1990 VALUATION ACTUARY
SYMPOSIUM PROCEEDINGS

Sessions 8 and 14
Workshop: Small Company Issues

J. Daniel Ellis
William H. Lewis, Jr.
Robert B. Thomas, Jr.
Glenn A. Tobleman

SMALL COMPANY ISSUES

Workshop Leaders: J. Daniel Ellis
William H. Lewis, Jr.
Robert B. Thomas, Jr.
Glenn A. Tobleman

The agenda for this workshop is summarized below. Each item on the agenda is then individually addressed to reflect the comments and questions raised at the workshops.

I. History and Background

II. NAIC Model Law and Regulation -- Small Company Exemptions

III. When is Cash-Flow Testing Required?

IV. Costs and Benefits of Cash-Flow Testing

V. How to do Cash-Flow Testing

VI. Open Issues

I. History and Background

Cash-flow testing is discussed in the Actuarial Standards Board (ASB) Standards of Practice Numbers 7 and 14. In addition, the NAIC has recently drafted a proposal to revise both the Actuarial Opinion and Memorandum Regulation and the Standard Valuation Law. The new NAIC Standard Valuation Law model will be presented at the NAIC's December 1990 meeting, and the prognosis for its adoption seems to be very high. The revised Actuarial Opinion and Memorandum Regulation will be exposed at that same meeting, with adoption likely in June or December of 1991.

The roles of Roy Woodall from the NALC, and Tony Spano from the ACLI were discussed. Both of these individuals raised concerns expressed by smaller insurance companies. Many of the issues raised by Messrs. Woodall and Spano were incorporated into the proposed NAIC model law and regulation.

There was also some discussion regarding the Tweedie Committee report that laid the groundwork for cash-flow testing.

II. NAIC Model Law and Regulation -- Small Company Exemptions

There was considerable discussion about the proposed NAIC model, and its impact on small life insurance companies. In particular, there was a lot of attention focused on the exemptions provided for in the proposed model.

The rules for exemption are two-fold. The first requirement concerns whether or not the company is on a "priority" list for NAIC review. A company that has been designated a priority one company in either of the past two years, or a priority two company for the two most recent years is not eligible for cash-flow exemption.

Companies not on the priority list must then pass a second series of tests that focus on certain ratios. This second set of ratios varies depending on the size of the company as shown below:

Admitted Assets	Classification
<$20 Million	A
$20 MM to $100 MM	B
$100 MM to $500 MM	C
>$500 MM	D

Cash-flow testing is never exempted for Category D (i.e., large) companies. Category C companies will not be exempted when cash-flow testing is first mandated, but are required to perform cash-flow testing only once every three years if they satisfy the ratio tests. Category A and B companies may be exempted from cash-flow testing each year if they meet the conditions implied by the ratio tests.

The ratio tests are summarized below:

1. Capital & Surplus / Invested Assets
2. Annuity & Deposit Reserves / (Total Reserves - Mandatory Securities Valuation Reserve)
3. Book Value of Noninvestment Grade Bonds / Capital & Surplus

Category of Company	Required Ratio Test 1	Test 2	Test 3
A	> 10%	< 30%	< 50%
B	> 7%	< 40%	< 50%
C	> 5%	< 50%	< 50%

III. When to do Cash-Flow Testing?

The valuation actuary has ASB Standard of Practice (SOP) No. 14 as a guideline on when to do cash-flow testing. The effective date of SOP No. 14 is October 15, 1990. However, most of the state insurance departments do not require cash-flow testing and will not until they have adopted the NAIC model law and regulation. The earliest anticipated effective date for most states would be year-end 1992.

There was considerable discussion regarding the valuation actuary's responsibility vis-a-vis cash-flow testing for year-end 1990. Most of the workshop participants were not planning to do cash-flow testing for year-end 1990. Reasons given for not performing cash-flow testing included:

1. Type of business did not warrant it;
2. Not required by states;
3. Difficulty in convincing management to pay for cash-flow testing when it was not required by the state;

4. Inadequate time between now and year-end to perform.

There was general discomfort expressed by many at the workshop concerning the lack of clear guidance from the Academy on the timing issue. The consensus opinion is that the valuation actuary is guided by his or her professional opinion in determining whether cash-flow testing is required or desirable until the NAIC model is adopted by the states.

IV. Costs and Benefits of Cash-Flow Testing

Since a lot of the negatives regarding cash-flow testing are already well-publicized and discussed (cost, time, etc.), most of the discussion focused on the benefits of cash-flow testing. The benefits mentioned were:

1. Enables a company to restructure its assets before the problem is too late to solve;
2. Greater availability of cash-flow testing software and greater number of firms providing cash-flow testing services;
3. Can restore confidence in the insurance industry that has been rocked by recent stories trying to link the savings and loan crisis to the insurance industry;
4. May head off invasive government regulations;
5. Increases the responsibility of the valuation actuary.

One of the negatives discussed was the potential lawsuit exposure created under the valuation actuary concept. Many of the actuaries expressed a desire and need for Errors & Omissions insurance from the insurance company to protect them against this contingency.

V. How to do Cash-Flow Testing

The concept of model office projections was discussed, along with the setting of assumptions from a small company's perspective. The consensus of opinion is we should try to use our own company's experience in setting assumptions as much as possible, tempered by the credibility of the results.

Expenses were discussed in some detail. Workshop members expressed a concern over how to handle "excess" expense over and above the pricing expense assumptions. Most of the comments favored assigning full expense in performing cash-flow testing, although a written plan submitted and endorsed by company management for eliminating the expense overage could be considered.

There was also discussion regarding the differences between cash-flow model office projections versus the standard liability projection models that many actuaries have already used. Some of the special considerations and needs for cash-flow models include:

1. Dynamic assumptions (lapses, policy loan utilization, dividend and nonguaranteed elements, etc.) to accommodate different interest scenarios;
2. An interest crediting strategy for interest-sensitive and deposit products; and
3. Reinvestment strategies for cash flows and maturing assets.

VI. Open Issues

The following questions were posed but not resolved due to time constraints:

1. If as a result of cash-flow testing, the actuary sets up an additional reserve, will the additional reserve be allowed in determining the tax return?
2. How many failures, or what percentage of failures, does it take until an additional reserve is deemed necessary?
3. Why were universal life reserves not considered explicitly in the small company exemption ratios?
4. In applying the ratio tests to determine small company exemption, can financial reinsurance (i.e. surplus relief) be considered? What about last minute coinsurance treaties?