1998 VALUATION ACTUARY SYMPOSIUM PROCEEDINGS

SESSION 21PD

SMALL COMPANY ISSUES

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MR. JAMES N. VAN ELSEN: Erie Family Life in Erie, Pennsylvania, is the founder of this Small Company section. Bob is the driving motivation on the creation of the Society of Actuary Section for Small Companies. He's been an active participant over the years, and we certainly appreciate him. Bob is going to start off with a discussion on the illustration regulation. Then I will cover a number of other current regulations of particular interest to smaller companies.

MR. ROBERT H. DREYER: I'm going to be relating our experience with illustrations. I think of this as the illustration actuary revisited. This will be old hat to some of you, but there are probably a few in the audience who don't know what they're going to do, but will have to plan on getting into this soon.

Erie Family Life issues life insurance solely through the property/casualty agents of our parent company. Thus, most of our agents are multi-lined producers, and only a few sell life insurance exclusively. As a group, they tend to be less sophisticated when it comes to life insurance than those who sell life insurance exclusively. Therefore, their sales are often less complex, and the agents require a good amount of home office support. We have two universal life plans subject to the illustration regulations. Because I'm a stickler about valuation laws, all six of our term products are indeterminate premium and must also be illustrated. All of our life products can be illustrated (if the illustration is required), or proposed (if not), using a software package that we provide to our agents.

At this time, four states where we do business require the NAIC illustration format. They are North Carolina, our home state of Pennsylvania, Ohio, and Maryland. In addition, Illinois, where we expect to start selling business January 1, 1999, has adopted the regulation.

Our initial approach was to follow both the letter and the spirit of the regulation as closely as possible. We wanted to prepare our agents to do the same. We went to numerous seminars sponsored by the Society, the Academy, the American Council of Life Insurance (ACLI), and others to learn as much as we could. The project was spearheaded by our chief operating officer, who happens to come from a marketing background. In addition to myself, the project team included an in-house attorney, a systems specialist, and a sales support person. As the project took on a life of its own, this group was expanded to encompass an entire product development committee of 11 members.

We worked closely with a software vendor, which happened to be a subsidiary of an actuarial consulting firm, to develop an appropriate format for our dot matrix printers. It's amazing the difference in size and the number of pages if you don't have to use a dot matrix printer. Care was taken to comply with the latest version of the drafts that kept emerging from the NAIC, including the questions and answers, as well as interpretations that different groups gave to those drafts. We really wanted to stay on top of the situation, and we obtained extensive support from both our internal law division and from the ACLI.

An early decision was made to introduce the new illustration format and requirements on a state-by-state basis as each adopted the regulation. This required us to maintain two sets of illustration/ proposal software. We have a number of agents living near state borders who sell in more than one state. If they weren't required to use the complex illustration software issuing in a neighboring state, we let them use the old format proposal that they were used to. The big advantage of this state-by-state approach was that North Carolina, a relatively small state in terms of our volume of business, was the first state to go online. It was followed about six months later with Pennsylvania, which accounted for nearly 60% of our business. This really provided us with the beta site in the North Carolina to test our planned procedures.

At the time of introduction, we had two branch offices in North Carolina with three sales managers operating out of each of them. The marketing division developed a script for presenting the new illustration format that was reviewed and approved by the product development committee. General descriptive material, including a new section for the agents' rate book, which is looseleaf, was sent to the North Carolina marketing personnel in advance of the actual presentation. The following week, the program itself was presented via television hook-up with the two branch offices. The marketing team was supported in this effort by systems and actuarial personnel to handle any technical responses or explanations they might need. It would then be the responsibility of the sales managers to meet with their assigned agents and instruct them on the objectives and usage of the illustrations. It was fortunate, as it turned out, that we were able to start out with a relatively small state.

The results were far from encouraging. Since our sales managers, like most of our agents, are primarily property/casualty oriented, they did not grasp the concepts as quickly and as clearly as we had anticipated. As a result, much was lost in the translation to the agents themselves. Our home office support people had to do a lot of direct training of the agents by telephone. This usually occurred after we received improperly completed applications and illustrations at the home office. We sent our market training team back to the drawing board. Three months later, when it was time to introduce the illustration software and requirements in our home state of Pennsylvania, they were ready.

