1998 VALUATION ACTUARY SYMPOSIUM PROCEEDINGS

SESSION 16IF

PRACTITIONER'S FORUM

Michael E. Mateja, Moderator

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Craig R. Raymond

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MR. MICHAEL E. MATEJA: I'm Mike Mateja, and I'm going to serve as moderator. The purpose of this session is to get you, the audience, to be heavy participants.

Craig Raymond from the Hartford Life and Powell Palmer from Berkshire Life are chief actuaries of their respective companies. They served as co-moderators of the Chief Actuaries Forum earlier this year. I came back with the idea that the valuation actuaries might profit from similar discussion. We ran a version of the Chief Actuary Open Forum at the 1997 Valuation Actuary Symposium. It was well received so I was asked to do it again.

Our goal in this session is to address issues of concern to senior or chief actuaries, with particular emphasis on actuarial issues that may be of concern to the management of the company. The operating plan is simple. One of the panelists will provide an opening remark or two about a particular subject and the other panelists will add their perspectives. Then I will throw it open to the audience. Craig is going to kick it off with the subject of risk management.

MR. CRAIG R. RAYMOND: Until I moderated a panel on risk management about three years ago I hadn't seen a panel on risk management at a Society meeting that was specifically focused on the new concepts of risk management and what it means. Since then, every one of these meetings have had panels talking about risk management. Risk management seems to be a big issue for everybody.

In some ways, it's disappointing to me that risk management is a big issue. It's coming from outside the actuarial profession from the problems that shot up throughout the business world from derivatives and consumer issues a few years back. Suddenly, the words "risk management" became a hot button for everybody. All the boards knew they had to be worried about risk management. Every CFO reads *CFO Magazine*, so they have to be worrying about risk management and how they are doing. As a result of this, it's become a big issue for most insurance companies whose biggest questions are, what is risk management and how is it done?

In a lot of ways, my reaction to risk management is that it's great to start focusing management on this idea because it's a major function of what the actuary does. When I took over my current position, I told my boss that one of the major roles I thought the chief actuary had was making sure that the senior management understands and has an identification and quantification of the risk basis of the company. That's the risk management function.

What surprised me over the last few years, though, is that companies are not always looking to the actuaries for risk management. Consultants are coming in from the banking world and other places, so the new concepts aren't necessarily actuarial. We could view this as a threat, but I see it as an opportunity. The sensitivity has been raised to the idea that risk management is important. To do it right for an insurance company, actuarial involvement and understanding is necessary. Management wants to hear it, the board wants to hear it, and outside agencies want to hear what you're thinking about it. It's a great opportunity for the actuaries to step up and show that they can add this value.

I know there has been discussion at risk management sessions about the concepts from the outside world that are attached to risk management, such as value-at-risk. In my personal opinion, I don't like the idea of value-at-risk. However, understanding what it is and its strengths and weaknesses is important because people are coming to us about it. People from the finance and banking side are coming to the insurance industry, and they're used to what they've been seeing. We need to understand these tools to determine how actuaries can make an impact. How can we take these types of tools and apply them to the insurance business? Instead of just letting somebody else do it, or sitting on the side and saying, "That just doesn't work for insurance. Do it my way." That's not the right answer.

If we embrace what's going on, understand it, and show how the actuarial function can add to this and provide information, it's an important thing.

MR. HOWELL M. PALMER III: That's true. Over the last couple of years, we've tried to make our basic asset/liability management (ALM) models more sophisticated than they used to be. I've always felt that those models were at the core of providing good decision models for the company.

We've taken the ALM models and, in conjunction with some segmentation work, separated the company into the major business lines that we're in. We've added new business models to those models and ended up with a capability for modeling the entire enterprise, separately, on our in-force and new business, and combined, looking at the whole company.

We're beginning to use these in a number of different ways. First of all, it's a good starting point for assessing the underlying risk the company is taking. You can quantify your risks, stress test specific categories of risk, and get a better understanding of the key drivers of risk within your organization. Once you understand what those risks are, you will better be able to monitor them going forward. For example, if you have a product line that is very sensitive to lapse rate changes, then somebody should be carefully monitoring the persistency of that particular line of business.

We are using these not only to assess our overall risk levels and sensitivity to changes, but also as decision-making models for the company. This is a critical part of running the business. Other professionals think they can do this, but I'd be very disappointed if the actuarial profession doesn't continue to step up to the plate and make its presence known on these kinds of issues. I don't see anybody else who truly understands the enterprise-wide risks that organizations are taking.

The subject of risk management is critical to the company. The actuary, and the valuation actuary, in particular, is right in the middle of this kind of work. This is an enormous opportunity for the actuary to have a very favorable impact not only on risk management, but also on those who manage some of your business units.

MR. MATEJA: It's fundamental to managers to be able to measure whatever it is that they want to manage. One measures profits, for instance, in order to manage profits. So the whole concept of managing risk has, as a prerequisite, some type of measurement or quantification device. The quantification of risk seems to be at the heart of what actuaries are doing.

