1997 VALUATION ACTUARY SYMPOSIUM PROCEEDINGS

SESSION 28

Regulatory Topics

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REGULATORY TOPICS

MR. TROY J. PRITCHETT: The discussion of this session is intended to be a little more conceptual. It's about hot issues and assessing where we are with the valuation actuary concept, where future developments are going, and the attitudes that regulators have when relying on the judgment of actuaries. I think we'd like to discuss experiences people have had and questions they have about directions that various regulatory topics are going. Audience input will be critical.

Kerry Krantz is an FSA and an actuary with the Florida Insurance Department. He has been there about two years, and he has done a lot of examination work on actuarial opinion and memorandum topics, and he has also participated in many working groups at the NAIC.

I'm with the Utah Insurance Department, and I've been there for about three years. I've also participated on the Life and Health Actuarial Task Force, and various working groups of the NAIC, and also the State Variations Task Force of the American Academy of Actuaries.

Basically, I'd like to divide the time up into five big categories and two issues under the hot issues for regulators. One is the whole complex of questions surrounding state variations and state regulation. The second is the evolution of examination and review standards for actuarial opinions. For regulators, that's one of the hardest things to deal with -- you get all these opinions. Now what do you do with them? How do you get the staff to review them? How do the examining actuaries coordinate with the financial-analyst-type people who are basically the desk auditors? The next big topic is where are future developments going? Then we'll go into the attitudes toward relying on the judgment of company actuaries and assessing how the valuation actuary concept is working.

So on that first topic I'd like to tell about the background and some of the issues I think are important. Then I hope to get some audience questions and input on those issues.

When you look at the state variations issue, for historical reasons, it's kind of an anomaly if you look at other countries. Insurance is regulated on the state level, and all state regulators are zealous about how they protect that power. We're in Georgia, and the insurance commissioner from Georgia loves to refer to the sovereign state of Georgia. No one's going to tell the sovereign state of Georgia how to regulate insurance. Although the other states don't wear it on their sleeves quite so much, everyone feels, that they have the absolute last say on what any particular valuation standard is. Well, that obviously creates substantial problems in the environments where most companies work and sell business. For many of them, it is in all 50 states.

Where we're seeing one particular problem is in the language of the actuarial opinion and memorandum. It hasn't matched basically how it has worked in practice. The letter of the law in the opinion says that you're signing that statement to comply with the laws and regulations in the state in which it's filed. Now in practice there has always been much more deference given to the state of domicile in examining that company, in determining any differences of opinion about what the standards mean. But the letter of the law is that you have to be aware of all the laws and regulations in each of the 50 different states.

Shirley Shao is an actuary with Prudential and, obviously, there was some difference of opinion about how thoroughly all the different companies were complying with that. It's a substantial burden, to be sure. There are all the different effective dates, and all the different calculations are done in all the 50 different states. That issue was brought to the NAIC, and the NAIC asked the American Academy of Actuaries to develop some reports on that topic. During the past year or year-and-a-half, there has been an ongoing process of trying to deal with the issue of whether that language should be changed in the model act or in the regulation. In the interim, how do you go about possibly setting up a central depository or some improvement in the way states communicate both with each other and with the actuaries as to what their standards are, to try to bring down the compliance burden of complying with 50 different state's laws? That effort, like all efforts when you're trying to get 50 people to agree on something, takes a long time. The advantage that you gain with state regulation is innovation and diversity, but what you lose is efficiency and how fast you can get a decision made.

So one other thing that's pushing that topic is that in one southern state -- I won't say which state it is, but it has the same name as a major river -- a position was taken by its attorney general who gives legal advice to the insurance department that upon examination that state should be sure that any company it is examining is complying with the valuation standards of all 50 states. Likewise, the other states should be doing that for this state to make sure that if that company writes business in the state, that it is complying with those laws. If one attorney looks at it, and that's the interpretation, then that's what the law means for that state. The insurance department regulators are uncomfortable with that because it puts those companies at a disadvantage. Also, from the regulator's point of view, if that's not being done, how can you rely on another state's examination if it isn't actually looking at your laws? Who is then? That state doesn't have the time and the staff to audit all the companies.

I think that's about as far as I'll go now. I'd like to get some questions and input on what people think about that issue, the issue of how states are coping with the fact that business is written all across the country, with 50 different sets of regulations. How many people wish that 20% of the time there was federal regulation of insurance? Okay. How many wish that 80% of the time there was federal regulation of insurance? We're about 50/50 then, I think.

MR. KERRY A. KRANTZ: How about if I jump in for a second? I've been active on Actuaries Online, and I've been talking with other actuaries. I've always tried to say that it was my own personal opinion that the standard valuation law ought to be a standard. It should be the same everywhere, and differences that are state variations should not be part of the standard valuation law. They would be separately identified and easy to locate for companies so that they'd be able to find whether Florida has adopted XXX. The answer is no. How do they know? They can look and specifically find an area called differences from the standard valuation law or Florida variations.

I think that any law such as that ought to contain a sunset provision. Therefore, if it was a good idea when you first had it, and somewhere along the line it isn't, it doesn't live forever. If it's a good idea, then you have to vote on it again and keep it in place. I believe that if 26 states or 51% of the states representing 51% of the population adopt something, it ought to become part of the standard valuation law. That's the way we work, majority rules. The standard valuation law should be like the constitution. It should change very infrequently.

