1995 VALUATION ACTUARY SYMPOSIUM PROCEEDINGS

SESSION 14

State Variations and Reconciliation Requirements for Valuation/Appointed Actuaries

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STATE VARIATIONS AND RECONCILIATION REQUIREMENTS FOR VALUATION/APPOINTED ACTUARIES

MS. SHIRLEY HWEI-CHUNG SHAO: Frank Buck from Deloitte and Touche will go over the confusing reconciliation requirements with which appointed actuaries have to comply before signing off on the actuarial opinion. I will discuss the equally confusing state variations issue.

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MR. FRANK J. BUCK: Shirley asked me to speak about reconciliation requirements principally because there were new requirements in 1994 that required auditing firms to give opinions about. I should talk about what that means and what that is.

You will have received an updated set of practice notes for the year. Practice Note 1994-3 is pretty well unchanged from last year. I didn't detect any significant changes in it. The practice note is the one about reliance upon third parties and how the appointed actuary actually can rely on data. It sets out the details of the supplemental schedule with the life and health annual statement.

I am then going to talk about some practical issues that we came across over the last year. And I am not sure if there was a battle between the actuary and the auditor, or just a disagreement or difference in opinion, or whatever. But there was certainly different approaches to what the schedule meant from the two professions.

In the practice note, the first question is, may the appointed actuary rely upon the company's auditor for the substantial accuracy of the records and in-force information? The practice note then refers you to two areas: the National Association of Insurance Commissioners (NAIC) model regulation, which suggests that the actuarial opinion should include a statement saying that the actuary has relied upon an accounting firm for the substantial accuracy of the in-force data and information concerning

the liabilities. On the other hand, it also shows that the American Institute of Certified Public Accountants (AICPA) issued a very different statement in February, 1991, which said very clearly that the auditor should not consent to being referred to in an actuarial opinion in which the actuary expresses reliance on the audits for the accuracy of the data. And it goes as far as even suggesting that the auditor, if he hears he is going to be referred to in such a way, may want to consult with legal counsel. It appears that there is a battle between the two professions.

And this has really arisen, I think, because regulators were concerned that the appointed actuary was signing opinions and was relying upon information that the actuary had no way of knowing, for example, whether there was a $10 billion in force in this plan, or $20 billion. The actuary was just taking it on face value to a certain extent that the in force was there, and the actuary had to rely on somebody. And, you know, who better than the auditors because the auditor is obviously going to guarantee everything on the financial statement.

The result was to come out with a supplemental schedule, and this was effective in 1994. In response to the annual statement instructions, actuaries can rely upon certain people, usually within their own firm. You can reconcile relied upon data to anything in the annual statement, the supplemental schedule being one of those things. This supplemental schedule was subject to audit procedures, and the auditor does a Statement on Auditing Standard (SAS) 29 on that supplemental schedule.

Before I go on, I just want to get some sort of sense of how many of you deal with auditors? How many have some idea just what all this is? That's pretty good. About two thirds of you responded. How many of you really know what an auditor's opinion is? Is it saying that the auditor really has guaranteed the records? Guaranteed everything in the annual statement? How many people think that is the case? Well, that's good.

I'm just going to talk a little bit about what an audit is. The deliverables of an audit is, first of all, the auditors standard report, which is a set of basic financial statements together with an independent opinion. There may be a need for some special purpose reports, which the auditing firm might be

asked to do, including other pieces of work, like a report on internal management, or financial statements. There could be supplementary reports in the supplemental schedule as well as these.

The auditor is appointed by and reports to the audit committee. The auditor gives a report each year to the audit committee on the state of the financial position, and makes recommendations to management. The auditor's standard report consists of pretty basic things: a balance sheet, income statement, retained earnings, changes in stockholders' equity, and changes in financial position, and notes to the financial statement. Maybe also the report will have a description of significant accounting policies. It's whatever the auditor needs in order to be satisfied that the financial statements are presented in a fair way.

Regarding the independent auditor's opinion, I'm going to read one to you just to stress three or four points. This is an actual opinion, but the name has been changed to protect the innocent.

We have audited the accompanying balance sheets of X-Y-Z Life Insurance Company, as of December 31, 1994 and 1993, and the related statements of operations and surplus, and the cash flows for the years unended December 31, 1994.

The financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with generally accepted auditing standards. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. This brings in the concept of materiality. "An audit includes examining on a test basis evidence supporting the amounts and disclosures in the financial statements. It includes assessing the accounting principles and significant estimates made by management." So you're looking at significant estimates made by management in this, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

And we then get back to our opinion. "In our opinion, the financial statements present fairly in all material respects the financial position of the company as of whatever the dates are, and so on."