The second perspective is an historical one and goes back to when I was signing an actuarial opinion. The last opinion I signed was about seven years ago. When I look at that seven-year-period, I wonder if we're not kidding ourselves about the concept of risk management. The world has gone through some dramatic change during this period. We haven't been testing for anything approaching the reality of the last 10 or 15 years. What we've experienced is an extreme scenario, compared with what I would say was expected. I don't know what that means in the context of risk management, but it deserves some reflection.

MR. ROBERT A. MEILANDER: What do you think would be the characteristics of a good risk management report for senior management and the board?

MR. RAYMOND: I've found it difficult to boil it down to a simple report. I'd like to see management get a full understanding of the wide range of risk.

One of the things we're working on is a process where we make presentations to management about various risk issues that are facing us on a regular basis. In many ways, that is a better educational process than doing a monthly report identifying the cost if mortality fluctuations. With the latter, they look at a bunch of numbers and pass it on.

I like to think about what things can happen that will significantly affect the company. What are some bad scenarios? What are some of the issues? What are the exposures if interest rates keep going down? This is a big issue. We've done a couple of presentations earlier this year at our company about it, and, as we watch interest rates every day, we start to think about it more seriously.

MR. MATEJA: Who's accountable for something like that? There were two points that I made earlier. First, you have to quantify a risk in order to manage it. Second, someone has to be accountable. If financial performance is measured partly in terms of your ability to manage lapse risk, who's responsible when lapse risk manifests itself?

MR. RAYMOND: I think that the two go together. I see actuaries identifying risks and making sure people understand them. Then, as part of this process, we look at what happens if interest rates get to certain levels. Not that any of us could imagine it, but what would happen if interest rates fall as low as they are, say, today?

MR. PALMER: That could never happen, and it's very easy to convince yourself that such a scenario is not going to be devastating to a company because you have many ways to manage it.

MR. RAYMOND: That goes along with identifying the risk. We should say, "For each of my businesses, here are the ways I can manage risk and control it." Then make sure that you understand who is responsible for these actions when it happens.

Rates have dropped to a level that we never expected. We had to go back to the people in the lines, who had control over those issues to ensure that they're following through on the commitments they made about managing these risks. A key point of managing is to have accountable people making operating decisions.

MR. PALMER: We've had better luck demonstrating the impact of interest rate risk to our senior management and to our board. We created some nice graphs and charts that show what happens to capital formation over various time periods, what happens when you throw in new business, and what happens when rates get as low as they are or lower. So I think we've done a good job of simplifying what is obviously an enormous amount of information.

Where I don't think we've done as good a job is on the other drivers of risk. It's a little easier to determine who's responsible for the asset/liability relationship as opposed to who's responsible for persistency. We are all responsible for persistency, but that doesn't help answer the question. For some of these drivers of profitability and risk, it's very hard to nail down whose job it is to manage.

MR. RAYMOND: You can get to that point where you can say, "This person is accountable for this risk." Then you need to take the next step by saying, "For something like persistency, here are the ways I can manage it." Finally, make sure that somebody is accountable for each of those checkpoints.

MS. KIMBERLY M. CURLEY: Does your definition of risk management also include litigation risk? The environment we're in now, especially with low interest rates, has exposed companies that were illustrating vanishing premium policies eight years ago. Financial performance of these policies is much lower than what policyholders saw in illustrations when the policies were purchased.

MR. PALMER: I spend a lot of time worrying about the risks that I haven't thought of yet. Litigation risk isn't a risk that any of us were worried about 10 years ago, except perhaps in a very narrow sense at the case level.

Litigation risk is a much bigger issue at the policyholder level than it used to be, and it's certainly a much bigger issue at the corporate level. Any time you have a product that might not live up to customer expectations, you have litigation exposure. Anybody who doesn't think he or she has a litigation risk isn't worrying about enough things.

MR. MATEJA: Things like litigation risk, or even market conduct risk on a more global scale, are the focus of risk management. It's the blind side. If you're in the life insurance business, you know by definition that an epidemic is bad. Epidemics have happened in the past, and insurance companies have suffered high losses. There still are many people worried about this risk, with good reason.

Do any of you remember the Asian Flu epidemic? It really wasn't an epidemic, but it certainly was a scare. I did some risk analysis work years ago and talked to some of the folks at the Centers for Disease Control in Atlanta. When you talk to the experts in this area, you quickly develop a lot of respect for the risk of epidemics.

I'd be interested in whether there's any experience represented here in making presentations to the board. I know members of the panel have made them, but is that happening in other companies, and are actuaries a part of it? How many companies are involved in risk management in a more or less formal manner? It looks like just a couple. I find that surprising. Maybe that's a cue to move on to something else at this point.

FROM THE FLOOR: When you talk about risk management, is it a discipline or a tool? The value-at-risk that is prevalent now in the banks is almost a science or tool. What we've been doing as actuaries for quite a few years is more of a discipline than a tool. It's not one tool. There's not a single software package that can provide you with all the answers, which is what I think value-at-risk is. We're viewing it as a management discipline. But I don't know whether we're creating a tool or software, so to speak.