MR. DONALD E. SANNING: I'm not going to deal with that question, Kerry, but I would like to make a pitch for actuaries to become familiar with the changes that are being contemplated by the Life and Health Actuarial Task Force that deal with this other state certification problem. At the end of this week the task force is meeting to consider some changes that will be made. I hope an exposure draft is put out soon about this. This could change some things that we do. It'll be a slow process because it's a change in the law. Therefore, it will have to be adopted state by state, but it is a possible solution to the problem of certifying to the valuation standards in every state in which you're admitted. But there are some other things that would change with it. There are some changes to the Section 7 opinion. There are also some changes in relation to reserves and codification possibly. So this is something that's coming up. You should be aware of it, and you should express some opinions on this when it goes out for exposure.

MR. KRANTZ: Currently, as Troy said, you're required to file your reserves as being adequate in the state of filing. The approach that's being considered is a two-tiered approach, state of domicile plus NAIC model. I'm not sure how the details will be worked out. It would still have to meet the state of filing. I would think you'd have to amend the standard valuation law so that we could accept reserves that may not be as strong as those we require in our state if we're to accept the state of domicile plus the NAIC model. Unless we can determine that the NAIC model reserves are as strong as those required by our state model, then I'd have to request a separate actuarial opinion that says that the company's reserves meet the state of filing requirement if I think that for some reason our reserves are stronger than both the state of domicile and the NAIC Model on the specific issue. I don't anticipate that happening, but should it happen in our state, that would be a requirement.

Because that doesn't improve things, it definitely needs to be a standard valuation law change. I would like to be able to accept nonmaterial differences from other states, as long as I can be assured that they are nonmaterial.

The committee that Shirley Shao heads originally was trying to address the issue of a central depository that would be adopted and filled in by the representatives of the state insurance departments and maintained at the NAIC. If there are variations among the states, we would spell out specifically our rules so that somebody could go on-line to the Internet and look up the differences. I don't know where that would be, depending on how they resolve the issue of the NAIC models. One of the controversies with the NAIC models is, what if a model hasn't been adopted by anybody? Are you still required to comply with it? That's where my 51% of the states or 51% of the people's proposal comes in. If a model has been adopted by the NAIC and nobody else, the issue is that nobody elected the NAIC. It is a tool of the states to help us to do our job, but the NAIC does not pass laws or regulations.

MR. ALASTAIR G. LONGLEY-COOK: Any state provision or even some of the proposals around the clearinghouse or model law might be doable from a company standpoint. The real problem is that many states do not stick to those regulations. We find that the standards that we are meant to comply with are not written in that state's regulation or, in fact, anywhere. Could you comment on what we see as a proliferation of state insurance departments interpreting regulations the way they think they should be interpreted rather than what's in the regulation, perhaps not in keeping with any Actuarial Standard of Practice that we're aware of or the state using other states' regulations when they haven't passed them themselves?

MR. PRITCHETT: What I thought would be a positive side effect of having a central depository is to try to basically reverse the burden of proof a little bit from the actuary to the state. If you want to hold someone to something, it should be published in that database; in other words, try to draw out for actuaries something to rely on that says where you were looking for those regulations. It's not published here. How can it be a real regulation?

Now, obviously, each state has its own particular regulatory framework. Even if you didn't change the language, which I hope will get changed in all 50 states because states want the power to have the last word on it, at least it would say, "We're going to publish those regulations, and we'll make a positive request." If it's a company not domiciled in our state, we will say we want you to comply with it, but here's the regulation, here's what to do. At least you know what it is you have to comply with rather than try to keep up with the fuzzy regulations or interpretations that may change as rapidly as the personnel that changes in that state.

MR. KRANTZ: In Florida, before we can pass a regulation, which we call a rule, it has to go before the Joint Administrative Procedure Committee (JAPC). When we adopt the rule we have to indicate where in the law we are allowed to make that rule. So, for example, if we say something such as, with the commissioner's consent, and there's nothing in the law that says the commissioner can give consent to things, then we have to spell out specifically what it takes for the commissioner to give consent and, therefore, point to where, in fact, in the law it gives the discretion to the commissioner.

When I go to a company to do a financial examination, I have three tools. I have the law, I have the rules, and I have the examiner's handbook. The examiner's handbook was adopted by a rule as part of our tools to examine a company. Therefore, it's the same thing as using a rule as one of my tools. Because the examiner's handbook contains the actuarial guidelines, and as long as we keep the rule current by saying it's in the 1997 handbook, then I can use all the actuarial guidelines that are in the 1997 handbook. We're not allowed to change mortality tables without the legislature actually doing it. I'm going to get into that later on with a specific example. But when I go to a company, I'll tell them that the *NAIC Accounting Practices and Procedures Manual*, which was also adopted by rule, says that you're supposed to adhere to the instructions of the annual statement. I went to a company, and an attorney there said, "Well, our actuary said that it said in the rules that we can do it the way we're doing it." I asked him to specifically show me where it said that. He couldn't do that, and I read to people there specifically from page two of the annual statement the instruction on how to do deferred premiums. That's the way I do my job. I apply a rule that's there, and I apply it as written and intended.