Instead of the teleconference that had proved ineffective, a video introducing the basic concepts was prepared, and detailed descriptions were presented in person. The video was produced in-house by people that they recognized and respected within the company. Four home office marketing experts were sent out to the field to make these presentations to the agents. Each one presented the program in two or three districts. Agents were notified in advance. Attendance was taken. In some instances, alternate dates were available to the agents, although it might mean driving three or four hours to get to the alternate site. We did not say that you have to be there in order to sell, but the fact that attendance was being taken got the message across. The approach produced much improved results. While some agents were upset about the extra work, the proportions of support phone calls and improper illustrations dropped dramatically. We have used this dog and pony show successfully in two more states since then, and we are prepared to continue it in the future as new states come online.

As you might imagine, acceptance of the additional requirements was lukewarm, at best. Those of you who have ever tried to generate life insurance sales from property/casualty agents can imagine what happened. For years we had bent over backwards in the home office to try to make selling life insurance as easy as possible for them. Now we were hitting them with the most onerous set of requirements that they had ever seen. Most took it in stride, amazingly, and with a minimum amount of grumbling. Actually, our sales for the year were up, although a few hard core complainers just stopped promoting life insurance—at least for a while.

After a few weeks, we started hearing complaints that our procedures were more rigorous than those of other companies for whom they sold life insurance. (We do not have exclusive contracts with our agents.) This gave us something to think about. Internally, we found that matching the new policy and the illustration was creating a bottleneck that could add three days or more to the delivery time of a policy. Delays also occurred when the application was received electronically. It was accompanied by a note reading. "Illustration to follow." The illustration rarely arrived in a timely fashion, which again caused further delays.

Another problem was the additional work required in-house to print a revised illustration when the policy issued differed from the original application. Finally, we had a problem with some agents who made inappropriate use of a form we had given them for obtaining signatures in situations when a printer was not available to provide a printed illustration. We're aware of at least two district sales managers that told them, "Just get that filled out and signed every time, and home office will send out your illustration." We found out about that quickly. All of this gave us more things to think about and to reconsider.

At this point, we decided it would be a good time to undertake a thorough review of everything that we were doing and what had transpired to date. We spent a good deal of time investigating the significant complaints we had from our agents. The product development committee also undertook the review of our internal procedures. In addition, we attempted to learn through the ACLI and other sources how the industry in general was interpreting and applying the regulations. Were they really having the agents take out 13 copies of a nine-page illustration? We came to the conclusion that our original approach was indeed too strict to be practical in the marketplace.

To correct this, we adopted two changes in our procedures. First, we expanded the use of the "No Illustration Was Used" form to include situations where the agent had made an honest effort to prepare one or more illustrations, but the client elected to buy something that was different. We had the short form signed, and sent it to the home office with the application. In addition to saving time and paper, this took a lot of pressure off our property/casualty agents. The other change was to modify our issue system. The issue system had all the information in it so that it could be used to produce two copies of the fully compliant illustration each time we printed a new policy. The agents were required to obtain signatures on those two illustrations, and commissions were not credited until the signed copy was received back in the home office.

This streamlined our internal procedures. We eliminated the need to compare illustrations with the final policy, and we got the policy out the door much quicker. In those instances where an agent might balk at getting the second signature, we agreed to compare the policy summary page to what he or she had produced, and waived the second signature requirement if there was a match. Now we were looking at maybe 1 out of 50 cases instead of every case. The operation, while still onerous, is now working more smoothly with fewer complaints. The new approach of training our agents directly has also proven to be successful as each additional state comes online.

From an actuarial viewpoint, we had no significant problems. Our company has always been quite conservative, and our pricing assumptions already reflected fully allocated expenses, which are lower than the Generally Recognized Expense Table (GRET). We had no problem other than the time and effort involved in passing the self-support and lapse-support tests. Our board of directors made the appropriate appointment. I gave them an appropriate letter of acceptance. We used the certification text that had been recommended by the illustration practice notes. The certification letter from our responsible officer was drafted by our own law division. We received no feedback from any of the states where we filed.

The annual experience studies used to develop pricing assumptions are prepared in the spring each year. With North Carolina starting January 1, 1997, I had to file my first certification at the end of 1996 based on 1995 data, which was more than a year-and-a-half out-of-date. When Pennsylvania started July 1, 1997, I had my 1996 experience completed, so I was able to file on a more timely basis. Fortunately, the 1996 data did not require any changes from the 1995. In December of 1997, I had to refile in North Carolina, plus make the initial filings in Maryland and Ohio. Again, I was a year-and-a-half out-of-date. This year in June of 1998, I updated all of my filings, and will continue to file as of July 1 in all states so that I can provide the most current data available from a company our size.

When it came to recertification, I used basically the same format as the original certification. We only changed the appropriate dates and made reference to the fact that there had been no changes in any of the underlying factors.