MR. RAYMOND: I think you're right. In many ways, that's the opportunity for actuaries because, if you ask them whether they do risk management, most are going to say yes. The opportunity lies in the fact that when your board, your senior management, and others looking in from the outside think of risk management, they think of tools that others use. If you're not using those tools, they don't necessarily see that you're performing a function. Many managements do not see the things that actuaries are doing as meeting this new idea of risk management. You're exactly right. It's a process. It's a discipline. It's a matter of communicating it in a way that people understand it. That's what we're doing—providing that information.

MR. PALMER: The insight that you can give to your key audiences is enormous, and they immediately start asking the next level of questions, the ones you might not quite be ready to answer yet. But there's a tremendous amount of insight that can be given. This is an evolving process. You work to get to a certain point and then, as soon as you get there, you see the next 50 things that you can do.

MR. MATEJA: This is also related to the changes in the higher levels of management in insurance companies and their boards. There was a time when the management of life insurance companies came from the insurance ranks. Senior managers knew the insurance business because they rose up through the ranks. They didn't need someone to explain risk management to them. Historically, management understood the life insurance company as a risk manager as well as how the basic insurance risks were managed. That's not necessarily true today.

I think another unique aspect of the insurance industry today is that the nature of the risks companies have been assuming recently is far beyond what it was back in the 1950s or 1960s.

We're doing a lot of different things today. Companies in general, the managements of the companies, and certainly the boards do not have a full appreciation of the risks that are assumed. That's why we have the current focus on risk management. As I said, you can't manage a risk until you understand and quantify it. Getting people at the board level to understand risk is the quickest way to make sure it's effectively managed.

Howell is going to lead us into the next issue, which is capital management. In most companies, capital management is one of the critical issues of the day, and we're going to look at how actuaries contribute to that. Risk and capital, of course, are closely related.

MR. PALMER: Capital management is a subset of risk management. The amount of capital your company has in aggregate needs to be a function of the risks that the enterprise is taking on. Needless to say, it's critical that you understand the risks you are taking, where the key sensitivities are, and the interaction of those risks. Many of these risks are offsetting in some ways.

The total level of capital is also a function of the company's and senior management's tolerance for risk. If the CEO is lying awake at night worrying about how much surplus you have, that might indicate you don't have quite enough of it. I would like the CEO to sleep well, so we try to have enough capital. In addition to the overall level of capital, you must be concerned with the volatility of your earnings.

You need to understand where your capital is coming from. In a mutual company, capital is coming fundamentally from internally generated sources. Stock companies have additional sources of external capital. You need to understand what kind of returns you're getting on your capital. If you get returns that are too low, you'd better do something about it because your audiences or your clients, whether they're rating agencies or Wall Street, will penalize you. Similarly, if you have too much capital and you're not making good use of it, there's a price to be paid for that also.

One of the things we do in terms of trying to assess our capital needs, in aggregate and by product line, is to work off of the NAIC's risk-based capital formulas. Many companies have their own internal formula for capital, but aren't at that point yet, so we work off of a multiple of the NAIC's formula. We also go through all the rating agency formulas and look at their capital requirements. You'll find that the rating agencies do not have all the same view of capital adequacy. We do try to monitor capital requirements in terms of how rating agencies will view us, but it is not possible to make them all happy unless you have an excess of surplus.

Once you get an overall level of capital, you have to find a way to allocate it by line of business, by product line, or wherever your key businesses are. As a mutual, we have distribution of surplus issues, and you can't adequately get to the question of what your total dividend payout should be until you have figured out whether you have enough capital currently and for the future. Therefore, capital adequacy and dividend distribution are interrelated subjects.

One of the hot topics today is the issue of mutual companies changing their form to a mutual holding company by demutualizing. There are concerns about whether they have enough capital for the long-term, and a number of them are looking for ways to access external capital. Assessing long-term capital needs is a critical issue for mutuals as they deal with their basic strategic direction.

MR. RAYMOND: I agree with just about everything that was said. It's interesting, though, that every time we bring this subject up, it ends up in a long discussion. Howell started by saying he sees capital management as a subset of risk management, and I agree with him. But capital management is an immense issue in itself.

Mike wanted us to talk about things that keep us awake at night. Capital management is clearly one of them. I work in a corporate role, and capital management is one of the key drivers of how we do our business.

I think of capital as being in two big buckets. One is, how much do I need? And the other is how do I control and manage how much I have? Both of those are pretty big jobs. We look at how much capital we need based on a group of internal measures.

We have had internal capital standards since well before I joined the company. We used to have the luxury of being able to get together as a group of actuaries and determine, based on our analysis of the risk to the business, how much capital we thought we needed to set aside. That number always came out to be much more than anybody ever told us we needed, so we would make sure that we had that much and go on our happy way.

