The next question is: If a new universal life model regulation is passed, will it apply to new business only, new policy forms only or all business? I guess this means with regard to valuation.

MR. MONTGOMERY: I think it depends on the state, but in California anything retroactive would be unconstitutional and so it could only apply to new business. However, just as a matter of interest, we are drafting a regulation on reserves for universal life in California, and, again, it will not be retroactive. However, if a company appears to have a minimal amount of surplus and might have difficulty with going forward for solvency purposes in the future, we may ask them to furnish a demonstration applying a more conservative valuation basis to all their business just as a matter of information to the department, and not require them to do anything, but maybe put them on warning to get more surplus.

MR. CALLAHAN: I'm shocked that a state feels that it cannot apply reserve requirements to past business. If conditions change such that under current conditions it appears as though business issued in the past would push the company into insolvency, I feel that the state should be able to come up with new requirements for that past business and provide for a transition period to put up those higher reserves.

Now, obviously we in New York feel that we can extend the reserve requirements to past business. We had extended liberalizations of reserve basis for annuity business to past business, plus, under the actuarial opinion and memorandum in the law of 1985, we put the requirement in as interpreted for 1982 and later business, step rating that in first with 1986 issues and then requiring 1982 and later issues by 1988. Then the legislation this year made it fully clear that we wanted these requirements to apply to all in force business, and that will be required by 1989.

MR. BECKER: Can I speak to this? The question has raised concerns about the model, and I think it's likely that the model would just look toward the future and be prospective, but I'd also like to answer the question from the point of view of Texas. My idea of reserves is more like Mr. Callahan's on this issue than Mr. Montgomery's, and in particular with respect to universal life insurance because the Standard Valuation Law contemplates that each state would issue a regulation. We do not have a regulation in Texas, but the policy forms were approved anyway. They were approved conditionally on the grounds that the companies would comply with whatever regulation was adopted later. And I don't think there's any particular constitutional right to just keep going on the original pattern just because the company might have started out that way.

MR. MONTGOMERY: If a crisis ever were to develop requiring or endangering the solvency of the company, some means of getting around this matter of constitutionality would have to be brought before the legislature, and we'd have to have some form of constitutional amendment to do it.

MR. BECKER: I don't think anyone would want to act arbitrarily or just try to create problems for their own sake, but if something really needed to be done and we were persuaded it needed to be done, I think the authority is there.

MR. DICKE: This is another type of question. Would you please compare the responsibilities and liabilities, financial and ethical, of the actuary as a state regulator to those of the actuary as a valuation actuary for a company?

MR. BECKER: Was this question submitted by the actuary from Wisconsin?

MR. DICKE: Maybe I should have phrased it exactly as it was, but I wasn't sure.

MR. BECKER: Because I think the actuary of Wisconsin is in a peculiar situation wherein he also performs valuations.

MR. DICKE: Oh, I see. Let me state it the way it was originally phrased. Does the actuary as a state regulator have different responsibilities and liabilities, financial or ethical, as a valuation actuary than others do? I guess they mean state employed actuary that's doing valuations then is what it really means.

MR. BECKER: I would think if he has the responsibility for preparing an actuarial opinion, it would be exactly the same as anyone else.

MR. MONTGOMERY: When the state actuary certifies the reserves of the companies' domestic to his state, in effect he is carrying out the same type of duty that a valuation actuary would be doing.

MR. CALLAHAN: That's an interesting viewpoint. Our law calls for this actuarial opinion and memorandum to be acceptable to the superintendent in form and substance. This past year, upon completion of a given company's actuarial opinion and memorandum, if we found it acceptable under current standards, we generally wrote a letter to that effect. If we had questions before finding it acceptable, we wrote questions. In some cases we outright rejected it and required either a revised submission or that they put up penalty reserves. I think, that this puts upon the insurance department actuary a tremendous amount of responsibility.

This opinion and memorandum has to be acceptable in form and substance. When we do write a letter after concluding that it is acceptable, will that company then publicize that fact that it has met New York's requirements for cash flow testing? If there's any serious questions about that company, I think that we have to take a very close look before we write any letter telling them that we find it acceptable. At this point I'm not sure that I will find all of the actuarial opinions and memorandums that were submitted for 1986 acceptable.

MR. DICKE: What do you do about valuation certificates for those companies that don't conform?

MR. CALLAHAN: I have not issued one company's valuation certificate for 1985. I was about to issue it based on revised figures when I checked its actuarial opinion and memorandum, and even though this company used a higher set of valuation interest rates for annuities in course of payment and structured settlements, it provided no actuarial opinion and memorandum for its 1985 in force. I have not yet issued the certificate of valuation for 1986. It's possible I may never issue that certificate of valuation for 1986.

