1988 VALUATION ACTUARY
SYMPOSIUM PROCEEDINGS

NEW YORK REGULATION 126 REVISITED

MR. ROBERT J. CALLAHAN: The following remarks represent my personal views and not necessarily the official position of the New York Insurance Department. The Department has received actuarial opinions and memorandums (AOMs) under the Insurance Law since 1982 and, for 1986 and 1987, under Regulation 126 with its more extensive application.

From my observation of these AOMS, I offer the following comments:

1. Interest-Rate Assumption

   The choice of interest-rate assumptions varied widely. Some actuaries used rates differing by the term of the assets (short, intermediate or long) and based the initial interest rates upon the yield of new investments available as of the valuation date. Others chose an interest rate for some benchmark duration, based on current rates as of the valuation date, and developed interest rates for other durations based on an assumed yield curve. Some actuaries chose benchmark interest rates lower than current rates, perhaps believing that the business would be conservatively valued. Very few actuaries chose benchmark interest rates higher than those justified by market interest rates as of the

valuation date. Some actuaries varied rates by type of assets, some by quality of assets. The standard of actuarial practice required by the New York Insurance Department is that the benchmark interest should be justified by reference to some market interest rate as of the valuation date. For long-term rates, some referred to Moody's averages for the month of December coincident with the valuation date.

2. Calls

A review of the 1986 AOMs indicates that typically very light provision was made for calls. We questioned various companies but were lenient. Although Regulation 126 was issued in December 1986, the prior requirements set forth in Circular Letter 33 (1982) stated that calls should be considered. Nonetheless, many companies submitting for the first time may not have been prepared. Others may have retrogressed. A review of 1987 AOMs indicates companies are more often properly reflecting calls. We plan to add more details in a revised regulation.

3. Projection Periods

For deferred annuities with cash surrender values, 1986 AOMs frequently used long projection periods. 1987 AOMs typically use ten-year projection periods or show intermediate results for the tenth year for such. Group guaranteed interest

contracts generally have a guaranteed duration of five to ten years and typically have been modeled to the maturity date with transfer or cash out then assumed. Annuities and structured settlements in course of payment have typically been modeled over long projection periods of twenty to forty years.

4. Combining Business

The New York Insurance Law does not allow the offsetting of reserves for life insurance and for annuity business. It does permit the aggregate test within each of such categories.

As noted, the duration of liabilities differ for various classes of annuity business. We would likewise expect the duration of assets to vary. The cash-flow testing should be done separately. Then the results of different blocks with different projection periods can be combined by using present values as of the date of valuation.

5. Asset Selection

There has been some difference of opinion concerning asset selection. Some actuaries believe assets should be selected to match the characteristics of the product with segmentation of assets and consistency between the years for the assets for a given product segment. Others believe there need be no correlation

so that, at year-end, the actuary can then pick and choose among the assets. Both Section 95.8(c) and 95.9(a)(2) of the regulation encourage but do not require the segmentation approach. Where assets are selected at year-end, the actuary may then need to satisfy himself that the assets remaining for blocks of business, which are not being tested, are sufficient. The regulation may need to be amended to make this clear.

6. Federal Income Tax

While we recognize that reflection of federal income taxation is a technically difficult issue, most companies have incorporated some provision for federal income taxes in the 1987 AOM.

7. 1986 and 1987 Submissions

From a total of approximately 285 licensed life insurers, accredited life reinsurers and fraternal benefit societies, we received 123 submissions for 1986 and reviewed 61. We rejected 7, of which 6 either made a satisfactory resubmission or set up additional reserves, and we imposed additional reserves on one. For 1987 we received 146 submissions: 70 insurers had no business subject to the regulation, and 69 set up some penalty reserves or had sufficiently conservative reserves. As of September 19, 1988, we have reviewed approximately 122

submissions. We have questioned many insurers, and we requested resubmission from at least two of them.

8. Are Penalty Reserves Effective?

While both the law and regulation call for penalty reserves in case of no AOM or an unacceptable AOM, the establishment of penalty reserves is not a test of the success or failure of the regulation. If anything, the establishment of penalty reserves could indicate failure. The purpose of the penalty reserves is to coerce the insurer to do the cash- flow testing and, in turn, to take whatever action is necessary to restructure assets and/or liabilities. To date we are aware of only one company that set up additional reserves after testing.