The financial results are the responsibility of management. Second, we have done some tests, or have done an audit, and we think that the financial statements fairly present the financial position of the company and are free of material misstatement. Basic financial statements can be on a GAAP basis, or some other comprehensive basis of accounting including statutory.

The supplemental schedule is subject to an SAS 29 opinion, and Statement on Auditing Standards Number 29 gives guidance to the auditor when he or she is providing additional reports that are not considered necessary for a fair presentation of the financial condition. So this is something extra. It provides guidance in the form and content of the reporting when he or she is doing this. It very clearly says that the information is outside the basic financial statements and is not considered necessary for presenting the fair position of the financial condition.

A sample opinion was included in the handouts. We say very clearly that it is presented for complying with NAIC instructions, and is not required as part of the basic financial statement. On the second page of the opinion, we state very clearly that the additional information is the responsibility of company's management. The information has been subject to auditing procedures, is fairly stated in relation to the basic financial statements, and is subject to overall materiality limits.

In doing an audit of any company, we would set a limit on materiality. We would go to the company and would calculate a materiality limit. For the sake of this discussion, say that's $10 million. Any item that's less than $10 million, we're not going to look as closely at as for the larger items. If you have a misstatement of a million dollars somewhere, you need ten of those before you start running up against the materiality limits. It's not significant. When we come to the supplemental schedule, we still apply the materiality of the overall basic financial statements. The same $10 million is going to be applied. And for some of the individual line items in the basic financial statement, $10 million could be quite material. But they're not going to be subjected to anything more rigorous than the materiality for the overall presentation. This could be a weakness of the actuary relying on the supplemental schedule.

The supplemental schedule itself consists of four pieces: analysis of investment income, analysis of the assets, analysis of the in force, and the analysis of the claim payments. The investment income is split up into a number of pieces. Bonds are split between government and other bonds, and the other bonds between affiliated and unaffiliated. Investment income is shown separately for mortgages, real estate, derivatives, stocks, and other investments. And stocks, again, are split between preferred and common. And both of those between affiliated and unaffiliated, and other investments. Once again, I think you can begin to see that we're beginning to analyze, to review items in more detail, and create more of a breakdown than we would in the annual statement. The annual statement doesn't go into such detail.

When we look at the assets, there is more detail in the way they are split out. The bonds are split by maturity, by class, and between public and private. Mortgage loans are shown by client and by standing. By type, I mean, farm mortgages, residential mortgages, and commercial mortgages. And by standing, I mean are they in good standing? Are they restructured? Is the interest overdue? Are they in foreclosure? Stocks are split into preferred and common. And the bonds and stocks are separated into those of the parents, those of subsidiaries, and those of affiliates.

The other investments include financial options owned and written, and in force and other long-term investments, short-term investments, and cash.

So it's all pretty standard stuff. Much of this has been subject to overall procedures, but a lot of it is now analyzed in greater depth, and into more breakdowns than we would have done before.

The in force is split up. The life insurance in force is split by type, and also shown by those with disability provisions. I do not think we would ever have segregated out those disability provisions in our basic audit. Accidental death in force is shown separately.

Regarding life insurance in force, I would doubt that we would have done much apart from making certain that the total file was right, the control targets were right, and those sorts of things. We wouldn't have gone through and analyzed the in force as part of the basic audit.

Annuities are split in ordinary and group, and immediate and deferred. The accident & health (A&H) is split into three component parts, ordinary group and credit. We also have deposit funds and dividend accumulations. Also, we take a look at claim payments by the year loss incurred, the year the loss was reported, and by product.

So there is a lot of information on the supplemental schedule. A lot of it was already being audited as part of the basic audit. Some of it is now being split out into a more detailed presentation. But how much use is it? Can the actuary rely on it? Can the actuary use it?

And a couple of major issues that we came across last year when this came through was people saying, the supplemental schedule shows what happened at year-end 1994. But we did our cash-flow testing in September 1994. How do you reconcile those two? Someone else said the supplemental schedule shows 1994 investment income. But our projection starts in 1995. How are they being used?

If you have done your cash-flow testing as of September 1994, you have to roll it forward to the year-end anyway. You have to do some sort of test to roll it forward. And you have to use the information as of December 1994 and compare that with what you had in September 1994 and ask, are there any significant differences? Has anything major happened? Have you had a major restructuring of your portfolio? Have you been hit with a nasty loss in real estate, or whatever? And roll that forward.