MR. MONTGOMERY: We have similar circumstances in California, as you know.

MR. BECKER: Well, I just wanted to say that as a practical matter when you have hundreds of companies licensed in the state there are constraints on what the regulatory actuary can do.

MR. MONTGOMERY: Yes, I sympathize with Mr. Becker. You must have 300 domestics, don't you?

MR. DICKE: That's going to get down in one of our later questions. The next question relates to level premium life insurance policies with no non-forfeiture values, level premium term to age 100, if you want to call it that, which is currently being sold in Canada. The only appropriate question about this is: If such a product were introduced in the United States, which is, of course, a non-forfeiture issue rather than a valuation issue, what would be the valuation situation as you see it? What implication would that have for valuation actuaries?

MR. BECKER: We now have legislation authorizing stipulated premium companies with certain capital and surplus requirements to write this type of policy. This 1987 legislation is also being interpreted to allow legal reserve companies to write the product. If it's written at premium rates lower than policies with non-forfeiture benefits (as you would expect it should be), it could be a very dangerous product. We don't know what the company can do if it sets premium rates too low and then if nobody lapses. So it's a scary product. Before it can be sold in Texas, our Board has to promulgate a regulation. I don't have an answer to the questions, but I'm very interested in this issue.

MR. DICKE: Perhaps we should mention that type of product. The typical problem is that it's often priced assuming that profits are made at the point when people lapse. So, higher lapse rates would mean higher profits.

MR. BECKER: Yes.

MR. DICKE: And that leads to valuation problems.

MR. BECKER: If there were no reduction in gross premiums, it would not be serving the marketplace well, obviously.

MR. CALLAHAN: I don't think we would approve this policy for issue in New York, but it may be possible that perhaps some other states would approve it and that the company licensed in New York may be issuing that policy in another state term to 100 without cash values. I do think the statutory formula for reserves for term to 100 would apply to that policy and that, in addition thereto, the valuation actuary would have to look at the cash flow analysis, taking into account lapses, and that he would have to under current procedure set up the higher of the two reserves.

MR. MONTGOMERY: Mr. Callahan, your legislature may surprise you.

MR. CALLAHAN: That's possible. I don't think they're so inclined at this time, though.

MR. MONTGOMERY: Yes. It's important to remember that this is just conjecture, and certainly I wonder if our Society's committee on revising the standard non-forfeiture law would consider such a product, and if so, whether it would ever get through the NAIC.

MR. CALLAHAN: Well, your life and health actuarial task force considered this product back in 1982, and then it took it off its agenda.

MR. BECKER: I did want to emphasize that this new law in Texas was proposed and supported by certain elements in the industry. Our Board did not express an opinion on it to the Texas legislature, but did review the proposal and made certain suggestions for amendment.

MR. DICKE: Question on federal income tax: IRS Code Section 807 says tax reserves must be less than or equal to statutory. If the Standard Valuation Law is rewritten to allow lower statutory reserves, should cash flow or other testing warrant it? Won't Section 807 reserves be a limiting lower level?

MR. CALLAHAN: Tax reserves and statutory reserves need not be the same. I, frankly, am sick and tired of hearing some of the proposals for statutory reserves saying, well we can't change it because it's going to affect our calculation of tax reserves. If the tax reserves are lower than what they should be for solvency purposes, then we should require higher reserves for statutory purposes. If the tax reserves as now defined prove to be redundant such that we could allow lower reserves for solvency purposes, so be it. I believe the tax reserves are currently tied in now with the NAIC standards and the interest rate in with an interest rate adopted by 26 or more states. It's possible that a given state such as New York could allow lower or higher reserves than what the NAIC model would allow.

MR. DICKE: Without changing tax reserves?

MR. CALLAHAN: Well, I just want to point out that solvency is the primary concern of the state regulators, and taxation is only a secondary matter.

MR. DICKE: The next question: Do you expect the 1985

Commissioners' Disability Income Table to be approved as a valuation standard, and, if so, when?

MR. MONTGOMERY: Well, the NAIC adopted this as a standard last year, and in a number of states it's just automatic that it becomes a standard.

MR. CALLAHAN: We haven't yet adopted it in New York. I would like to get somebody to draft a revision to our current regulation on accident and health reserves to adopt it.

MR. BECKER: I wouldn't see any problem with using it in Texas. We have only the unearned premium reserve and the actuarial opinion in Texas. We don't have any higher requirements for accident and health active life reserves right now.

MR. DICKE: The second part to the question is: In New York under Regulation 126 did the 5% penalty reserve for 1986 single premium annuity contracts apply to 9.5% or 9.25% or 8.5% reserves?