What has all this accomplished? We certainly have not had any input or questions from the insurance departments. Are they satisfied, or do they just not care? As has happened in the past, they throw a new burden on us, and then we hear nothing more from them.

On the negative side, we have seen the additional time, effort, and ongoing expense that the illustrations have caused. Are there any positives? Obviously, the industry and our agents, particularly our property/casualty agents, who take this very seriously, are more knowledgeable and more aware of the potential problems. I also believe that, as a whole, the industry is being more careful in the way they illustrate their products and present them to their potential life policyholders. However, I question whether the general buying public is significantly more knowledgeable than they were before. Was the cost of the effort to develop and use these illustrations justified? In my opinion, with few exceptions, the ones who read these illustrations are the same people who read the policy when they receive it, talk to their agent, and ask questions about anything they don't understand. The rest are treating the illustration just the way they would treat the policy. It goes in the drawer. I hope I'm wrong, but that's my reading of the situation.

MR. JOHN J. MARTIN: Our experience has been pretty similar to yours. We didn't have any difficulty filing. Listening to what you had to say makes me wonder whether I, as the illustration actuary, should be doing some research regarding how the procedures I put in place are actually being used. I think I'm going to go back to my company and get an audit before a state does an audit and finds something I'm not aware of.

MR. ROBERT H. DREYER: I would suggest that you discuss that with the responsible officer who signs the other certification for your company. He's the one that's really responsible for that aspect of it.

MR. VAN ELSEN: Has anybody had any experience with an insurance department actually reviewing any of the illustration actuary work? Has there been any market conduct, or has anyone done regular triennials? Is this just totally off the radar for them?

MR. GRAHAM J. LARSON: Tom Foley is the North Dakota state actuary. During the market conduct exam, there were certification questions about topics such as how we justify using the GRET rather than fully allocated and how we knew that the GRET was bigger than marginal expenses. It was done in the context of a market conduct exam, and was taken out of that exam in the end. It wasn't in the market conduct exam, but it was questioned because of the exam. I feel that part of it was because Mr. Foley is our department's actuary.

MR. VAN ELSEN: For those that don't understand the context of that, Tom Foley was vice chair of the illustration working group, and was instrumental in its adoption at the NAIC. I guess it would be expected that he would want to see what's happening in his state.

FROM THE FLOOR: We didn't have any trouble with it, but he did have some questions.

FROM THE FLOOR: We've never received any feedback from any of the states filing. We've been submitting a Section 8 opinion, and have never heard any comments. This past year for a variety of business reasons we filed a Section 7, and once again had no feedback, except for Best and

Standard & Poor's (S&P). They asked us where our memoranda was just because they had a slot in their folder and there was nothing in there from us. I really question that the departments are interested in anything other than creditation.

MR. A. GRANT HEMPHILL: I remember that one of the reasons for all this work, especially the actuarial part, was that many people thought the companies were selling products that were illustrating unsupportable projections. One intent was to bring about some market discipline. I haven't seen any change in the marketplace, and I wonder if anyone else thinks there has been increased discipline.

MR. DREYER: We have not received in the past year any comparisons with, for example, Universal Life (UL) products that obviously had interest bonus or mortality bonuses in them. We used to get them regularly from our agents. We've stopped seeing them.

MR. HOWARD W. HEIDORN, JR.: Along the same lines as what Grant mentioned, I was wondering if there were any illustration actuaries in the room that, due to the illustration regulation, revised some of the product parameters in order to make the product illustratable. I am an illustration actuary for some small fraternal benefits societies. We did have to revise product parameters compared to what was priced originally in order to illustrate the products. I was just wondering if there was any other experience.

MR. VAN ELSEN: Personally, I have not run into that situation, but I am aware of some clients that have made adjustments in products. Parameter revisions have also become a constraint during the product development process. They design what they think is competitive, and they end up having to back off just a little bit in order to comply. It's my sense that there's an edge off the requirement for competitiveness of the illustrations. You still need to be in the ballpark, but the need to be better than everybody else doesn't seem to be as hot as it used to be.

MR. DREYER: At least not with the UL products. Term products, I think, are different.

MR. VAN ELSEN: Term is another issue.

MR. DREYER: Many companies don't have to illustrate the terms because they guarantee their rates.

MR. LARSON: On a different subject, does anybody have a definition of adverse changes? If there have been adverse changes during the year, you're supposed to print that on the annual statement. We're struggling with that. We're not exactly sure what that means. Does that mean any change in the interest rate or doesn't it? When a person purchases a universal life product, shouldn't they expect the interest rates to fluctuate? Is that or is that not an adverse change? I'm looking for a definition. I am wondering if anybody has one.