A number of actuaries modify their opinion really saying that they use this information as a basis for reconciling their projections going forward. The investment income was whatever it was last year. The actuaries had to take into account any unusual items in that investment income in considering the projections of the investment income going forward.

The final issue really is, we had to do more detailed auditing in order to separate the investment income into its various component parts, looking at the asset classifications, which we have never

really looked at in absolute detail before, and splitting out the in force and the claim payments between the various component parts. That really is it for the reconciliation.

MS. HWEI-CHUNG SHAO: I will go over the background of the state variations issue, present the challenges, show the current practices, and discuss several resolutions.

Background

The actuarial opinion and memorandum (AOM) and new standard valuation law (SVL) language explicitly require compliance with each state's minimum standards, albeit in aggregate, in addition to meeting the domiciliary's minimum standards. This means that the appointed actuary must certify that reserves meet the requirements of each state in which the insurer files an annual statement. Since reserve requirements differ by state, the actuary for a national insurer must compile, analyze and opine on 50 sets of laws, regulations and procedures. The bigger challenge, however, may be the introduction of the appointed actuary. This person is now personally liable for strict compliance with this difficult task.

Actually, since its inception in the 1940s, Section 2 of the standard valuation law has always had the wording which expresses the reciprocity spirit (i.e., acceptance of another state's valuation provided the other state will reciprocate). However, the wording regarding which state's "minimum standard" the state will accept is confusing and possibly in conflict with the reciprocity spirit. A technical reading of the SVL will mean that State A will accept State B's valuation only when that valuation is performed based on State A's minimum standard. This reading is inconsistent with reciprocity since states will only issue a certificate based on their own requirements, not another state's. In practice, the reciprocity spirit had been applied and commonly accepted.

However, the 1990 version of the SVL, coupled with the AOM regulation, made the spirit of reciprocity no longer applicable. Instead, compliance with each state's minimum standards, albeit in aggregate, is required.

What are the Challenges?

As I discussed this issue with other actuaries, I was amazed at how little actuaries know about the challenges. For those actuaries who are aware of the issues, four questions seemed to come up repeatedly:

1. Is there any one, definitive source for uncovering variations?
2. What are some variations we have uncovered?
3. How do the costs and the benefits of the variations match up?
4. Does anyone understand the risks being placed upon the appointed actuaries?

Source of Information -- How does a valuation actuary begin the task of complying with the aggregate minimum reserve requirement in all states where the company is licensed? First, the valuation actuary would need to know the reserve requirements applicable for each product line in those states. Second, to the extent that one product line does not meet the minimum reserve requirement, a further understanding of that state's aggregation requirements (i.e., whether aggregation across product lines is permitted) may be necessary. I will discuss this second point shortly.

In theory, to complete this task, the actuary should gather and thoroughly review all relevant valuation laws, regulations, bulletins, circular letters, guidelines, and so on, in each state. If you do that, you will end up with piles that will take over your office. But even if one actually plows through the piles, it's still not a trivial task to comply. As we all know, it is very difficult to interpret legislative language prescribed by our own state, not to mention other states.

As model laws and regulations are updated, some states still have older versions on their books, while others have newer versions, and each state may have incorporated its own variations before adoption.

Another area that presents problems is "tables approved by the commissioner" for various kinds of group coverage. While a company should have a very clear understanding of what tables its

domiciliary state has approved, it is unlikely to be aware of the agreements other states have reached with their domestic companies.

While most valuation requirements are spelled out in the laws and regulations, other interpretations may have been established by less formal means such as letters, bulletins, or private communications.

For example, some of these states have indicated that they meant to adopt the new laws and regulations, but just have not had the time or resources to do so. In some instances, they waive the old requirements in private. It is difficult for the valuation actuary to ascertain some of these unwritten requirements, particularly in a nondomiciliary state where the insurer may not have a direct relationship with the regulator. In other cases, some states have never adopted certain models, so there is no specific guidance at all.

In practice, instead of going through the laws and regulations directly, some actuaries have relied on various sources where summaries are provided for ease of review. A list of sources that you may refer to include the *Life and Health Valuation Law Manual*, the American Council of Life Insurance Valuation and Policy Form Compliance Service, Red Books and IN Source CD-ROM from WILS, and consulting firms. All of these sources have shortfalls. They are often incomplete, subject to errors, not updated on a timely basis, and do not provide enough detail to be used as a stand-alone resource. In fact, the Academy's *Life and Health Valuation Law Manual* explicitly states that it is subject to errors and should not be used as a substitute of laws. In fact, I have sampled a couple of valuation requirements by going through laws and comparing them with what's in the manual regulations and found that in both situations, should an actuary solely rely on the manual, he or she would fall short.