The world has changed in the last five years or so to the point where the amount that we think we need is nowhere near what people from the outside are telling us they expect us to have. So we do a lot of analysis around the outside world constraints, which are probably the most constraining elements as far as how much capital we need, such as what the rating agencies are telling us we need to maintain our ratings.

Part of the risk/capital management function is talking to your management about the cost of having that extra capital, making people think about the implications of rating changes, making accurate capital decisions, and showing how that relates to the ratings. It would be devastating to lose those ratings, but it's an interesting exercise to make people think about what would happen in that scenario. How much more efficient can I make my operation? How much could I reduce my cost if I didn't have to have all this capital? What would be the implications of that? Could I add value by having more or less capital?

MR. MATEJA: When you get into the challenge of financially managing a life insurance company, capital management ranks way up there as one of the things you worry about. Most CEOs of companies would like to succeed, and they have figured out that they can't unless they have the capital to keep the company going. When they turn over the ship to their successors, they would like to say that it's a stronger company and more vibrant than when they started.

In the two companies represented on this panel, you have an actuarial presence in that process that is appropriate and significant. There was a time when actuaries were not holding their own in this regard. As I see it, capital management goes beyond a simple accounting perspective.

I'd be interested now in what others are doing and whether there is actuarial input into the capital management process.

MR. RAYMOND: I had an interesting experience. A few years ago, we were going through a very fast growth period when capital was a very significant issue to us. The importance of actuarial involvement in capital management became clear when we were assessing where capital comes from and how much we could expect to have. It was made very clear to the rest of management that, because the actuaries control the biggest numbers on the balance sheet, our ability to assist in managing the level of capital was very strong.

However, when you try to work on capital, it becomes a very difficult issue.

MR. MATEJA: Did you have a model in place to do that?

MR. RAYMOND: We did a number of different things. We did some modeling work plus many other techniques and approaches to make capital usage, products and reinsurance structures more efficient in order to free up capital and minimize the use of capital. These are things actuaries can have a great deal of control over. And they are difficult for other disciplines to control and manage.

MR. STEPHEN P. BLASKE: I wanted to pursue your comment on the rating agency requirements versus the internal company requirements a little further. How would you bring that over to a business unit allocation? Almost every company probably feels it needs less capital than the rating agencies require and only wants to keep what is needed to meet those requirements.

Do you pass this on to the business units as you allocate capital to them to determine returns, etc.? Or do you try to bridge that and hold it in a corporate level also as opposed to making the business units "pay" for the ratings? Obviously, the business units don't like having to get the extra capital to make the rating requirements, yet the company needs it to keep production up and so forth.

MR. RAYMOND: You have to start from the point that there's a business reason to maintain those ratings. If one of your lines of business says, "I don't need those ratings," then you don't need the capital?

There are two points of view here. I have been through arguments where one line of business needs the ratings, and another one doesn't. The approach we have taken is that we've made a corporate decision based on the valuations of all the needs of the different businesses. The rating level needs to be maintained, so paying for that capital is a cost of being part of our organization.

I don't know how you can ignore this. If capital is a constraining item in your operation, it's very important that you recognize it and make sure that each of your business operations is paying for the cost of the incremental capital it uses. If you want the units to be managed for the good of all operations, this is necessary.

We do not use rating agency allocations. We determine the aggregate level of capital that we need in the company on the basis of many items, including ratings needs. We combined our evaluation of risk with various outside views of risk to determine how to allocate capital.

MR. MATEJA: Do you allocate only the capital that you have?

MR. RAYMOND: We have formulas that allocate a number. Sometimes actual is more and sometimes it's less than allocated capital. We don't automatically make it exactly the capital that we have.

MR. MATEJA: The reason I ask is that when the question was asked, I couldn't help but think about when I was reflecting on this very issue years ago. Allocating more or less capital than actually held presents a unique problem. If you have $100 million of capital in your company and you want a return of X%, somebody has to be accountable for each piece of the capital and deliver the target of X. Otherwise, you have a guaranteed shortfall to the extent that the unallocated piece is going to get an after-tax investment return. Practically, there's no value-added from the business point of view. So you're guaranteed to come up short of the target.

MR. PALMER: We also allocate all of our surplus out to the lines and pass on the higher capital requirements needed to maintain good ratings. It's the price each line pays to be part of the enterprise. The company needs favorable ratings. A specific product line might not be in a rating sensitive business today, but it might be a year from now. Our company and probably most others are holding more capital than they would otherwise if it wasn't for the rating agency capital requirements.

MR. MATEJA: One of the things that always troubled me about capital management is that if you go back to the earliest years that you have business on the books, different cohorts of business were priced with different return expectations. So the returns that you are achieving at a particular point in time represent some amalgamation or weighted average of all of the returns on the different cohorts of business written in the past.

MR. MATEJA: It is not possible, from a practical standpoint, to alter the returns on the company's book of business dramatically because that existing book of business is priced and has a finite return associated with it. You can influence returns through expense management, but the pricing mechanism is going to limit what can be done in this regard. I don't know how well this is understood in most companies. If you really want to influence the returns on capital, this is a gradual process that takes a lot of discipline.