MR. DREYER: When we lower interest rates, for example, they are included in our annual letter. We have not lowered interest rates recently, but I would also look at any change caused by a change in assumptions. If I were making changes in the illustration assumptions, I would say they should be disclosed, also, to the extent they impact in-force illustrations. I think adverse changes would be anything that would affect what you had originally projected to the applicant. That's my definition.

MR. VAN ELSEN: I am a consulting actuary with Van Elsen Consulting in Colfax. Colfax is a very small town just outside of Des Moines. Prior to being with Van Elsen Consulting, I was with a number of small companies. The majority of my professional experience has been with small companies, and I did serve on the Small Company Council. The vast majority of my clients are smaller companies, so that's the reason I was invited to this panel discussion. I intend to cover an XXX update, and just the small company aspects primarily. We're going to talk about the changes to Actuarial Opinion and Memorandum Regulation (AOMR) that are being discussed. I have some other issues that are starting to surface that we'll discuss. I'll also cover how a small company actuary can keep involved in things that are coming down the pike.

I'll discuss in particular some of the aspects of XXX that affect smaller companies. I'm not going to cover the whole regulation, but I'm going to focus on the things that affect smaller companies.

The Life and Health Actuarial Task Force exposed the draft of the regulation on September 12, 1998 and the comment deadline is September 24, 1998. The Life and Health Actuarial Task Force will be meeting by conference call shortly, and I think at that meeting they will resolve the regulation that they will vote on October 5, 1998. So the conference call is extremely important. This will be pretty much where the regulation is finalized. The "A" Committee will meet also on October 5, on the same conference call, in fact, and they also hope to adopt the regulation on October 5. If that occurs, the Executive Committee is expected to approve it before the December NAIC meeting. If they do that, the Plenary should adopt it in December at the Orlando meeting, coincidentally. That would mean that NAIC is adopting the revised XXX this year. State approvals would happen during 1999. With any luck, we'll have a common effective date of January 1, 2000.

The latest draft of the regulation can be downloaded from the NAIC's web page at www.NAIC.org. It's a Microsoft Word document. They do have a viewer that you can also download. That is the only source of the current document. I used to be the source, but now it's the NAIC's document. I don't hand it out anymore.

We did have a conference call at another session. The XXX workshop joined a conference call with a number of Life and Health Actuarial Task Force members, as well as some other industry members. There were some changes made during that call. One significant change: there had been a proposal for additional disclosure requirements put forward by the Connecticut Insurance Department that I think will be taken out of the regulation. The industry seems to be very reluctant about that additional requirement.

Deficiency reserves are a new part of this. The way we calculate deficiency reserves in the new regulation will have significant small company angles, and we'll need to discuss those in detail. There are things that you're going to have to do as a smaller company with deficiency reserves that you're going to need to pay very close attention to. There's an exemption from yearly renewable term (YRT) reinsurance, which again, has a small company angle on it. Universal life secondary guarantees tend to be the choice of a lot of smaller companies, and we need to make sure you're aware of that. Then we're going to have a Wisconsin and a West Virginia update.

With the new deficiency reserve methodology, you're going to be able to choose X. X is any number that's at least 20%. You're going to multiply that X times the valuation mortality rates and be permitted to use that for deficiency reserve purposes. There are a lot of strings attached to setting X. It has to be at least 20%. It can vary. It can vary by duration, policy form, underwriting classification, or anything which might reasonably lead you to expect a difference in mortality. Also, you can vary X. You envision it as being a vector. However, if you use an X which is less than 100%, you will have to do a Section 8 opinion. The Section 7 opinion will not be available to you—that's for the company as a whole. You will have to produce a separate opinion subject to actual standards of practice on the appropriateness of the X that you've selected. You're going to have to be able to document the appropriateness of the X that you've selected.