MR. PRITCHETT: From a small-state perspective, one of the real difficulties with valuation issues is that the knowledge doesn't really reside always in the department. On examinations you'll often have a contract actuary so there's no one person you can ask whether this is the state's position on a given topic? It depends on who's hired to examine that company, what interpretation that person makes, whether Actuary A or Examiner B looks at the issue, or whether somebody asks the commissioner. It's frustrating. I imagine it's a lot more frustrating being on the other side of the table, not being able to get an answer.

MR. GLENN A. TOBLEMAN: Kerry, you asked for comments on the way things ought to be, and I just want to say amen to that. I definitely agree with your idea about the same valuation law and then the states having specific rules. But I'd like to expand the topic a little bit. We're talking somewhat about state variations with respect to actuarial opinions, but it goes way beyond that. It goes into policy form approval. It goes into rate increase filings, which Kerry's state, Florida, is infamous for. You have to get a rate increase filing in one state versus another. The reason why 80% of the people might want federal regulation or at least uniform regulation as opposed to individual state regulation goes way beyond just the actuarial opinions. It goes into the form filings, rate filings, and everything else.

MR. KRANTZ: As Troy said, the legislatures are very jealous of their authority, or sovereignty is probably the better word to use. Therefore, say I want to change a law. For example, Florida has not adopted the smoker/nonsmoker mortality tables. I went to four or five different companies that used them, and I had to ask each of the actuaries to demonstrate that the reserves in the aggregate were at least as great as those that would have been calculated had they used the aggregate tables. I didn't feel like checking that because I thought they were probably adequate with the smoker/nonsmoker tables but, as I said before, the law says that they were supposed to use the aggregate table.

To get that changed last year, or this year, 1997, we adopted risk-based capital, which was part of the certification requirement of the NAIC. An amendment was attached to that at the urging of the industry, and I sort of whispered in their ears that I wouldn't object if they had that, to adopt the smoker/nonsmoker tables, and so now we have those.

But if we want to adopt new mortality tables, every time the Society does a study and the NAIC adopts them, other states can adopt them by rule. We have to get the legislature to pass them by law. I would like to have that changed, but I don't have the political clout. It's not a hot-button issue with people in the department.

Another amendment made the GAR 94 table and the annuity 2000 table optional during 1997. If we can get the rule adopted in time, they will become mandatory tables in 1998, which is part of the plan that the NAIC has. Other departments will adopt them by rule, we'll adopt them by rule only because we had the statute written so in that one particular case we can. But the next time that mortality improves for life insurance we'll have to go back to the legislature.

MR. PRITCHETT: Sometimes, at the NAIC level, we'll get into discussions, and the subject will come up. "Well, our state would never approve that, or we don't think you can get that done." I always remind them that there's a market for jurisdictions just like there's a market for anything else. If it gets too cumbersome and burdensome, I think there will be a push to take it to the federal level. So there is always tension among states recognizing what they have to do to keep authority at all and what they have to do to protect their own consumers and policyholders as best they can.

MR. ARMAND M. dePALO: A couple questions all lead to the final question as to multiple filing of annual statements. As an example, one of the controversial subjects that is still out in the industry, and it's probably been bouncing around now for almost ten years, is Regulation XXX. Regulation XXX has been bouncing around, trying to find some wide acceptance by the states for more years than I can remember. The problem is that, as an example, New York State has adopted 147. So, in effect, New York companies can use 147 or XXX in the state of domicile, but if you try to ask the states if they allow you to create a concoction product in which you have a term product and some high-premium product later and then file it as a unitary reserve, some say that they don't allow it. Some states say they don't know what you're talking about. Some states say that they allow it.

But the result is that a New York State company might believe that the unitary method is an appropriate method. This is a difference of opinion, and I'm sure plenty of people in this audience think they're doing the right thing by using the unitary method to reduce early reserves. But if the states fail to adopt a unified method, it could put the companies that, for argument's sake, have a more conservative view on this, at a serious economic disadvantage. They can't adopt the reserves of their state of domicile.

Now, what does this mean? This is where the question comes. It means that if you want to file a statement in your state of domicile that'll allow you to hold XXX-type reserves, you have to file much larger reserves in your other states and, in effect, be filing an annual statement in other states that have much less surplus than the state of domicile that you work at. It's possible that ultimately we may end up having to file 50 different annual statements and get into major conflicts with the advertising regulations. What annual statement do you use for advertising in which state? If I have a statement that has a billion dollars' worth of surplus in New York but only a half billion dollars of surplus in Florida, do I have to advertise in Florida if I want to show my financials reflecting the half billion dollars? Do I stop from running national advertising? This is a serious problem if we can't find some way to get some uniformity.

I'm not sure how the regulators on audit will want to do this. On audit what will you do if you have seven different annual statements, the domicile statement being seriously different from the statement filed in your state? What if one of those statements is insolvent? That's the basic question.