MR. RAYMOND: A wonderful tool for this is a value-added or a shareholder-value model. You're exactly right: When you focus on a return on equity (ROE), you miss the point that adding value and incrementally adding returns above your target don't necessarily show up appropriately when you look at the aggregate return on a block of business.

Here are two examples. I worked with one of our lines of business that we brought from a very low return to a double-digit return. An easy perspective to take when you look at that is, "Maybe it's double-digit, but it's still not where you want it to be." If you turn that around and look at the value-added of that type of operation, even with a much higher hurdle, you can see that you're adding significant additional value. Everything you're doing—all the actions and all the additional business you're adding—is adding to that return. Incrementally, it's adding an acceptable return to the business and value.

We had another line that dropped from a 22% return to an 18% return in a couple of years. Just looking at ROE, you might say, "That's great. Everything is going well." But in dropping from 22% to 18%, you might have incrementally destroyed a lot of value in that business. Being able to look at an economic value-added model can give you the kind of insight to measure the management decisions you're making incrementally. It is something to get people thinking and gives you a much better picture.

MR. MATEJA: Having listened to the discussion of the first two subjects, it's apparent that there's a role for actuaries in the management process. Risk management and capital management are high-profile activities in a life insurance company. It's clear, at least in some companies, that actuaries are contributing significantly to these elements of the management process.

On the other end of the spectrum, we have actuaries fulfilling what I would call regulatory mandated roles, including the role of valuation actuary, which brings us all together here. There's also an illustration actuary regulatory requirement now and proposals for a dynamic financial condition opinion similar to that of the valuation actuary. So, on the one hand, you have the position of the actuary as a contributor or a participant in the management process and, on the other, you have the actuary fulfilling regulatory mandates in what I characterize as a watchdog role.

Those of you who have reflected on this probably have figured out the same thing we have: The more interesting job is being an integral part of management and providing actuarial input to the management process. I would be interested in hearing your thoughts on this general subject.

MR. PALMER: Many elements of our jobs are regulatory in nature, for example, when we're making sure that companies are in compliance with valuation or illustration issues. Those are important and necessary functions that must be performed within a company. I'm concerned, though, that in many companies, that's all the actuaries are doing, and that's all that the management is looking for from the actuary. This is an extremely narrow and limited role.

The CEO expects you to be in compliance. It's a minimal level of performance. So you do all this work and say, "I have some great news. We're in compliance." Big deal! Tell me something I can use to run the business. Going back to some things that we were talking about earlier, I think it's critical, having done the work that goes into the valuation, that we take the next step toward making it a decision-making tool to help advise CEOs, boards, and top management. That's where the profession and we, individually, can make a much bigger contribution to our companies.

Let's examine the role I have in my organization, which is not an unusual situation. Three or four years ago, I was operating in a functional environment. I spent about 20% of my time advising management, and 80% being an actuary. Now I spend at least 80% of my time working with the CEO and top management on strategic issues, which is what I should be doing, and a lot less time in functional work.

That same thing has happened to people who work for me. They have shifted the emphasis on what they're doing. We used to spend a tremendous amount of time performing the valuation actuary function. We have become much more efficient at it and spend a tremendous amount of time using the work that went into the basic valuation work to help make business decisions. That's a very different role for the actuary in many organizations, and I think that's where we can make a huge difference in our companies, and it is a lot more interesting. We did all the work; now let's do something interesting with it.

MR. RAYMOND: I'd just like to add two quick comments. I agree wholeheartedly with Howell's comments as far as the role to play. I have told a number of people the story about when I took over as my company's appointed actuary. One of the first things I did was sit down with the president of our company to talk about my new role. He pulled out a copy of our valuation actuary opinion which was a small book. It was a beautiful piece of work that took an immense amount of effort. He put it down in front of me and said, "What do I need to know that's in here?" I picked it up, threw it in the garbage, and said, "That doesn't tell you what you need to know." Then we spent the next hour talking about what we should be doing with the work that went into that report to make it meaningful management information.

The document was geared purely toward telling the regulators that we did what we were supposed to. Unfortunately, that's what most appointed actuary work has been. The trick is to take it to the next step by turning it into useful management information. The package that meets your regulatory requirements isn't structured to give managers information they can make sense of and do something with. We spent a lot of time trying to turn that process into something that can be meaningful.

The other comment I have is, think about your role as an actuary and as a member of the management team separately. I found lately that talking to lawyers can be a very interesting experience. As a profession, we don't do a very good job of separating our roles and of providing management advice. Lawyers understand this line very well. When they have their lawyer hats on, it's their duty and obligation to provide legal advice. When they step into their role as part of a management team, they say, "Let's, as a team, decide what we need to do."

This is an important perspective for actuaries to keep in mind. You're not losing that professional independence by becoming part of a management team. Do your job as a professional by providing good, clean, clear, and sound actuarial advice, and communicate in a way that people understand they're getting complete professional actuarial advice. Then play your role as part of the management team to take that advice into the context of whatever else is happening to make management decisions.