One of the current concerns you will have, if you're not doing a Section 8 opinion, is that this is an additional cost to you for writing competitive term products. You will have to do a Section 8 opinion for your entire company. You have a choice. You can use 100%, but I'll guarantee your product will not be competitive in the term market. Smaller companies are going to have a harder time justifying X. You don't have the experience, and you don't have the resources to accumulate the data, yet you're still going to exert the same effort to justify your placing of this valuation assumption as the larger companies. The new valuation methodology is much more complicated than what we've seen in the past. You're going to have to gear up your valuation systems to handle it. Let's say you choose X as a constant 60%. You might end up with a very normal humpback-type reserve. If after five years you can no longer justify 60% and you have to go up to 80%, you may be forced to go up to 80% immediately. I want you to consider the risk a small company takes when setting its valuation assumptions where they can cause future changes in reserves of the magnitude I'm illustrating. That's something you're going to have to take into account. I also believe it's something you're going to have to consider with your reinsurers. This may not be a risk your companies are able to assume. It does seem reasonable to me that you may be able to buy some sort of mortality fluctuation reinsurance to hedge against this potential risk in the future. It's something that is certainly going to affect smaller companies much more than the larger companies. It will complicate your creation of new term products in the coming years.

There is a provision in the regulation to exempt certain forms of YRT reinsurance. Basically, it allows companies to avoid all of the complicated calculations associated with YRT reinsurance. If your reinsurer elects to take the exemption for YRT reinsurance, you will be limited for this business to a reinsurance credit not greater than the amount held by the assuming company. We've been able to keep that out of reinsurance regulations elsewhere, but it now appears in XXX, and is something that you'll have to become aware of. Again, this affects smaller companies more than larger companies.

Universal life secondary guarantees poses a concern for smaller companies. This is a product of choice of many smaller companies. There is an exemption for some forms of universal life if you have a product with a secondary guarantee or no lapse premium that's five years or less. There are also a couple of other requirements. If it falls into that category, you don't have to worry about XXX. You're totally outside. If you have products with secondary guarantees, only for the purpose of getting by the initial surrender charges, you'll want to look very closely at these requirements. If you can design your product to fit within them, you can avoid a lot of the complications of XXX.

However, if you don't fall within that exemption, you can essentially view that secondary guarantee as being a term product within your universal life product. You all know how simple universal life valuation is. There is the "guarantee maturity premium" and all that stuff. That's simple. To make it a little more interesting, you're going to have to hold the greater of that reserve or that produced by XXX. If you have secondary guarantees, it brings your policy into XXX. You're going to have to look at your valuation system and do testing to see which reserve you're going to have to hold.

Wisconsin has passed XXX. They passed the version adopted by the NAIC in 1995, and it is effective January 1, 1999. If nothing changes, that's what's going to happen. They may move to the new proposal. They may move it back to January 1, 2000. We believe the action on October 5 by the "A" Committee will play an important part as to whether Wisconsin is willing to do that. They haven't committed by saying that if "A" Committee adopts it, it will move back. They haven't said that. I do know if they don't adopt it, they're not moving. So, I know the one side. I don't know the other side. There has been a lot of discussion about how companies intend to deal with

Wisconsin possibly putting XXX into effect January 1, 1999. I want to dispel some rumors. I've heard the statement made that we just won't file this product in Wisconsin. That isn't going to work. The actual opinion that you file in Wisconsin has to reflect Wisconsin laws for all policies in all states. Therefore, not filing that product in Wisconsin is not sufficient. If you're licensed there and have to file an actuarial opinion, you're going to be subject to it. I've heard some companies say that they'll just withdraw from Wisconsin. That's not going to be as easy as just writing them a letter. They may not let you leave, particularly if you have policyholders in your company from the state of Wisconsin. They still have concern for them. I guarantee that if you do succeed in leaving you may never be permitted to go back. That seems like a very drastic solution to a short-term problem. There are those who believe that the Wisconsin law will not affect the product sold in other states, but it will. I want you to envision the situation. You're filing this statement in Wisconsin based on Wisconsin laws for all your policies. For companies writing significant amounts of term, it's not unusual to project running out of surplus in anywhere from six months to a year-and-a-half. This essentially says you're insolvent in their state. I suspect they may have a hearing. I know most companies don't like the word *insolvent* used in the same sentence with their company. I don't think you're going to be able to ignore it.

There are also those who believe that when this happens in Wisconsin, everyone will just go to five-year guarantees. There are enough companies, particularly big companies with subsidiaries that aren't licensed in Wisconsin, that will continue to have 20-year term with 20-year guarantees. If you're a small company licensed in Wisconsin, you have a problem. A good part of the market is not going to change, and yet, you're going to have to deal with this regulation. That's why I think it's important you realize how imperative it is that we get the situation fixed in Wisconsin. I believe uneven adoption of XXX, in whatever form, adversely affects smaller companies disproportionately. Bigger companies are going to be able to dodge more easily than smaller companies.