MR. PRITCHETT: I agree. I have that on my list as being one of the things that has been most disappointing to me. For whatever reason, I can't figure out how it's gone on as long as it has. Take XXX as an example. When Commissioner Bob Wilcox, who is an actuary, was there, we used to joke that we had the government of the actuaries, by the actuaries, and for the actuaries. He said, "Let's get moving on XXX," and we went through the rule process to adopt it. The argument heard from our companies was not that it was a bad reserve standard. They thought it was a good reserve standard, but that they couldn't be competitive if we adopted that.

In the interim, what's come about is this kind of 51% rule. We basically piggybacked on the Illinois language and said, "All right, we think it's a good idea, we'll adopt it, but its effective date won't be until everyone else does adopt," to get around the issue of inconsistency. It's a partial solution. It seems to be a stopgap measure, but I don't know where exactly it's going to go. It's a serious and significant concern when the states, as a whole, lose the capacity to make changes that are needed for new products. We'll see the same thing, I'm sure, on equity-indexed annuities. There will be a diversity of opinions on reserving. I don't know if we can limp by for another hundred years, but, as I say, I agree.

MR. KRANTZ: I spent three sessions on equity-indexed annuities, and at the end of that time I've discovered that I have a lot to learn. If I'm going to regulate them, and if someone starts selling them in Florida, I'm going to have to figure out how to calculate the reserves just the way that the appointed actuary or his or her staff calculates the reserves. But I'll also have to do something else because I'm not going to check each policy one by one. I'm going to have to figure out some kind of a roll-forward type of logic. What do I do to test it in the aggregate without checking a large enough sample? I don't have the time to do it company by company. For annuities, you can do a roll-forward. You have the beginning value. You have the premiums based on an average date that they were paid. You take out the surrenders and the withdrawals and maybe policy loans, if they have them. You apply the interest as the balancing item, and you compare that with the credited rate to see if that's reasonable. What are we going to do with equity-indexed annuities? Right now the policy level formulas are being developed, but we also will need to develop those.

State legislatures are slow. They don't pass laws quickly. What do we do in the interim to handle that kind of thing? We will have to develop laws so that we can have perhaps a regulation that has a sunset clause that says for two years this is what the companies will do until we can think of the best solution and give legislatures time to pass a standard law that 26 of the states will pass. But that's my hypothetical world. I minored in philosophy, but I also majored in math, and math is a lot more practical.

You have to be realistic. If you're going to pass laws, they have to be passed, and those are the ones I have to rely on. So, you have your XXX, which is a response to something that has been around awhile, but you also have new developments that you have to take into account. What's the solution for that one?

MR. PRITCHETT: One other theory I've heard proposed that made a lot of sense to me was to compare it with the asset valuation situation. A standard valuation office for assets is run through the NAIC. All the states basically agree to use this one methodology for putting a rating on assets. This person said, why can't we develop a standard liability office? With any particular reserving methodology, one group would be responsible for making those interpretations and any changes that are needed on new products. All the states could agree to use the interpretation of that standard liability office the way they do the standard valuation office. To me, that kind of a concept made some sense. You maintain state regulation, but you gain uniformity. I'm a minority of one as far as I can tell, other than the person who proposed it, for that concept. I'd like some comment on what people think might not work about that, but that seemed to make some sense to me.

The other thing that may be driving things is the accountants. They face somewhat of the same issue on different state standards. That explains the codification push to get an OCBOA -- other comprehensive basis of accounting -- so that there's a standard that all the different states could certify to. Now, I don't know whether the accountants will be any better at generating enough push with the companies to get that standard adopted. If that happens, it may carry along on the reserving side the same kind of system of designating certain models as what the accounting standard is, that's kind of a baseline. We've had many discussions when we've talked about this at the NAIC level. What do you use for that benchmark? If you say that just the state of domicile is the valuation standard, and that's different for everyone, that wouldn't be as good as if you had a common benchmark that you could look at. You could understand where your state's laws were in relation to the benchmark and know whether you needed to request a separate valuation for your state.

Let's move on now to the next topic under hot issues, which I've entitled the evolution of examination standards. Basically, I think the issue here is that the actuarial memorandums are rolling in, and the states have different capacities and different knowledge on how to deal with them. As regulators, we kind of informally got together and asked, what does your state do? How much time do you spend reviewing a memorandum? What do you look at? How do you coordinate between, as I say, the in-house examiners and the other ones?

One of the things that came up in those discussions is that there's very little precedence for what to do if you have an unprofessional memorandum. In other words, there are not many clear-cut guidelines on sanctions or what to do. Now, it may be because all the work is totally professional, but that wasn't necessarily the reaction. The reaction was, okay, what do we do now? What road should we take? I think, in one case, the company was forced to get someone else to do the work. It was a question of the appointed actuary not being competent for the job, but there's basically very little precedence on that.

The other common, big issue is trying to get a summary that's reviewable. In other words, some states don't have the time, the resources, or the commitment to do much of anything. Even the states that do obviously don't have the time to go through and actually audit all the numerical calculations that go into developing an actuarial opinion. So, the push is always on the summary side -- to get something that's a meaningful assessment of the assumptions and the methods and any changes in those assumptions and methods and what the concerns of the actuary are about what experience would have a significant impact on the required reserves or the solvency of the company and to get some conclusions. There may be a push in this latest rewrite of the memorandum or the model act to develop a new summary that requests different information because it's very hard to have a meaningful review of a memorandum.