MR. MATEJA: I would characterize all of this as adding value in an organizational sense. If actuaries are adding value in the truest sense of what that means, sophisticated management will recognize it. I'm interested in how many of you are adding value in your organizations in this context. Can you share that with us?

MR. JOHN D. MURRAY: We're an unique organization in that we have no corporate actuarial staff. It's strategic business unit (SBU) driven, yet the CEO and a number of the SBU heads are actuaries. I'm the financial officer for one of the SBUs, which is 80% of my job. Forty percent of my job is being the company's appointed actuary.

A concern I have is that, as a profession, we may have sold ourselves down the road because the appointed actuary reporting is an awful lot of work for not much payback. I have a lot of dialogue with state insurance departments if our filings are too skimpy. I don't know if that's good news or bad news. And I question the usefulness of it.

Here are two examples. In our pension SBU, we've done sophisticated ALM for years, and the appointed actuary work becomes a by-product of that. We use the basic ALM work to do all of the risk analysis for our studies. I don't want to say it's a nuisance, but we don't get much value out of it.

On the individual side of the business, we do not have much long-term guarantee business, but we do have a lot of renewable interest rate business. It's not quite as interest-sensitive and has not had an extensive ALM process, but now they've had to put one in to satisfy the appointed actuary, and they're building this risk analysis. The end result can go either way. I still think we've built a pretty big mousetrap here and that are liable to get caught.

MR. RAYMOND: If I were going to build management information, it wouldn't be centered around the valuation actuary work. I'd start from the point of view that I have to do this, and it will take a lot of work to do it. Therefore, I'd make sure it's surrounded by a process to transform it into good information. This addresses much of what you're saying. Unfortunately, we tend to put an immense amount of effort into doing something that isn't providing good management information.

MR. PALMER: We tried to evolve the regulatory work into something useful, but three years ago we ended up throwing everything out and starting over again. We started with the ALM work and modeling, and we built the business models into it. The regulatory work was a by-product of the overall business models.

MR. MATEJA: The panel has described a lot of the work that goes on in life insurance companies to produce management information. No one, however, has mentioned the Statutory Annual Statement, which is a regulatory mandate. A lot of work is required to produce that each year and there also are some quarterly filings required. To what extent is the statutory statement a useful management document in terms of running the company? From my perspective, it's not very useful, or at least I'm not aware that it is.

I look at the valuation actuary report in much the same manner. From a management standpoint, it doesn't add much value. You have to go one step beyond regulatory requirements to get useful management information. If actuaries aren't doing that, they're missing out on an opportunity.

MR. RAYMOND: The *Blue Book* by itself is not a very useful document, but it has an immense amount of information. I think the valuation actuary report is a similar document.

FROM THE FLOOR: If the actuary views his work or her work as merely compliance, I can guarantee that senior management is going to try to minimize that because compliance function on its own doesn't really add value. As Mike said, "We're in compliance. That's a basic function. Let's go on with business."

MR. PALMER: There's no question that the role ought to be taken seriously. Management recognizes that it has to be compliant and views a lot of the work that has been assigned to us by regulators as a necessary evil. It's just part of the cost of being in business. I don't happen to want to be a necessary evil that's the cost of being in business, and I don't want anybody that works for me to be in that position. So it's critical to go beyond the regulatory level of work. Otherwise, we're going to be relegated to the back burner when it comes to participating in critical management decisions.

MR. MATEJA: We're going to move on to another topic, which will be valuation. Craig, you're going to lead off.

MR. RAYMOND: Bob Wilcox and others are going to be participating to discuss the unified valuation system work that has been going on as a result of a request from the NAIC. This was initiated by an Academy Task Force that has been taking a totally fresh approach to valuation.

Rather than talk in detail about what they're doing, I want to put some context around what I see going on at the regulatory level. I see what's being said about valuation as a reaction to the world today. In our industry, there's a developing recognition by many people, including a number of regulators, that our industry is changing. The financial services industry is changing, and our business is moving very quickly. New products, new issues, and new concerns crop up constantly. We must deal with a regulatory system that is very rule-based, constraining, and inflexible.

To keep up with that change and maintain a vibrant industry going forward, we need a much more flexible, and responsive regulatory structure.

There has been a great deal of discussion about looking at disclosure, nonforfeiture rules, and valuation rules from a fresh perspective. When you put all that together, I see a different approach to regulation, one that moves from being very inflexible and rule-based to being much more flexible, conceptual, and based on clear disclosure to policyholders. The regulatory rile will be to ensure that the deal or the commitments companies arc making to the policyholders is clearly understood, and that the policyholders understand what they're buying.

The company's role will be to ensure that professionals are standing behind the work. In particular, actuary professionals are essential from a valuation point of view. And that's a significant issue being looked at with a new valuation system: Regulation that is much more based on a conceptual framework, with an actuary giving a professional opinion on the appropriateness of the reserve and capital levels in the company.