MR. CALLAHAN: The valuation interest rate for single premium immediate annuities for 1986 issues is 9.25% using the annuity formula. Therefore, the 5% penalty reserves for 1986 issues of single premium immediate annuities would apply to the 9.25% reserves. The 8.5% figure is the rate for the 1986 issues based upon the life insurance formula. The way the law is written we would no longer use that life insurance formula to determine the valuation interest rate for the standard reserve. In the regulation we could determine the penalty reserve where the company did not do the actuarial opinion and memorandum by using the life insurance formula. Now, for 1982 to 1985 business the regulation did extend the requirement for the use of the life insurance formula for the 1982 to 1985 business unless the company furnished an actuarial opinion and memorandum for that business. Then, if the company had done so, it could use the annuity formula or the higher set of valuation interest rates.

MR. DICKE: What savings in regulatory-related costs can a small company expect to offset the additional costs related to valuation actuary certification?

MR. CALLAHAN: The cost that he's referring to is the cost of doing all these calculations for the statutory formula reserves -- that is, all the calculations for the duration factors, summarizing the business in force. The valuation law allows the approximations. Under the current laws, companies are able now to use approximations to reduce the administrative costs of making these calculations. Yet what we have experienced in New York in reviewing the supporting data submitted by our domestic companies for the statutory formula reserves is that once these companies found that they could make these calculations exactly with these electronic machines, they abandoned approximations and went to exact calculations. At one time when a given company made a detailed valuation and determined approximate factors during an off-period of the year and applied those factors for 5 valuation years, the year-end supporting data may consist of 10 sheets. Now all of the sudden we had a foot and a half of valuation material for something like accidental death dismemberment reserves where the reserves as a percentage of the total exhibit eight reserves was .05% of 1%. We told these companies, look, don't give us all that paper. Give us the final results. We'll look at the trends, and we will reserve the right to request some sampling.

I think that the companies have to look over their current procedures now to see where they can cut the administrative costs within the current framework. However, I am firmly convinced that we need to retain some form of a statutory formula reserve. I feel the current statutory formula reserve needs to be revised, brought up to date and made current to the date of valuation. I am uncertain as to whether we will head toward something like market value of assets and market value of liabilities, but because of the subjectivity involved in the assumptions now in the use of the actuarial opinion and memorandum, we do need to retain a statutory formula calculation.

MR. MONTGOMERY: I agree with what Mr. Callahan said. Going to a new valuation system is like changing computers. You run parallel until you're sure that the new system is really functioning. Additionally, the valuation law, as it becomes revised, is going to have to go through a period of parallelism retaining all the features of the current valuation law, and then a period of testing what is being proposed against that to see if it's a valid system of valuation. This is going to take 5 or 10 years to verify. So, we're going to go through a lengthy transition period to do this sort of thing and we're not looking at the valuation actuary coming next year or the following year; it may be the end of the century before we get there. It's something that is going to have to be worked out over a period of time during which we catch all the bugs in the system.

MR. BECKER: When this idea is operational, it might shorten the examination time for periodic examinations, and in Texas the companies are charged on the basis of the examination time when we check out the domestic companies.

MR. MONTGOMERY: The main purpose of this proposed revision of the valuation system is to lessen the risk of insolvency and thereby reduce contributions to guarantee funds. Also, as a result of this proposed revision, eventually, and it may be years before it happens, such things as mandatory securities valuation reserves, premium deficiency reserves, excess interest, guarantee reserves may all become obsolete under a new system. Although we don't know that yet, we have to try it.

MR. DICKE: Next, we have the following series of questions: What is the problem we are trying to solve with the valuation actuary concept? In what significant respects do current valuation requirements fail to work? What insolvencies would have been avoided if this concept had been in place? Let's take that one first.

MR. MONTGOMERY: The first question was what are we trying to solve? Basically it's the reserve adequacy and solvency surveillance. The current universal life regulation on the second question, which involves the success or failure of current valuation requirements, there, it doesn't recognize a variation in administrative expense, and we're finding in examining the IRIS results that, I think, a lot of companies have underestimated the administrative expenses of universal life. It may require more conservative assumptions as to reserves than they had anticipated. Rapidly fluctuating investment conditions are not recognized as immediately in the current valuation system even though the dynamic interest feature of the 1980 amendment has greatly assisted it. It doesn't provide the entire solution. So, we may have to go further in that area, then too, there are changes in claims' experience, especially the possibility of a massive epidemic in Acquired Immune Deficiency Syndrome (AIDS). These are not recognized by the rather fixed tables that we now have. We have to find out if a company is going to have enough surplus to withstand these possible fluctuations. Then in answer to the question, Has it been used? Yes, it has been. We've already, through this system, at least half a dozen companies in our analysis which have perhaps benefitted by this technique, and I will submit that if the surveillance systems now in place existed in 1982, we perhaps might not have had a Baldwin-United. I think we could have headed off some of the problems that came from that with the current systems we have even in place at this time.