Another question there is kind of what I would describe as the black box reliance on vendor models. Many regulatory actuaries are concerned. They go out and they ask a company, "Well, what assumptions went into your model, and why did you pick this particular asset model?" The companies say, "I don't know. That's what the package did." The regulators aren't comfortable with that kind of answer. They think there needs to be a better understanding of the models and also an auditing of the software. If there's a bug, whose responsibility is that to have found that bug or to certify it or not certify with that bug in the calculations?

MR. KRANTZ: Black box reliance is a timely subject. I have an anecdote concerning an examination or two. I went out to a company that was using the seriatim method to calculate the interest maintenance reserve (IMR) amortization schedules. I had them give me their original, because I didn't want to make them copy a stack of paper at their expense. I figured that as long as they just gave me their originals, I'd make my own photocopies for the examination report. I looked at one specific bond that showed that in the first year there was a negative amortization, and in the second year there was a positive one. So I went to the person, who was not an actuary, and I asked her if she thought that made sense. She said, "Well, I don't understand the concept of IMR. So I talked to the appointed actuary, and he said that he hadn't really reviewed the IMR. Then we discussed it, and he agreed with me that it didn't make sense."

So, I asked the lady at the company for the name of the software vendor. I called the vendor, a company in Colorado, and I discussed the possibility of getting the formulas that were used so that I could do a spreadsheet and try to reproduce the exact amortization schedule. They refused to cooperate with me because I wasn't a client. So I asked the client to ask the vendor to give the formulas, and they couldn't get anything from this vendor either. The best they could do was just not use the company anymore. But I had no authority at all to be able to get the formulas.

Last year I went to a second company, and I found out that it was also doing amortization using seriatim. I asked what happened to the company it had bought the software from. When they said Colorado, I said, "You might want to check into it because I found that there are problems with this company's calculations." I checked an amortization, and found that it wasn't exactly what I thought it should be, but it looked reasonable. In the aggregate I accepted the IMR. I did tell the company, though, that because I wasn't confident about that vendor, as part of the examination report, I would require that the company request copies of the formulas used for the amortization and maintain them on file for future examination purposes. They said they would.

I have problems with black boxes. I started my career on an IBM 1130 computer with punch cards. I used to get the printouts and use a machine where we'd separate the three parts. The carbon paper would go into one pile, and the three parts would go into three piles. I used to cut myself and have to get a Band-Aid. But I realized that you have to desk check. That's one of the important things that I learned at my first company. You can't take for granted that your program will work. You have to check individual cases and make sure that it works. If appointed actuaries aren't doing that, I don't think that they're doing their job with due diligence. So it seems to me that if actuaries say that they checked and have determined that the reserves and the page two assets have been computed according to standard actuarial practice, that they have, in fact, checked to make sure that was done.

MR. PRITCHETT: You wouldn't feel like you went to a regulatory topic discussion if you didn't get a little scared. So, we'll say you had better know what's in every one of those models. I think that's another good point about this area. On the asset side, the state of the art for modeling assumptions seems to change every time the *North American Actuarial Journal* comes out. A different asset model is proposed as better explaining the real environment.

One other thing concerned me. At an NAIC meeting a speaker talked about equity-indexed products. It seemed a little bit as if some of the companies were relying for their model on the people who were selling them the assets. It makes you want to say, "Mmm, they're making money selling the assets, and they're telling you how good of a job it's going to do." Something just didn't set right there for me. Any comments on the examination side? How many people have had a question from a regulator or an examiner about their opinion or memorandum?

FROM THE FLOOR: I believe cash-flow-testing the memorandum is a big move forward for this industry, and I think it's something that's needed. But the timing that happens right now where you have to get your memorandum out by February 28 along with your annual statement, and basically either use nine-month assets or 12-month assets, puts the company on a very tight schedule to produce a document as large as that with the analysis that has to go into it.

I think it would be better served, for both the companies and the regulators, either that the regulators say you do your cash-flow testing based on six-month in-force and six-month assets and submit it with your annual statement or, conversely, you use 12-month assets and 12-month liabilities, but you submit it six months after the close of the annual statement. The time frame that's involved in working within a two-month time frame is very, very hectic, and my company has a relatively large staff working on it. We get it done, but as products and assets get more and more complicated, it's hard to get information from your asset side in time. It's hard to get your liability in time. You're doing all the work in what amounts to probably four weeks with people working an incredible amount of overtime.

It goes out to the regulators, and I really question -- do the regulators really look at the cash-flow testing in the memorandum until six months anyway? So you'd really get a better work product if the regulators somehow could detach the memorandum from the annual statement. I know you're concerned that you're filing something and you don't know for sure that your memorandum's going to match up with the annual statement, but that's why I suggest that if you did it six months in advance, most companies could make a statement that nothing substantial has changed between June 30 and year-end.

I am interested in reviewing a carefully prepared financial analysis. I don't care if it does not arrive with the annual statement. I'd rather see a continuous analysis of the condition of the company because I don't think it will go broke at one instant in time. I think it's likely to happen any time during the year, not only on December 31 at midnight.

MR. JOHN D. MURRAY: I have a question from the examination standpoint. In reviewing memoranda and the asset adequacy testing, to what extent are you concerned about methodology and approaches and how the job was done as opposed to the bottom line, which is are the reserves sufficient?