It's a very significant change in the mindset from a regulatory point of view. What is disturbing to some regulators, company people, and actuaries is liability and commitment you're making when putting a professional opinion behind something like this. But this is what's driving these discussions, and it's a big step forward. It's going to take a long time to see any major change in the structure. But there's a lot of concern over the ability of the current regulatory environment to keep up with the changes going on in the industry.

Many of you have seen the efforts that went into setting up a regulatory structure to handle equity-indexed products. There was an immense effort from a great number of people at the Academy working with a group of regulators to put together nonforfeiture, valuation and disclosure rules for equity-indexed products.

These are just a few products that are out and will be coming out. Everyone wants to make sure that we don't have to do this fire drill every time somebody comes up with a new idea. We need a framework to put new products in. We don't need rules that deal with each specific issue.

I've been impressed with the number of regulators who are willing to step back and think about things from a different point of view and imagine what this new world could look like. It's going to be a long time before we get to a new world that is more flexible and less rule-based, but the proposed valuation structure is a major step in that direction.

MR. PALMER: There's no question that the financial services business is changing at a phenomenal rate. To expect a regulatory environment that is not too much different than it was 50 or 75 years ago to work in this environment is absurd. The real challenge is making the transition because regulators need to be comfortable enough that we're going to set appropriate reserve levels or nonforfeiture values for our clients.

That's a significant issue for them, and it better be for us as well. We may find ourselves in a position where we control (much more so than today) the reserve levels and, therefore, the levels of capital and profitability of our organizations. That's a different kind of job than we have now. But we would have some comfort in knowing that there's a cookbook somewhere that says, "This is how to calculate reserves." And no one can blame me for using the cookbook because that's what I have to do. If we don't have a cookbook, it will be our responsibility to determine the level of reserves. Even though we still have that responsibility now, this is very different. We had better make sure we're ready for it when the regulators are ready for it.

MR. MATEJA: I have my two-cents worth. If you are frequent attendees of these sessions, you might remember me talking about risk-based reserves. There is an assumption made in valuation standards as they exist today that all life insurers are risk look-alikes, which I claim is nonsense.

We did some analysis a couple of years ago when I was trying to add some dimension to the issue of risk-based reserves. We took average individual life mortality and tried to determine the margin in the valuation standard relative to average mortality. Then, given that this margin produces an adequate reserve, we tried to determine what level of valuation reserve you would need for a preferred underwriting book of business. The goal was to have the same degree of conservatism in the reserve for the preferred business as for the business that produces average mortality. I can't remember the specific results, but I do remember that the difference was material. It was of the magnitude of a 15% price reduction that you could make on your preferred book of business, assuming that you could hold the lower reserve reflecting the mortality risk associated with the preferred business.

The bottom line is clear: Valuation is at the heart of the life insurance business. The biggest numbers in the balance sheet are the actuarial reserves. And if they're redundant, it artificially drives up the cost of our products. So valuation is a very important subject at a management level, and, at a conceptual level, as we start competing in a broader financial marketplace.

FROM THE FLOOR: I want to comment about the valuation actuary not having a cookbook anymore. In Canada and in Australia, they don't have a cookbook. The absence of one creates enormous responsibilities because the valuation reserve will affect the profitability and, hence, the competitiveness of the product. This is particularly true versus the bank products that they try to make out to do something similar to a life insurance product or an annuity product. If our reserving standards are higher or maybe more realistic than their reserving or surplus standards, then they will have an unfair competitive advantage.

MR. PALMER: The actuary in Canada has a very different role than what we have here in the United States.

MR. CRAIG D. KRONLUND: I have a comment about the cookbook approach to statutory reserves. It appears to me that statutory reserves, although they have a cookbook element to them, are not a cookbook. There are product implications that certain actuaries might view as requiring reserves and other actuaries do not view as requiring reserves. Triple X, for example, came about as a result of trying to deal with some of the secondary guarantee issues.

You might think about unitary reserves, and whether you're using them or not. Others might be thinking about using variable products as a place to otherwise create a variety of guarantees to the public; these products don't have nearly the specificity associated with more traditional term products.

MR. PALMER: Term product valuation is an interesting issue that illustrates where we are today. Actuaries can have very significant differences of opinion about what adequate reserve levels should be for term products with long-term guarantees.

Imagine working in a company that has a conservative actuary who says, "We need reserves that are this big. We can't offer a 30-year guarantee." Then you have another company across the street that has a different view, and its premiums are dramatically lower. Now, either as a pricing actuary or as a valuation actuary, you've just taken your company out of a market.

MR. RAYMOND: The underlying issue here is the fact that we have a regulatory structure built around the idea that we have a cookbook. Our current environment makes it virtually impossible to keep this cookbook up to date enough to be useful. This is the centerpiece of what we need to change. The fact that it's taken us about eight years to develop it illustrates that this approach won't work.

I had a discussion last night with four other senior actuaries about the new Triple X, questioning whether the reserves that result from that are still too conservative. Two of them said they were, and I said, No, they're not. From the perspective of how I have to calculate statutory reserves in general, the majority of them are just as overly conservative as the reserves required by the new Triple X. Other companies might be even more conservative than that."