What Variations? -- My recent experience in going to actuary gatherings is to exchange "what have you heard recently" from the states or whether other companies have discovered yet another variation. Here I've listed some variations just to illustrate the complexities of today's compliance world, but by no means do I intend it to be a conclusive list:

1. Effective Dates

   Even when the valuation requirements are identical from state to state, they may be enacted in different years.

   One example is that some states adopted the dynamic maximum valuation interest rates for annuities as early as 1981, while others as late as 1985 (e.g., Arkansas and Oklahoma). This could lead to different minimum standards for annuities issued during this four-year period depending upon which enactment date is applicable.

   In practice, some actuaries (including regulators) seem to be comfortable complying with the effective dates stipulated by the state of domicile only, while complying with the other aspects of the valuation requirements from other states. However, the SVL and AOM imply that compliance with the year of adoption would be required.

2. Curtate versus Continuous Commissioners Annuity Reserve Valuation Method (CARVM)

   The NAIC model requires reserves to be calculated based on the maximum of the present values of benefits (net of surrender charges) as of the end of each policy year (i.e., curtate CARVM). Several states have taken a different interpretation of CARVM -- reserves calculated using the maximum present values of benefits on any day (i.e., continuous CARVM). Some states prefer the continuous approach method for all annuities, while others only refer to the approach for certain types of annuities, such as those where the policyholder can withdraw funds without incurring a surrender penalty for a limited period after the policy anniversary.

3. Universal Life Regulation

   California's universal life regulation for policies issued after 1991 is similar to the NAIC model, except that the valuation rate cannot exceed the guaranteed crediting rate in the contract. Alternatively, companies may opt to hold a reserve equal to the mean of the cash value and the fund value. Depending upon the contract design and the relationship of the fund value to the guaranteed minimum fund, this method may produce greater reserves than

the model regulation. However, California does not consider the interest rate restriction as a variation, but rather the correct interpretation of the NAIC model.

4. Variable Life Insurance (VLI) Regulation
Many states still have the 1983 version of the VLI regulation where the minimum guaranteed death benefits reserve for flexible premium plans is calculated quite differently from the 1989 version of the model. A handful of states have adopted the newer version, and several states still do not have any VLI regulation.

Somewhat related, on the variable annuity side, while the NAIC provides little guidance on how the minimum guaranteed death benefits should be reserved, a letter from Connecticut in 1994 has sent companies scrambling to comply.

5. Valuation of Life Insurance Policies Regulation (previously known as Guideline XXX)
Most differences between the model regulation and New York's Regulation 147 should be resolved if New York amends its regulation. However, California may enforce valuation requirements (Bulletin #74-11) for policies with nonlevel premiums, which could require reserve levels significantly different from XXX. Also, in light of recent publicity and the industry's concern, several insurance departments are grappling with whether this regulation is necessary and whether it benefits their consumers.

6. Minimum Reserve Standards for Individual Group and Health Insurance Regulation.
For group long-term disability (LTD), these variances include the effective date of 1987 Commissioners Group Disability Table (CGDT), the optional use of experience in years three through five (with approval), and the use of whole life interest rates or single premium immediate annuity (SPIA) interest rates less 100 basis points.

- Reinsurance: It is unclear whether the appointed actuary is opining that gross reserves meet minimum standards or whether reserves net of reinsurance do. One insurer strengthened a block of reserves so that his gross reserves met minimum

standards, only to cede that business to a reinsurer. However, if the actuary need only opine on net reserves, another question arises. If the reinsurer is authorized in the state of domicile, the ceding company used to be able to take credit for the portion of reserve that is ceded. Nowadays, however, if the reinsurer is not authorized in all 50 states, then how does the ceding valuation actuary opine that the net reserve is at least as great as the minimum requirements of all states?

- Aggregation Rules: Different interpretations of the word *aggregate* exist when taken in the context of the AOM ("...at least as great as the minimum aggregate amounts required by the state which this statement is filed"). Some valuation actuaries feel that it means aggregate at the company level, while others feel that the particular state's aggregation rules should be followed.

  For example, the state of New York requires that reserves be aggregated by certain major lines of business. Do valuation actuaries from foreign companies have to comply? If so, how many other states have defined, formally or informally, different aggregation requirements?
  As a related issue, some clauses of the SVL allow for categories to be established by the commissioner. Again, how many states have established restrictive categories?