9. How Should Defaults and the Mandatory Securities Valuation Reserve (MSVR) Be Handled within the AOM?

Theoretically the reference in Section 4217(c)(4)(B)(vi) to the requirement that "reserves for all annuities, annuity benefits and guaranteed interest contracts in force at the end of the year covered by such report, and the assets held by the company in support of such reserves, make good and sufficient provision for the liabilities of the company with respect thereto" can be interpreted to include all future risks and expenses as well as benefits. Thus, the reserves for C-1 default

risk, C-2 pricing risk, C-3 interest rate fluctuation risk and all other risks could be combined.

However, current annual statement instructions call for a separate MSVR built up out of charges against assets and out of capital gains decreased by any losses due to default and by any capital losses. The tendency of many raters and appraisers of insurance companies is to consider the MSVR as earmarked surplus and to add the MSVR to surplus in determining its ratio to either liabilities or to total assets.

Accordingly, until the accounting and/or reserving procedures are revised, the New York Insurance Department's position as of August 1988 is that the C-1 risk can be provided for either (1) by ignoring the assets supporting the MSVR but making a charge equal to 75 percent of the MSVR normal charge or (2) by using the assets supporting the MSVR and a default risk equal to at least 100 percent of the MSVR normal charge and demonstrating that such assets do not support risks other than the C-1 risk. In either case, provision should be made for assets not covered by the MSVR or by any other method specifically approved.

10. Should Specific Rules to Form a Decision or Judgment be Promulgated?

The actuarial opinion is just that, an opinion. The conclusions are based on the judgment of the actuary. Yet the AOM must be acceptable to the Superintendent and involves a judgment on his part. When the Superintendent rejects an opinion, the actuary has the right to question the basis of that judgment and to demand to know the rules ahead of time. This could lead to a number of cookbook recipes. It could result in rules, which would trigger additional reserves and perhaps would determine the amount of such additional reserves. This would lessen the amount of freedom the actuary has in forming an opinion.

11. Failed Scenarios

Regulation 126 suggests testing seven specified deterministic scenarios. There is no definitive guideline on how many failed scenarios require additional reserves. Assessing reasonable or plausible scenario deviations is subjective. Therefore, it is quite difficult for a regulator to independently verify or justify the qualified actuary's conclusions. If deterministic scenarios show failure, then stochastic methodology may be an appropriate tool for deciding if additional reserves are needed.

12. If the AOM Indicates a Need for Additional Reserves Due to a Mismatch of Assets and Liabilities, Should the Regulation Require a Restructuring of Assets or Simply Require Additional Reserves?

As currently set up, the regulation does not require a restructuring of assets. The requirement for additional reserves may indirectly bring about such a result if an insurer cannot afford the surplus strain. There has been some suggestion that the magnitude of reserves be related to the degree of asset management. Among the New York legislative changes in 1985, a provision was added for a market value separate account to fund guaranteed benefits with the liabilities also based on market values.

The Insurance Department has had an advisory group working on Regulation 128 since 1985. There have been several drafts and changes of perspective by the advisory group. The latest version calls for a daily monitoring and valuation of the assets and of the liabilities. It calls for certain deductions from the value of the assets depending on the type and quality of the assets and whether the assets and liabilities are cash-flow matched, duration matched or not matched. On each day, the value of the assets are such that the insurer could purchase a contract guaranteeing the benefits. If 100 percent were in stocks, a greater amount of assets and of reserves would be required. Only insurers with large surpluses and the ability to absorb surplus fluctuation could do this. If an insurer had

supporting assets with cash-flow matching of the liabilities and certain good quality bonds, then the amount of assets and of reserves would be lower. This current draft focuses on asset management, but using the market value separate account would be at the option of the insurer and only for that portion of the insurer's business that it wishes to put into the separate account.

13. How Should the Fluctuation in Assets Required Due to the Changes in the Year-end Valuation Interest Rates Be Handled?