MR. CALLAHAN: This perhaps had some of its origins in the group guaranteed interest contract area wherein in the early 1970s we came up with new money rates, working with an industry advisory group consisting of both domestic and foreign insurers, to derive formulas and factors for the valuation of these group guaranteed interest contracts, some of which guaranteed a very high interest rate for a period of, let's say, 7 years, and at the end of that period provided a lump sum transfer. Then that rate was more liberal than what the rate would have been if we had determined that the rate in the valuation law for annuities applied to these contracts. However, the way the law read, the law really did not cover the valuation interest rates explicitly for these guaranteed interest contracts, and we could use a general provision of the law which allowed the superintendent to require such reserves as he considered necessary.

Now, we discovered as interest rates shot up that if these companies did not protect themselves prior to the maturity against premature transfer, that these companies might have to liquidate assets at a loss to pay the transfer values.

We came to the conclusion that the statutory formula reserve by itself did not assure that reserves were adequate. We realized we needed to look at both side of the equation. Later, the input into Regulation 126 was done by a group of individual product actuaries having in mind individual SPDAs and much of their thinking was vastly different from the thinking of the people who devised the valuation requirements for group guaranteed interest contracts. By the same token, you take the 1982 issues of single premium immediate annuities, and the valuation interest rate for 1982 single premium immediate annuities is 13.25% under the NAIC version, in New York we would require an actuarial opinion and memorandum for use of that 13.25%.

Let's say at the time that the company had assets invested yielding 14%, and let's say that during 1986, as many companies did, it swapped these assets and got capital gains if there was call protection -- protection against the exercise of call options on bonds -- and if there was no call protection, the borrowers repaid and refinanced at lower valuation interest rates.

Now, how can the valuation actuary continue to value the remaining payout at 13.25% when his assets no longer support 13.25%? We have the classic illustration about the statutory formula not being appropriate for the type of liabilities and assets supporting those liabilities. Now, theoretically, the requirement for the cash flow analysis and the requirement that you put up as your reserve the minimum amount of assets that would be considered sufficient to support these liabilities should result in some reserve strengthening. It should, but many a state does not have this requirement, and even in New York some companies would decide that they can offset excesses under other blocks of business against a deficiency here. Even so, I don't see that there's any way that the actuary can continue to calculate reserves according to a formula in a vacuum without looking at both the products and the assets backing those products.

MR. DICKE: Another question: Regulators seem to have barely enough resources to review traditional mechanical valuations. How will they find sufficient resources to analyze actuarial opinions which are complicated and subjective? Mr. Becker?

MR. BECKER: Yes. I just wanted to say that we're hoping to work out some kind of seminars or training sessions for regulatory actuaries and make them affordable enough that state actuaries can attend. If not, maybe they can receive the material through the mail and be trained that way.

MR. CALLAHAN: Most states now don't have sufficient actuarial staff resources to review all of the actuarial opinions and memoranda of their domestic insurers, let alone of all licensed insurers. In New York, we have gotten the cooperation of the insurers, and we do apply our requirements to all licensed insurers. However, I think that these insurers would tear their hair out if they had to have their review done by all of the state insurance departments of the states in which they are licensed.

There has been one suggestion that an actuarial staff be created at the NAIC central office to do the review for all the states, or at least those states requesting the NAIC central office to do this review.

Although there are funding problems, those problems presumably could be resolved. There are practical questions concerning whether all the states would use that central office or do their own review, and whether the state would accept the results of the review of that central office. That central office would not of itself have regulatory force in and of itself. There is still another group that would perhaps feel the only practical way is to replace state regulation of solvency by federal regulation of solvency.

MR. MONTGOMERY: What you suggested about the NAIC could be incorporated in the solvency surveillance system of the NAIC, the IRIS project which already has examiner teams, and that also an actuarial review section to that. However, the budget for that could be considerable because a pretty large staff would be required to do it. It's something that is going to have to be examined for feasibility. It is possible that this may become something like the IRIS tests which many states, when they originally devised this test, didn't have the resources to do them, and the NAIC is doing the tests for these various states, and it's proven to be pretty satisfactory to most states.

MR. CALLAHAN: I do think there could be practical considerations if the company affected is not unhappy with the review and goes to the commissioner of its domestic state and politics become involved.