- AOM language/table presentation: When adopting the AOM, many states have deviated from the model in terms of prescribed language, reserve table format, deadlines for extensions, and so on. Does a separate AOM need to be written for each state to capture these variations?

Costs versus Benefits. The costs, for the industry and states, associated with compliance to the formula reserves in all states are substantial and sometimes prohibitive. These costs will ultimately need to be passed on to the policyholders and contractholders. But whether these costs are justifiable to the policyholders given the marginal benefits derived from the whole exercise is the question.

For states, while it is theoretically possible for each state to audit, review, and enforce compliance for every licensed insurance company, the cost may well be disproportionate to the benefit. With budget cuts and changing administrations, regulators are often faced with too few resources to adequately review every company. It may be more beneficial for the policyholders if reserves underwent a thorough review by the domiciliary regulators.

For insurance companies, substantial resources are necessary to become familiar with the laws, regulations, circular letters, bulletins, and so on in the domiciliary state and to keep the knowledge up-to-date. To repeat this effort in all other licensed states becomes unbearable and prohibitive. Resources are also needed to perform multiple sets of reserve calculations and sometimes may mean a large systems effort. Since the valuation actuaries and their staffs are already inundated with completing the asset adequacy analysis, it can be particularly burdensome to require this same staff to spend even more time on state variations.

In addition to the resources needed, the reserves essentially need to be established on the most stringent formula basis of all licensed states. This level of reserves seems to be exceedingly conservative, raising the question of whether this requirement is too excessive for insurers in today's competitive financial world. Some insurers cannot afford to establish reserves at this level, forcing the actuaries to file multiple and/or qualified actuarial opinions.

This affordability issue is further compounded by the retroactive aspect of the SVL and AOM. If the actuary finds a requirement that is substantially different from his own state's, he or she may need to strengthen that block of business -- even if it has been in force for years. At the time the block was priced and issued, the actuary probably had only worried about his or her own state's requirements, not about all the other states.

From the regulator's view, the extraterritorial aspect of the law allows regulators to exercise control over a nondomiciliary insurer. Since the level of reserves, as a result of these requirements, tends to be high, the regulators can feel comfortable that the reserves are duly conservative.

From the insurer's view, the benefits derived from such an exercise are not obvious, particularly given that the valuation actuary is responsible for performing asset adequacy testing to assure that formula reserves are indeed sufficient to meet the company's promises. In fact, some actuaries argue that the "this state" requirement is inconsistent with the valuation actuary movement. This requirement may also seem to be contradictory to the NAIC accreditation effort, which is to ensure that key laws and regulations for each accredited state are "substantially similar."

The appointed/valuation actuaries are being asked to undertake the task of understanding 50 sets of laws, regulations, bulletins, letters, and then possibly computing reserves based on the most stringent of these requirements. I basically think this is an impossible task, but some actuaries think "impractical" may be more correct to say politically.

Despite the impracticality of this task and the scarcity of both human and financial resources, appointed actuaries are required to take on both professional and personal risks for any associated noncompliance. When approached, some states admitted that they do not have the resources to review foreign licensed states and that "best effort" from the appointed actuaries will suffice if they do review in the future. However, it is not clear what the definition of "best effort" is, and such wording does not appear in the SVL nor the AOM. Moreover, the regulators do not like to see "qualified" actuarial opinions that contain exculpatory language to reflect "best effort" (but not 100% guaranteed) compliance. To make matters worse, today's trend is for increasing, not decreasing, regulatory scrutiny, which subjects the appointed actuaries to greater risk.

At the same time, the Academy is requiring the appointed/valuation actuaries to comply with the Actuarial Standards of Practice. The Actuarial Board for Counseling and Discipline was also established to address any noncompliance issues.

Pressure on the appointed actuaries is coming from all directions. And the actuarial profession is still grappling with what all of this means in terms of its professional and personal liability.

What Seems to Be the Practice?

The industry's practice when dealing with state variations seems to vary quite a bit due to differences in:

- understanding and interpreting the laws, regulations, etc.
- cost and resource implications
- attitude towards compliance

The appointed actuary may approach his/her opinion in one of the following ways:

1. *One opinion.* The AOM Section 8B(6)(c) language is used for all states. This opinion can be derived by calculating reserves on the strongest of the reserve bases in all states. This may be performed by product lines or by the company as an aggregate. This approach is the strongest with the greatest potential for reserve redundancy.

2. *Two opinions.* The AOM language is used for those states that have adopted the newer SVL (30 states effective for the 1994 annual statement), and the less onerous opinion language contained in the instructions to the annual statements is used for those states that have not adopted the SVL. The valuation actuary may opine that the minimum valuation requirements of the state of domicile are met without any opinion (i.e., no calculation of reserve) regarding the valuation requirements in non-SVL states.