West Virginia has adopted the emergency rule that repeals XXX. However, it must be also repealed by the legislature within 18 months. The emergency rule is to repeal an action of the legislature. They can only do that for a short period of time. The legislature has to ratify it within 18 months. I do believe they will do it, because if they don't, I don't know what they're going to do with all these insolvent companies. This is the same situation as Wisconsin, only this has been in effect since January 1, 1998, and the 18 months it takes companies to run out of surplus has already run. Therefore, I believe West Virginia has no choice but to repeal that regulation.

AOMR is another issue that has been hanging around for a while. There's a new proposal on the table from Larry Gorski. He's proposing to totally eliminate Section 7 opinions. There will only be Section 8 opinions. Everyone will be subject to some form of asset adequacy analysis. One advantage is it will also permit an actual opinion based on the state of domicile.

By eliminating Section 7, all companies regardless of size and lines of business, will be required under the new proposal to opine based on moderately adverse conditions. A change is that the new regulation will be silent on the actual requirements for backing up that opinion. Today it talks about the New York 7 interest scenarios. It will be much more silent on that. Instead, there will be new actuarial standards which it would address. Apparently this is where the small company relief is going to come. Presumably, smaller company concerns will be addressed in the new Actuarial Standard of Practice. The Actuarial Standards Board (ASB) has set up a new sub-committee that will be considering revision of the Actuarial Standard Practice Number 7 to reflect this request. The ability to fall on the state of domicile is something that will benefit smaller companies, so, it's not totally negative. The opinion will be based primarily on the laws and regulations of your state of domicile. It would eliminate future XXX problems. The reason we have a problem with Wisconsin is because of the extraterritoriality of the valuation laws. If those laws didn't exist, and you were able to file based on state domicile, Wisconsin wouldn't be able to have the impact on our industry as it does right now. However, the commissioner will still be able to require an opinion based on the state where filed. While it wouldn't happen automatically, Wisconsin could effectively cause this to happen by requiring all companies licensed in their state to file based on XXX for their state. It's good, but not all good.

One troublesome issue is the benchmark. The regulators in states outside the domicile state want something so that they can measure the adequacy of the valuation laws in your state. They want some sort of benchmark. One of the things that has been discussed is using codification as a benchmark. That has been vehemently opposed. However, using that as an example, if you have to submit a benchmark based on codification, that state knows how they compare to codification. Presumably they'll know the relative problems they may have with your state's valuation laws, and they could react appropriately. There are several options being considered. I don't know what's going to win. This regulation looked like it was ready to come out, and I think it has gotten stalled again. I actually talked about this regulation two years ago at the Valuation Actuary Symposium, and quite frankly, I haven't seen much movement since I talked about it two years ago. I believe that if they eliminate Section 7, the benchmark issue may disappear. That does give some protection on which the regulator can rely.

Future issues. Unified Valuation System (UVS). You have probably heard about this. It's a whole new valuation concept. I don't know how far off into the future it is, or if it has a future, but it's something that certainly may affect smaller companies in the future.

Nonforfeiture. We've been working with the Life and Health Actuarial Task Force to redo nonforfeiture for the last 15 years. They abandoned it about a year ago. They have now expressed a desire to bring it back up, so you will probably see some activity in nonforfeiture again.

Annuity Disclosure. For those of you in the annuity market, I do expect some regulation someday as something recent has been exposed. I can't tell you where it's going at this point.

ZZZ. If you have equity-indexed products, you want to review ZZZ. I won't go into it here, but we also have ZZZZ, which pertains to equity-indexed life insurance.

There is a sitting Life and Health Actuarial Task Force that will be continual. As the industry responds to its environment and comes up with new products and ideas, the regulators will continue to come up with new regulations. Sometimes those regulations affect more than what they had intended. Often the smaller company is going to end up in the sights of some of these new regulations.

How does a small company keep on the ball? First of all, I hope I've made it clear to you that these new things affect your business. It's possible to regulate your company out of existence. Regulations can become so onerous that they eliminate your purpose to your marketplace. Smaller companies cannot afford to not understand what's going on in the regulatory environment. Trade associations are one way of doing that. Obviously, you have the ACLI, the National Association of Life Companies (NALC), the Health Insurance Association of American (HIAA), and the fraternal's have their organizations. There are several others. Members of the Society of Actuaries, the American Academy, Certified Life Underwriters, and other professionals are avenues that smaller companies can use to influence the process. Trade publications can certainly help you keep informed of what's coming down the pike. I know you get a pound of paper, but part of your job has got to be to identify those things that are happening that are going to adversely affect your company.