We don't have a system that says, "Here is the appropriate level of conservatism to be in this reserve. Here is the appropriate level to evaluate this by." We have a bunch of rules. We do not have a way to answer the following questions: "Is this the right level of conservativeness?" "Is this appropriately big?" "Is it appropriately small when you look at statutory reserves?" That's the real reason it needs to be changed.

MR. PALMER: It's incumbent upon the profession to prepare actuaries to operate effectively in that environment so we don't feel as if we're taking our companies in and out of markets or dramatically altering profits and capital levels.

MR. MATEJA: One of our goals was to talk about actuarial issues of concern to management. This is obviously a key one. For risk-taking institutions, there does not appear to be a quid pro quo regarding risk. For example, if I decide to be a risk-adverse insurer while my competitor across the street is the ultimate risk taker, the valuation standards treat us the same. Then, the valuation actuary sits on top of the issue to opine after cash-flow testing analysis about whether one of the insurers has to hold more reserves.

FROM THE FLOOR: I agree with your cookbook comments. It's a comfort to me, as an appointed actuary of my company, to know that I have a cookbook to go by, but it's more important to know that everybody else out there is operating by the same cookbook.

I realize that there are also significant variations in the quality of regulatory authority by the states. Some states have very good regulators on the actuarial side, but most don't. The majority of the states don't even have actuaries working for them.

MR. MATEJA: I think the point about comparability of reserves is a valid one. Do you have any thoughts on how to assure that in some of the discussions that have taken place thus far?

MR. RAYMOND: This gets to be a very sensitive issue. The more you bring actuarial judgment into it, the more it's going to be an issue. When I talk to nonactuaries and even some actuaries, this becomes one of the biggest concerns. The biggest challenge for us, as a profession, is to be able to step up across the board to a higher level of professionalism so that we can be professionals. A big issue in making this work is the fact that not only are you doing the job well, but you can be confident that the guy down the street isn't finding an actuary to do something that you would not let your company do.

One of the ways this is being dealt with in the valuation system is some are considering having an independent review of the actuarial work. This is not being recommended to draw an opinion about whether the actuarial work behind the valuation is what the independent actuary would have come up with, but to make sure that a professional job has been done, that all the standards have been filed, that the regulations have been followed, and that the work was done appropriately.

To get to the level where you can have that kind of an opinion and independent work, you will need to have an independent review of that work.

MR. PALMER: That's why the profession needs to make sure that the education at the exam level, continuing education, and standards of practice are ready to educate and stand behind us. You don't want 50 people coming up with 50 different answers. It needs to stand up to a peer review.

FROM THE FLOOR: Craig, you said something I thought was really appropriate. If you build the structure based on standards to determine the amount of conservatism that you should have, maybe that will work.

MR. RAYMOND: That is the basis of the framework—to identify the level of competence in the reserves and building the reserves around that.

MR. MATEJA: Let me respond to your question because I have dealt with this before. If you took a particular company and compared it to its major competitors, what would you expect to find? Do you think it's fair to say that all those companies would be risk look-alikes? Are their management practices, their underwriting standards, their ALM profiles, etc. so close that they are risk look-alikes? I would say the probability of that being the case is probably very small.

So, to the extent that you have an actuary trying to understand the risk posture of a particular company and then setting the reserves accordingly, if he or she is successful, the reserve variation might have a reasonable theoretical basis. In fact, actuaries would have to be prepared to defend their respective judgments in this regard. This is the quid pro quo of having the responsibility of a valuation actuary. There would be some standards to provide guidance, and there should be some kind of external or other review mechanism.

There should be a minimum of 10% risk variation between the companies. I wouldn't be surprised if ends up as a 25% risk variation. And I submit that, to the extent that the valuation reserves don't reflect such risk variations, the financial underpinnings of the business are affected.

The regulatory mindset is what I would call the "stick" approach. It treats all companies as it would treat the worst of the companies and forces all companies into the same mold. I've always advocated the "carrot" approach. If management responsibly manages its business from a risk standpoint, I would hold out the carrot of lower reserves. You get rewards for doing the right thing. This changes the whole regulatory framework.

However, the probabilities of that happening any time soon are minimal. Despite the good noises coming from certain regulatory quarters, the fundamental mindset in the regulatory community, and the distrust with management generally, is such that the stick will prevail for some period of time. It would truly be a revolution if the approach to valuation changed overnight.

There is one final issue I want to pick up on. Several times we've mentioned the need for standards or practice, because much of the uncertainty with the issues we've discussed comes down to this.

Our success as a profession depends upon the success of the effort to develop practical standards. Standards have been around for about 10 years. I didn't pay much attention to them until I got on the Board of Governors years ago and began crafting the unified set of standards. I became concerned about the fact that few actuaries paid much attention to standards at the company I was associated with at the time. There's going to be a time when conformance with standards could be very, very important. And I think we all need to be mindful of that.