3. *Multiple opinions.* Reserves may be calculated on several bases and different opinions are filed in different states. For example, many insurers found themselves needing to file a separate opinion for New York.

4. *Qualified opinion.* The actuary may submit a "qualified" opinion. The degree of the qualification may vary from the use of exculpatory language, like "to the best of my knowledge," to explicitly stating that the reserves do not meet a particular state's valuation requirements.

Using "to the best of my knowledge" is probably the most prevalent practice, in conjunction with one, two, or multiple opinions. Some actuaries, jokingly I hope, expressed that they don't want to increase their knowledge base. I have to apologize if this session has increased your knowledge base in any way.

Alternative Resolutions

A good resolution should probably attempt to accomplish all of these things:

- give comfort to regulators that reasonable reserve levels are being established
- allow insurers to comply with those reserve requirements with confidence as to what the standards are
- keep the cost of regulatory oversight and cost of compliance within reasonable bounds
- let the valuation actuary concept work
- let the accreditation concept work.

Resolution A -- Each state would be permitted to rely upon the valuation standards of the insurer's domiciliary state, provided its laws and regulations are "substantially similar." If the domiciliary state's requirements are not substantially similar, the valuation standards would be based on the NAIC model, with some agreed upon set of effective dates.

This resolution is consistent with the "reciprocity" intent of the SVL Section 2 language. Furthermore, the NAIC model regulation requiring annual audited financial reports uses the same philosophy that exempts foreign/alien insurers from filing audited financial reports in another state if the requirements in the domiciliary states are deemed to be "substantially similar." Finally, this resolution is very consistent with the current accreditation effort that attempts to make the key laws and regulations of every accredited state "substantially similar."

This resolution would simplify the states' compliance activities since states' resources could be focused on a more thorough review of domestic companies' valuations.

There would be no need for insurers to research, compute, and establish the most stringent reserves to comply with variations in all states. Instead, they would be able to rely on their domicile state's requirements and the valuation actuary's responsibility to perform reserve adequacy tests.

One significant drawback of this resolution is that states would be conceding some of their valuation regulatory authority over foreign companies. In addition, the process of defining what is "substantially similar" can be contentious. One alternative is to substitute "substantial similar" with "accredited" so that each state can rely on the valuation performed by the domiciliary state if it is accredited. The drawback with this alternative is that some states are not accredited. This can possibly be resolved by using the NAIC model with some agreed upon effective dates, but this will obviously put pressure on those states to become accredited.

Resolution B -- Each state would be permitted to rely on the valuation standards of the insurer's domiciliary state, provided that the state certification identified the differences between that valuation and the NAIC models.

This resolution is very similar to the first proposed resolution, with many of the same pros and cons. It would, however, clearly and explicitly identify differences between the domiciliary state's requirements and the NAIC models. The accounting profession is currently undertaking a similar effort in the annual statement -- AICPA Standard of Practice (SOP) 94-1 "Inquiries of State Insurance Regulators" and Proposed SOP "Disclosures of Certain Matters in Financial Statements of Insurance Enterprises."

Resolution C -- Each state would allow the use of the effective dates of the domiciliary states, while continuing to require compliance with other aspects of each state's valuation requirements.

This a partial resolution, as compared to the previous two resolutions, which will eliminate some of the research and computation effort due to varying effective dates. In practice, some valuation actuaries are already working under this assumption, and the NAIC seems to endorse it, too.

The drawback is that it addresses only one aspect of state variations -- effective dates. Also, states would concede their right to control effective dates for foreign companies. This solution will not work neatly when the state of domicile has not adopted any version of a particular regulation.

Resolution D -- Each state would only require foreign and alien insurers to meet their minimum reserve standards prospectively, not retrospectively.

This resolution would eliminate the retroactive aspect of the current requirements. As a result, for those policies issued prior to the effective date of AOM and newer SVL, the insurer would only be required to meet its own state's minimum standards. However, those policies and contracts issued after the adoption of the newer SVL and AOM would be required to meet the aggregate reserve requirements in all licensed states.

For new business, this resolution will not be very beneficial since it continues to have all drawbacks associated with the state variation problem. Additionally, the effective dates of the SVL will be a complication.

Resolution E -- Each state would require compliance with its requirements only to the extent such requirements were documented in a central repository system.