MR. DICKE: At this point I'd like to turn to Edward Johnston, the government actuary from the United Kingdom, who has a few remarks to make about regulation.

MR. EDWARD A. JOHNSTON: Thank you. It's true that we've had a system similar to the valuation actuary in force for approximately 10 years, but I think that countries leap frog one another. I've learned many things that I can take home and put to use.

You're a great deal more systematic than we are about working out what's involved. Of course, it means you have a lot of committees and a lot of reports to read, but the result, I think, is that both the Canadians and the Americans have a much clearer idea than we have of what sort of research is needed to support the valuation actuary, and in one or two other ways I think it's a definite improvement.

I'll briefly explain the setup in Britain. We're not a federal country, of course. We only have one government with which to contend, and the insurance regulators there are a department called the "Department of Trade." All actuaries in the British government service are centralized in one department, the Government Actuaries Department, and although we are salaried public servants, we work like consultants. We advise the Department of Trade on insurance control, and we advise the social security people on social insurance and that sort of thing. I've got 7 qualified actuaries on insurance matters that cope with the nearly 300 life companies. We also do a bit of work on the casualty side.

Our system, the appointed actuary system, was set up after we had a number of scandals, and I think the system was accepted by company managements largely because the alternative would have been a lot more government regulation, and they didn't like that at all. The system has stood the test of time, but I have to admit that it hasn't been really very testing. Those 10 years haven't been very bad, and it's obvious to me as I watch it in daily operation that there are pretty strong commercial pressures on actuaries, and that there is a limit as to what we can expect of the appointed actuary. We try to support him, and I think it's very important to have a strong actuarial presence on the regulatory side. Unless one has that, I don't think the appointed actuary or the valuation actuary can really have the strength to do a good job in the sort of company which is difficult. One can get managements that feel that they shouldn't be told by the actuaries the way to run their business.

We've got a floor for the valuation method and assumptions. The most difficult task is to try to devise a floor which is reasonably flexible, and which is going to be reasonable as a minimum for all the different classes of business and for all the different sort of circumstances that the market can throw at us, and we definitely haven't got that right yet. We endeavor to scrutinize all the valuations, just taking up a point that's been made. We spend more time on some than on others. And we've now got an arrangement by which we ourselves, the actuaries in the Government Actuaries Department, rather than the Department of Trade, discuss points with the company which arise from the valuation. Very often we're talking direct to the actuary, which is a much better arrangement. We can argue the matter out with them without bringing the company management in to hear it all, and I think that helps the appointed actuary quite a bit.

We've had a bit of difficulty recently, wherein one company which got in trouble last year -- an old, established high profits company that shouldn't have gotten into trouble -- basically, I think because it had a management that wouldn't listen. If you've got that, there's nothing that anyone can do. With our financial services revolution, we've followed what we thought was the American model in regulation. It is the American model, actually.

We've now got a rule which says that an intermediary has to give the best advice to his client. So, if he's selling a profit policy, he has to choose the office which he thinks has the best dividend prospects, and he has to have a reason as to why he thinks that. Additionally, it looks to us as though someone's eventually going to decide, going to rank the offices, and that one office is going to get all the business. No one will dare to sell anybody else. That has really focused attention on the ways to analyze the real strength of an office. You don't do it from the statutory valuation, that's for sure, and many people are working on that now.

Finally, the issue that we have is the way to reconcile keeping some sort of actuarial regulation -- that is, some form of regulation valuation basis, a minimum floor basis? How do we reconcile that with the concept of the valuation actuary being responsible himself, for his valuation? If we make that regulation all-embracing, and there are a lot of companies which are on the minimum basis, and their actuaries are not exercising much discretion, they're just using the minimum basis. If we go that route, the actuary ceases to be responsible.

What we really want, I think, is for the appointed actuary to be an important person in the company. We want him to be at the table when important decisions are made, and I see this question of valuation regulations as a route to that. There were a lot of things in those cash flow projections which will require the actuary to have a dialogue with management, such as what investment policy will be followed in the future, what crediting policy and so on?

What one really wants out of it all is for the actuary to be involved in management decisions, even at the highest level. To take one example, quite a lot of companies in Britain have an investment committee which gives instructions to the investment managers and monitors the results. Now, we want the actuary to be on that committee. You can't legislate for that. All we can do is drop little hints and push from time to time and we manage to do that with some success. I don't know how that happens over here. I mean do actuaries have any say in the investment policy of companies? If they don't, it seems to me that the system is not going to work very well. Thank you.

MR. DICKE: I'd like to again thank all our panelists. I think this has been an excellent discussion.