Also, I can't tell you how underrepresented smaller companies are on professional committees that are writing the rules on how you're going to do business. You've got to impress upon your management that you're putting your company at risk when you choose not to participate in some of these committees. Smaller company interests have got to be brought forth much more clearly.

MR. VAN ELSEN: There was a question from the floor about XXX and whether it's part of codification. My understanding is that currently it is not. I seriously doubt if it would be added later.

MR. EDWARD M. MOORE: My current plan for 1999 is to file a separate blue book in Wisconsin. Presuming the traditional XXX goes forward, I'll have weaker surplus. I don't believe we'll be insolvent or be in danger, but is that a valid plan?

MR. VAN ELSEN: Your obligation is to file. There is debate whether you have to file a separate blue book, or whether it just applies to the AOMR. Others may be more knowledgeable about that than I am. Certainly you have to file something based on Wisconsin laws, and if you can do that without impairing your company, then that's a viable strategy.

FROM THE FLOOR: The accountants will not be too happy with the separate blue book. Could anybody comment? Can we put it in the AOMR?

MR. VAN ELSEN: I know of companies doing that. I don't know if they're supposed to do that, but they do.

MR. HAROLD H. SUMMER: Could you comment on the cash-flow test and the component of C-3 for risk-based capital (RBC)?

MR. VAN ELSEN: Not well, to be quite frank. I do know there's some active discussion, and it ties into the whole UVS approach. One concept is that the actuary, through the UVS, doesn't set reserves. The whole surplus and risk-based capital comes out of an actuarial memorandum, which encompasses everything. The shorter component is to take the C-3 risk and require a test of cash-flow—asset adequacy analysis. You've got to be careful when you extract a portion of that to become a component of C-3. I do know that at least one of the trades is opposing that particular activity.

FROM THE FLOOR: I'm a little perplexed about your comment regarding the extraterritorial aspects of the valuation laws. It has been my understanding that when you follow your opinion in your own state of domicile, you apply your own state to your entire book. That's clear. However, when you file the opinion in a state outside of your state of domicile, the section that says, "This meets the laws of the state of," wherever it's filed, applies only to the business in that state. Can you help me out here?

MR. VAN ELSEN: I don't believe that's what the opinion says. For instance, I'll use Iowa as an example, because that's where I'm based. If I'm an Iowa domestic filing in Wisconsin, my actuarial opinion will say, "This actuarial opinion is based on the laws of the state of Wisconsin." It does not limit itself to those policies. It's for all policies that are in this valuation.

FROM THE FLOOR: I would write the opinion, if I'm an Iowa domicile, to say, "This opinion meets the laws of the state of Iowa, and the state of Wisconsin," for the Wisconsin business. Wisconsin has no jurisdiction over Iowa on its Iowa business, but it certainly has jurisdiction over its Wisconsin business. Unlike New York, which has traditionally said, "You do something in New York, and you must do it throughout the country."

MR. VAN ELSEN: I recall, when this was being written in the AOMR, the viewpoint was that if I'm a Wisconsin regulator with policyholders in your company, I'm concerned about the reserves shareholding for all your policyholders. Inadequacies anywhere will affect our policyholders. This is my understanding.

FROM THE FLOOR: Where do we get this understanding, though?

MR. VAN ELSEN: I think the words say that. If you read the words carefully, it's fairly clear that the statement you file is based on the laws of the state of Wisconsin. It's not limited to policies.

FROM THE FLOOR: An article addressing this issue was written about a year ago in one of the section newsletters. It was not written about any particular state. That's where I came to the conclusion that was stated earlier.

MR. VAN ELSEN: The major impetus for the change in the AOMR from the company point of view was the fact that you end up with 50 extraterritorial states if licensed in 50 states, and an almost impossible situation.

FROM THE FLOOR: It wouldn't be impossible if you took your interpretation because you would just have to take the worst in the nation. That's what everyone would have to do. That's not impossible. Just one state comes up with the worst, and that's extraterritorial all over the world.

MR. VAN ELSEN: That's right. For most regulations, you're able to do some song and dance because it is an aggregate test. You may have sufficiencies in some lines of business that are more in offset, actuarial reserves. The problem with XXX is that the reserves generated are huge, and you can't find enough sufficiencies.

FROM THE FLOOR: I have a second question regarding the revisions to XXX. When discussing deficiency reserve mortality, you said if you can justify using a factor X and applying it to mortality rates, you should. Is that before or after application of already existing selection factors?

MR. VAN ELSEN: It would be after.