A central repository system would be established to summarize each state's variations from the NAIC model laws, regulations, as well as any relevant circular letters, bulletins, interpretations, and guidelines. States would be responsible for keeping the system up-to-date (or at least verifying the accuracy of their information), and the valuation actuary would be required to comply with the NAIC models and those variations listed in the repository.

The system would establish a central source of information with clearly noted variations to help the states ascertain what valuation standards the actuaries are opining upon. It will help actuaries by reducing the burden of researching through multiple sources and by clearly identifying their compliance responsibilities.

The drawback of this system is that states will need to devote resources in comparing laws, regulations, and so on against the NAIC models and file variances with the repository. One state already admitted that this will be a very difficult task. Also, states may have different definitions of what constitutes a variance. The insurers still need to understand and comply with variations that may remain difficult. This difficulty may be further increased with "eleventh hour" updates from the states.

One open issue is who will be "in charge" of this system. The Academy is not interested in this type of responsibility, partly due to its experience in putting the *Life and Health Valuation Law Manual* together in the past and its difficulties in getting the regulators to reply to requests for updated state information. Another big issue is whether this system can really supersede the laws, regulations, and so on.

All of the preceding alternative resolutions will possibly require amendments to the NAIC SVL and AOM. Although, Frank Dino pointed out at the September 1995 NAIC meeting that maybe avoiding AOM alone is sufficient, which in turn needs to be adopted by each state. Since a "substantially similar" SVL and AOM is identified as key criterion to accreditation, it is expected that most states will review the amended NAIC model promptly and will likely follow the model, as well. The states, of course, retain their right to modify the NAIC model if they wish. Also, Larry Gorski from Illinois is currently working on amending the AOM for other purposes. The revision in state variation language can be incorporated. Although I think the timing is right, I also recognize that this process is likely to be time-consuming. A temporary resolution is needed.

Resolution F is to issue an actuarial guideline as a temporary stop-gap measure. It may incorporate some of the resolutions mentioned if they are not in conflict with the SVL or AOM. We hope it may limit actuaries' liability.

This "quick fix" solution would provide a "something" today to the serious compliance problems. In addition, it would act as a stepping stone to the eventual amendment of the NAIC model and each state's laws and regulations thereafter.

Depending on which of the above resolutions is incorporated, the pros associated with that resolution will also be applicable to the actuarial guideline.

The drawback is that the actuarial guideline can be, at best, an interim solution and the NAIC SVL and AOM will still need to be amended followed by the states' adoption. Furthermore, whether the actuarial guideline can differ from the laws and regulations is subject to debate.

What's Next?

The working group presented a report to the NAIC Life and Health Actuarial Task Force (LHATF) at the September meeting. The LHATF recognized the impracticality of following 50 sets of rules and agreed that a resolution is necessary. In fact, the LHATF suggested that both long-term solutions (involving amendments to the NAIC AOM) and short-term solutions (possibly an actuarial guideline) be researched. Although no specific direction was given regarding which of the preceding resolutions is preferred, the general consensus at the meeting seemed to be that relying on the domiciliary state's requirements would be acceptable as long as states retain some flexibility in setting extraterritorial requirements. The LHATF also felt that the states should clearly specify the extraterritorial requirements, and the NAIC, with the help of the states, should take responsibility for maintaining a complete and easy-to-use list of extraterritorial requirements.

The working group would like to report to the LHATF at the December 1995 meeting on specific recommendations, which would ideally incorporate your thoughts and ideas. The working group also encourages you to raise this issue with your regulators, colleagues, and other actuaries, thus increasing awareness of this issue and its consequences. Only with your support will the working group be able to move forward with resolutions that are sound for the actuarial profession.

MR. R. THOMAS HERGET: When I do my cash-flow testing and I start with an interim date, such as 9-30 or 10-31, I do roll it out to December 31. But I also roll it out to the date I deliver the opinion, the date I sign it. And I wonder if you think that might be an overkill.

MR. BUCK: I don't think it's overkill. I think if you can reconcile twenty days or so, that's good. If the appointed actuaries were relying upon a schedule of information based on December 31, and you wrote it up and there are significant differences, then the actuary has to think again, just what that means. Does the actuary have to make some changes? Does he or she have to change the opinion? It's possible. It's unlikely possible if you have a major investment change in that time period. But I think you want to be as current as possible with the information. That's not overkill.

FROM THE FLOOR: Is it your view that the reconciliation requirement is geared more toward the formula reserve part of the opinion, or the cash-flow testing part, or both?

MR. BUCK: It's an issue, again, I think to the formula reserve. It's also needed for the cash-flow testing. You're making projections and investment income in the cash-flow testing. You're using historic investment earnings as a guide to the future projections. If there's any sort of major disconnect between these two, I think that will come into play in your review of the cash-flow testing as well.