MR. KRANTZ: The bottom line is that the reserves have to be, at least in the aggregate, as large as those that are required. Therefore, if you want to use the McClintock table and calculate reserves using 600% interest, that's okay.

FROM THE FLOOR: My question concerns the content of the memorandum: the methodology used; the types of analyses used. The bottom line, I believe, is still are the reserves sufficient? The actuary can use a lot of judgment as to how to do the testing.

MR. KRANTZ: I believe the purpose of the Actuarial Standards of Practice is to give the actuary a wide latitude of how to do it, and as long as the actuary can do it within those guidelines, I have no problem.

MR. PRITCHETT: A little follow-up on that. I guess I wasn't sure if you were asking if the regulators were concerned about methodology in situations where it was clear the reserves were sufficient no matter how you did the test but were still arguing the details of the test. I hope that doesn't happen, but I think regulatory actuaries do rely on kind of judging the sophistication of the testing and also the skill with which sensitivity to various assumptions is addressed as one measure of whether the company will be solvent. In other words, people who do good testing tend to manage their business better. In that sense, I think there's a heavy reliance on how good of a methodology there is for managing your business rather than the specific numbers for this year.

MR. KRANTZ: I just want to quote one thing on my previous answer. The actuary is to act as a professional at all times. I'd like to hear that. When you wake up in the morning, tell yourself that, and then do your job that day. You do act within the Actuarial Standards of Practice, but your conscience tells you that the Standards of Practice do not address something. You know that a standard should, and you know how it should say it. If it doesn't, you think you can do it differently. If you think ethically you should do something, then do the right thing. If I were to get into an argument with somebody who said the practice doesn't say something, and he or she said, "I got away with one," I probably couldn't do anything about it. However, I probably would lose respect for the person, and it probably wouldn't be as easy to work with him or her the next time.

MR. MARTIN E. UHL, JR.: I'm not the appointed actuary for my company, but what you just said is related to a remark I was going to make. Sometimes company management, and senior management, doesn't give a lot of weight to the Actuarial Standards of Practice when it comes to deciding what the best thing to do is under the current interest rate environment, for example. I would hope that you would realize that freedom for the actuary is a two-edged sword. The more objective standards you can have helps the actuary in going to management and saying, "Well, I can't push too far on this because of this particular standard, which is a hard-and-fast rule" as opposed to "I just have a standard of practice that says my assumptions need to be reasonable."

The best example I can think of is how to define how you fail a scenario. I recall a very good article in *The Actuary* about the Zen method of deciding whether you pass a scenario. That's all well and good, and it was an excellent article, but it doesn't help much when you're facing company management after interest rates have popped about 3% to 4%. So, the more standard objective standards you can have, the better it is, I think.

MR. KRANTZ: One of the points that we continue to make is, if we do away with formula reserves and rely more on the appointed actuary, "trust me" is a nice thing to say, but it doesn't help a policyholder if the company has to be taken over by the department. So we need something, and if it's not formula reserves, it needs to be something else.

MR. MORRIS W. CHAMBERS: Now that you've turned to this track of professionalism, I'm drawn back to a comment in the introductory part of this session. Reference was made to a circumstance in which you're faced with an actuary who has prepared an actuarial memorandum that does not comply with the standards. It is, in fact, unprofessional, and presumably the actuary is unwilling to bring that memorandum up to professional standards. Your question was sort of left up in the air. What do I, as a regulator, do? My response is itself a question. Why would one not take that issue to the ABCD?

MR. KRANTZ: I've seen incidences in which one actuarial opinion was basically a Section 7 opinion, but it didn't list the ratios or the reasons why it was qualified as a Section 7 opinion. I knew it was, and the actuary knew it was, but I considered it an unprofessional job not to be complete. I asked the actuary to do it over, and he did, and it was fine, but I thought that it was a sign that his work wasn't up to standard.

In another case, an actuary made an actuarial opinion based on asset adequacy because of the situation he was in. He and I agreed that perhaps the rules were adopted in such a way that if they had been written with his company in mind, they probably would have exempted the asset adequacy opinion, but one was required. The opinion regulation says that they have to do a memorandum.

He believed he said enough, and said that a memorandum wasn't necessary. I told him that I disagreed, and we worked it out amicably. I didn't want to bring him before the ABCD because he and I were able to work it out. I think the Guides to Professional Conduct say that we're supposed to try to work things out, and if we can't, then we go on to the other level.

If I were to see an actuary who did an unprofessional job, and it didn't meet the standards of an actuarial memorandum, the statute says that we can get a separate memorandum done by a consulting company at the company's cost. I sometimes say that, but I don't mean it if the company's willing to do it the right way to begin with. I just say that that's always an option, and I say I don't expect the company to do it. If it needs a few more weeks, then do the memorandum. If after three or four weeks (or however much time the company agreed was enough time), it didn't do one, then I would have to consider going to the ABCD.

The problem is that the company, not the actuary, is required to produce a memorandum. So when I examine the company I'm looking at what do I do as far as the company is concerned? The actuary's conduct becomes a separate issue.