There may be enough leeway in the statutory formula reserves to absorb the need for more supporting assets than the prior year. If not, the actuary may need to consider whether the same amount of deviation from the starting point is appropriate. If so, he must determine the need to strengthen reserves. In some cases, asset restructuring may alleviate the need for additional reserves. In other cases, there is no recourse except for additional reserves.

14. Should the New York Insurance Department or the National Association of Insurance Commissioners Prescribe each Year the Starting Interest Rate and the Minimum Specific Scenarios to be Tested?

This could involve a logistics problem if new-money rates at year-end had to be determined first and then promulgated to all the insurers. It might unduly delay the projections, which should be done before the annual statement is finalized.

At this stage it appears preferable to set general guidelines for the starting rate and suggested minimum scenarios.

15. Should the AOM be in Lieu of or in Addition to the Statutory Formula Reserves?

The statutory formula reserves lend some objectivity to determining the amount of reserve and, hence, the amount of surplus available for dividends. However, the current system of book value of assets and of liabilities contain many deficiencies. Furthermore, assets can be brought to market value by exchanging assets, with the result that there could be a hybrid of book and market value on the asset side with book on the liability side. The cash-flow analysis required by the AOM will correct part of this.

In practice the statutory formula reserves have been higher than those indicated by the cash-flow analysis, which serves as an audit of the reserves. If we were to eliminate the statutory formula reserves, then the actuary should have to determine the amount of reserves to be held -- not an easy task for anyone due to the judgment and subjectivity involved and the pressures by management for a given balance sheet appearance. It is my personal opinion that we need to retain a statutory formula reserve. But we need to use a revised formula which is

updated to the valuation date, with an AOM superimposed to ascertain that the reserves are sufficient for a particular company.

16. Stockholder Dividends

Several actuaries have indicated that stockholder dividends may be a material concern. The rationale is similar to that for considering federal income taxes. Given that some scenarios will show initial sufficiencies and subsequent deficiencies, modeling stockholder dividends is an appropriate concern. Therefore, we have been asking companies to comply with this requirement on the basis of their best judgment. The proposed revised Regulation 126 requires that stockholder dividends be considered.

17. How Should the Professional Discipline Process be Structured? Should it Be Provided through:

(i) the New York Insurance Department?

(ii) the American Academy of Actuaries (AAA)?

(iii) elsewhere?

Responsibility under the law and regulation lies with the Insurance Department. Without final standards yet, the Academy may be reluctant to handle discipline. AAA standards were exposed for comment with an expected date of December 1988 for finalization.

Page 418 of the AAA's 1988 Yearbook states, "The American Academy of Actuaries is a professional association of actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and seek accreditation and greater public recognition for the profession." It also states that the AAA's "primary activities include liaison with federal and state governments, relations with other professions, the dissemination of public information about the actuarial profession and issues that affect it and the development of standards of professional conduct and practice."

Today the AAA is not the sole actuarial organization, nor does it have standards of practice for all areas. However, it is increasing its efforts. After a trial period with an Interim Actuarial Standards Board (IASB), the Academy's membership voted to establish an Actuarial Standards Board. The IASB circulated an exposure draft of "Recommendations Concerning Cash Flow Testing" for life insurance companies dated May 1988 with a comment deadline of July 13,1988, and the expectation that the standards will be revised and finalized by December 1988. From my review of such standards, it appears that they deal more with broad principles. It is questionable whether regulators may feel comfortable without specific detailed requirements as to mortality, interest, lapses, etc. The requirements leave so much leeway to the actuary that it may be extremely difficult to sustain any charge as to a violation.

Regulators would prefer to see an effective disciplinary procedure before relying on the Academy. The AAA has no powers to subpoena. It is impractical in many situations for the Academy to rely on whistle blowers. Few actuaries are willing to blow the whistle since many whistle blowers have been known to lose their jobs or be ostracized as a result. The AAA will suspend any action whenever there is other relative litigation or action against the actuary.

18. Department Checklist

The Department utilizes a checklist, which is little more than an outline of Regulation 126. The checklist will need to be updated to account for the Regulation 126 revisions. A single checklist does not fit all different types of business.