MR. GILBERT SCOTT FEIN: Could you comment on the industry practice for handling the situation where the AOM in the state domicile allows for Section 7 opinion and, therefore, no cash-flow testing. But the AOM in the state file, Alaska comes to mind, doesn't allow for any such exception.

MS. HWEI-CHUNG SHAO: Is there anybody in the audience who knows about that?

MR. ROBERT H. DREYER: You have to file Section 7.

MR. PETER P. WU: In practice, companies have to file different annual statements in different states because of the different requirements. In other words, are you going to file different annual statements in different states, but then use the reserve for the state of domicile for your other reports, like rating agencies or your company's annual report? I was just wondering what the practices are.

MS. HWEI-CHUNG SHAO: For rating agencies and outside, you only have one book, and that's your state of domicile book. So all these other opinions you file really are not the most commonly used set for the public.

MR. BUCK: Also, the audit tends to be subject to the laws of the state of domicile. The state of domicile tends to rule in that situation. I'd rather see you try to present the best possible picture to the rating agencies.

MR. MICHAEL L. KASTER: I guess the one alternative that you haven't mentioned is probably the most obvious. What would be a single source for financial standards, either federal standard or some federal authorization for the NAIC to act as a single source? Obviously, that doesn't appeal to the states, but, frankly, based on the kind of research you've been talking about, it seems like that would be a reasonable alternative to discuss.

MS. HWEI-CHUNG SHAO: Well, actually, that was mentioned at the NAIC meeting by regulators, that is, the very possibility of federal regulation, if something doesn't get done.

FROM THE FLOOR: As a profession, I think the auditing profession has been very successful in applying pressure where it thought it had the upper hand. Obviously, as a profession, actuaries tend to lie down and play dead in some of these matters, I believe.

MS. HWEI-CHUNG SHAO: I absolutely agree. I think the accountants are a lot more aware of the risks and understand the risks. They will not take on unnecessary risks. I think actuaries are kind of new in this area. I think the appointed actuary concept really has awakened some of the actuaries for the first time to the liability associated with their signature.

MR. MARTIN E. GOLDMAN: I guess I didn't hear any mention of the advantages of having one uniform standard of creating a level playing field for all the companies operating in a given state, whether they're domicile or not. You know, it's an important consideration.

MS. HWEI-CHUNG SHAO: But effectively, if that's what the NAIC wants to do with the repository, that's what's going to happen because it's going to force everybody to follow this book, and that would be the level playing field, wouldn't it?

FROM THE FLOOR: But only if you're operating in all states.

MS. HWEI-CHUNG SHAO: Oh, right. That's true.

MR. WAYNE E. STUENKEL: Just to follow up on that. The variation coming forward with XXX possibly will be adopted by half the states next year and not so in the other half of the states. The reserve differences for providing a ten- or 15-year guarantee product are huge. And having one central definition of what's going on would be very useful.

MS. HWEI-CHUNG SHAO: So what are we saying? I'm trying to gather what we should do from this point on. It sounds like everybody thinks there should be a level playing field, that it should be centralized.

FROM THE FLOOR: There should be.

MS. HWEI-CHUNG SHAO: Or what?

MR. STUENKEL: If my company's domiciled in a state that hasn't adopted the XXX regulation and somebody else has adopted, then I can write that business as long as I don't pop through risk-based capital problems in the other state. I can write the business that that company can't write. And that would be patently unfair.

FROM THE FLOOR: Just an observation. As it relates to risk-based capital, if you file one statement and use the most strict interpretation of any of the states for aggregate requirements in setting the reserves, you end up pinching surplus and also increasing your risk-based-capital

requirements. So, that may be the thing that triggers all of us to end up filing multiple statements and multiple opinions. That's a very practical possibility.

MR. BUCK: It depends on how structured you are in your risk-based capital calculations.

MR. DREYER: I'd like to suggest that the industry and the profession, and the regulators in particular are losing sight of the forest for the trees. The objective here is not the precise dotting of the i's and crossing of the t's in the formulas that put these reserves together, but the protection of the company and its policyholders from insolvency.

I'm from a small company, as Section 8 companies go. The first year, our domiciliary state did not require that we file a Section 8 opinion, but said it would accept the Section 8. I filed a Section 8 single opinion every place and had no problems. Nobody came back and said, you can't do this. And I'm wondering. I'd like to hear from some people who have had difficulties in giving a Section 8 and the state came back and said, you can't do this.