MR. PRITCHETT: The only thing I'd add there is I don't know why they don't, but I think one of the reasons is that their friends don't. In other words, there are not ten other regulators you can turn to and say, "What happened when you referred that guy to the ABCD anyway?" Nobody wants to be the first one known as the person who turns in all the unprofessional actuaries. Where do you see it more? This is the interesting phenomenon I found. Actuaries on product filings have a different standard than they do on reserving. I think part of that is because with reserving, it's kind of the difference between something that's bad on its face versus something that's bad because the law says it's bad.

With reserving, actuaries naturally feel that on its face you should have an adequate reserve. You're not making an honest deal if you don't. When it comes to product filings or rate filings, I think there's an attitude somewhat that this is needless messing of the regulators in our work. But the consequence of that is that people in insurance departments have worked in the product filing area and have a much lower opinion of actuaries and whether they'll use honest judgment appropriately.

In fact, I'll blame it on the other guys. I took a Casualty Actuarial Society professionalism course. I was taking some casualty examinations, and we had case studies. You did the reserving case study, and everyone came up with the right answers. It was a product filing question, and everyone kind of looked at each other and said, "Well, the rule is to get the filing through." That was the standard. So I'm jumping down a little bit to the attitudes toward relying on the judgement of actuaries, but you can say that's one situation versus another.

People who don't have the actuarial background say, "Now, wait a minute. If the actuaries tell me one thing on the product filing side and a different thing on reserving, why should I ever believe them?" Believe me, almost no regulatory person who has dealt with product filings doesn't have several cases of what the vast majority of us would consider unprofessional work.

MR. KRANTZ: Could I just mention one other thing? On the subject of the memorandum, one state department of insurance, and it's not mine or Troy's, has decided that there's one actuary whose memorandum and professionalism was so poor that it will never again accept a memorandum or an opinion issued by that person. I don't know the name of that person.

MR. PRITCHETT: Let me just quickly mention the other points I jotted down about the attitudes of relying on the judgment of actuaries. There's a concern of regulators that the opinion language over time will become so caveated that it will say next to nothing. In other words, yes, you rely on the actuary, but the actuary's own opinion doesn't really say much. There are so many caveats that it's not really helpful.

Also, many regulators do put a lot of stock in having the asset adequacy test. In other words, when we're talking about formula reserves I don't know how many times I've heard it said, "Yes, but that should be picked up with the asset adequacy test." Yes, that's a concern. Perhaps the formula reserve doesn't pick it up, but that should be picked up. So, they're relying on the actuaries and the appointed actuaries to do their job and post the necessary reserves, but that's a big difference between willing to go to the next step and say, "Well, let's pull out the net. Let's pull out the formula reserves and then see what happens."

Right now the opinions basically say, yes, the reserves that were required are okay. They don't say what the reserve would be if there were no underlying formula reserves. That's kind of the next step with some of these products. I'm not sure there's the confidence at that level to just trust the judgment of actuaries.

One other thing kind of related to that is that there's a difference of opinion about how public actuarial memoranda and opinions should be made. Some states have very strict freedom-of-information laws, and the arguments for having it very open is that then there are more policing people. The rating organizations, consumers, or competitors could get in there and look to see if things are done well. Obviously, the other side is that we will never get the truth if it's open. People aren't going to put their proprietary models and their true judgements into an opinion of it's open. But the other half gets back into the product filing and disclosure issues. If you really are saying, well, let's trust the disclosure process, you have to have a very open thing to use to pass judgment.

Let me backtrack and throw another one out while we're talking about this. Where are future developments going? It's a little bit related. It's a little bit like trying to predict an earthquake. If it happens, it'll be a big change, but when exactly it'll happen or if it'll happen is subject to some probabilities. To me, the biggest driving force behind what's going to change is product development. As new products come along, they raise reserving issues, and that's the driving force. It's not so much the solvency that drives the solvency laws. It's how you deal with these new products, and accounting changes, and tax considerations. Those environmental factors seem to be the biggest things you deal with. It's not so much that we don't think this is working for solvency. It's how does the solvency mechanism cope with market value of assets on the accounting side or with equity-indexed products on the product development side? If we make this change, what does that mean for the taxation of insurance products? The external factors end up driving the processing, in my opinion.

Another area of concern for regulators is the pricing of financial liabilities. Let's say a different company will reinsure for the risk of a drop in the fund values when there is a guaranteed death benefit. Some of them will say, "Well, on our model it doesn't cost anything, so we're not holding any reserve." Obviously you're charging something for it, so they must have thought it cost something. What's the appropriate reserve there? There's some discomfort with selling a product that doesn't require any reserve. Let me open that up. Are there any questions on where future developments are going or on the attitudes of regulators in relying on the judgment of company actuaries?

MR. KRANTZ: Let me ask you a question about that product, because I've had a similar example. Was that product a monthly renewable term (MRT) product where premium was paid on the first of the month, and, therefore, it was all earned by the end of the month?

MR. PRITCHETT: No.

MR. KRANTZ: In the case of something that is pay as you go, there would be no reserve as long as there's no unearned premium. I'm talking health insurance, by the way. I was thinking of that as an example.

MR. PRITCHETT: The problem is that often those renewable things sometimes get canceled just when you need them the most. When experience goes bad, all of a sudden you can't renew what you were doing. He said he minored in philosophy. So, I'm going to give everyone a thought experiment. One of the questions that came up about doing a Section 7 opinion and a Section 8 opinion is whether it's worth it. Is it worth the money to require some of these companies to go to the time and expense of a full asset adequacy analysis?

To me, one of the ways of thinking about that is to ask yourself, if you were responsible for the claims of all the companies, would you spend your money to have an actuarial opinion and memorandum with an asset adequacy test for those companies? If I had to pay the claims, is that where I'd spend my money? I think that's one effective way to think about what you should be requiring. From a pure business point of view, would I pay to have someone do that calculation? If it can't meet that standard, we're doing the wrong thing as regulators to require all these tests if on a bottom-line basis it's not going to make an impact on solvency.

MR. KRANTZ: I have an audience participation question. Under the Kennedy-Kassebaum bill, certain products that were not subject to contract reserves for health insurance that have community rating may now all of a sudden be required to have contract reserves. A group is studying the issue -- I recently participated in a conference call. We were supposed to have a preliminary report ready at the next NAIC meeting in Washington, but because we couldn't come to a consensus, we weren't able to. The problem is, if a community-rated product in the past was individually rated, and you had contract reserves for a 20-year-old and a 60-year-old, each reserve would probably be adequate. The negatives in the 20-year-old contract reserve, if they developed, would not be able to offset the negatives in the 60-year-old contract reserve. A better example would be many policies at many ages.

What would be the appropriate approach to that? In that situation in which, by regulation, they're required to have a single-policy premium rate, should the young subsidize the old? Should we allow the negative contract reserves to be offset by the positive ones? Does that open the door to cancer-type policies in which there is a single gross premium rate for a large spread of ages? That's an issue that we're dealing with. We haven't come to a consensus because it's like Pandora's box. What might be a solution might open up bad consequences.

We gave up trying to solve the problem on the conference call. We're going to let the committee hear what we've decided so far. If anybody wants to think about it and come up with a solution, you can help the regulators out by coming up with good law.

MR. PRITCHETT: We talked about that in the health reserving session that I just came from. On rating you're not recognizing age because there's a mandate for community rating, and one proposed solution was to just not get age information. You can then take an average on the claims, and it'll all work out in the wash, but that was kind of a shortcut solution.

Well, the last topic is assessment of how the valuation actuary concept is working. I don't know. Many people are at this symposium. Does that count for success or failure? I'm not aware of any studies to look at the incidence of insolvency or losses under insolvencies pre- and post-actuarial opinion. I guess it'll be a while before there will really be experience to tell if it helps. Does anybody want to comment on how you would measure such a thing, or if it would be worthwhile measuring such a thing? We'll put it to a vote. How many people think that the valuation actuary concept is working? How many people think it's not working?

MR. KRANTZ: Unanimous, but most people didn't vote. By the way, the vote was, yes.

MR. PRITCHETT: I've heard both sides of this one but there has been concern with the legal liability of the actuary signing an opinion. You hear stories -- "Boy, I'm glad I don't have to sign our opinion. I don't want to get sued over this." Then you hear other actuaries who say, "Oh, that's nonsense. The chance of ever getting sued for signing an opinion are next to zero." Does that concern anyone, the potential liability of signing an opinion? Show of hands. How many? What changes in either the wording or the act would make that more appropriate if that's an inappropriate concern? If it's an appropriate concern, then that's good. If your own neck is at risk, maybe you'll be more conservative. I don't know.

MR. KRANTZ: One of the things that I discussed on the conference call was codification and the fact that the accountants are not going to be willing to sign an opinion except under the circumstances of the NAIC model. I said, "Well, what if the states won't accept it?" They say, "Well, it's too bad." I would say that we couldn't do much about it. If we require the companies to get a certified public accounting firm to make a certification, and every single certified public accountant was told by the profession not to do it, what are we going to do? Are we going to hold every insurance company in contempt? Are we going to train our own people to do it? I'm not sure what you do in that case. Do they hold us hostage? I think the reason we need to have a uniform law is so that something such as that can't happen.

MR. PRITCHETT: One other comment I would make there is I think it's important that the profession not hold itself out to be able to do things it can't. Compare it to physicians. Physicians treat people who die all the time, and they've been careful to be sure the standard to which they're held isn't that if someone dies, they did something wrong. In a competitive environment companies will die, and I think it's important for actuaries not to lead people to believe that if they're doing their job right, no company will ever go insolvent. That probably is not the case, and if you hold yourself out to be that, the legal environment may treat you that way and take your money based on that presumption.

MR. ROBERT H. DREYER: I'd like to shift gears. Not being licensed in either Florida or Utah, I'm not sure what your position is currently with regard to the illustration regulations. I'm wondering if you could comment on what regulators are doing or planning to do to review compliance.

MR. KRANTZ: I don't know on that one. I'm not the person. That would be Frank Dino in our department.

MR. PRITCHETT: We do have the illustration regulation in place in Utah. We're relying on the judgment of actuaries who sign those illustrations. We don't have the staff to review them as much as we would if we had more staff. If it works, it's somewhat self-policing, and if not, we'll find out about it five or six or ten years down the road, just like the current illustration problems.