FROM THE FLOOR: Is that deficiency reserve standard applicable only to the products XXX was aimed at, or as it is now written? XXX is a new law that applies to all products, period. In that case you can use the new deficiency reserve mortality for whole life or any other product.

MR. VAN ELSEN: Absolutely. It is permissive, and that's intentional. The new selection factors would be available for anything subject to the new regulation. Basically, if it's life insurance, it's covered.

MR. BRUCE D. SARTANE: I just was going to clarify your discussion earlier. Regardless of where the business was written, nondomiciliary states would require that you follow their laws and regulations. I was also going to mention that you do get some relief because it's in the aggregate if it's a nondomiciliary state.

MR. VAN ELSEN: Do you have any idea what Illinois might do with XXX?

MR. SARTANE: I think the intention is if your time chart works out, and it's adopted this year by the NAIC, then we go ahead and adopt. The intention is, and don't quote me on this, that we would go to the adopted one. We support the adopted one so far.

MR. ANDY F. BODINE: I don't know if this helps, but I'll try to clear up the extraterritoriality concept, primarily for New York. New York's extraterritoriality is most onerous for sales compensation restrictions and expense limitations, which are applied to business sold anywhere. I don't know of any other state that would restrict what you want to pay an agent, or limit expenses for business sold in another state. However, when we're talking about valuation, by its nature, the word extraterritoriality doesn't apply. A company is either solvent or it's not solvent based upon the risks of the whole company. It has a general account that is there to support all of its general liabilities. It can't say, "I've got inadequate reserves for the business written in this state, but they're adequate for business written in the other state." When filing, you have to set up what that state's standards require. That's their solvency basis. Valuation is a whole company concept, and the word extraterritoriality doesn't even enter the discussion.

MR. VAN ELSEN: I think that's a better clarification of it. The states essentially have the best view of solvency of life insurance companies, and they want to be sure that the companies selling to citizens of their state are solvent according to their standards. That's the current standard within the valuation law. Prior to the new AOMR, we were able to file things based on state of domicile, and there was enough similarity that commissioners accepted the opinions based on other states. We're hoping to put that back with the new AOMR.

MR. GREGORY L. FRITZMAURICE: In regard to the illustrations earlier, we had to drop our dividends 5% on one of our products because of the increased credit expenses this year. We wouldn't have done otherwise, so I guess the policyholder is sort of being penalized. I have a question. In past meetings there has been talk about a state clearinghouse of valuation regulations. I haven't heard anything about that in some time.

MR. VAN ELSEN: It died.

MR. FRITZMAURICE: It died totally? That's a shame.

My last comment is that I used to find Actuaries Online on CompuServe which was quite useful for disseminating information. I personally don't feel the website is nearly as good. It would be nice to hear other people's opinions on that. Perhaps it can be improved.

MR. R. DALE HALL: This year, in particular with all the AOMR and XXX being reviewed and re-reviewed all the time, it has been particularly tough to keep up with where those things stand. How do people try to keep up with where the regulations stand? Specifically how do we get new numerical examples as the requirements on XXX that have changed, and how do people go about trying to incorporate that when it actually comes into effect?

MR. VAN ELSEN: First, back to the question regarding Actuaries Online. The new web page is only as useful as the people using it. For one reason or another, the people who are so active on Actuaries Online haven't made the transition over, and I'm guilty. If you want the new page to be effective, you're going to have to get out there, use it, and be willing to say what's on your mind and ask questions. Functionally, there's nothing you can't do on the new one that you could do on the old one. I had my grievances with it. I must say they've worked most of those out. If you haven't been there lately, you should go again. As far as keeping up on XXX, there has actually been a list of people who have received information from the committee on XXX, and the cost of participating in that list has been nothing. You do need to be able to accept very large e-mail files because sometimes the files going out to that group were a couple of megabytes. There has been a lot of information disseminated through the Internet to people who express an interest in XXX.

Certainly, the small company section newsletter, *small talk*, provides some information. It comes out every six months. If nothing else it highlights some issues that you should be aware of. Often *The National Underwriter* will run articles about things happening at the NAIC, and you'll see quotes from different people. Call those people and find out how to stay informed. They'll tell you. The other thing I suggest is that the Life and Health Actuarial Task Force, or the NAIC, tends to be the source of most of your grief. They have a monthly mailing. It doesn't cost that much. Call the NAIC, get on that list, and you'll be kept up-to-date.

MR. DAVID M. NELSON: Our statute says that in preparation of the blue book, you follow the instructions of the NAIC and the procedures manual. I'm just wondering about codification. What is the status? If they're actually about to approve it and put it into the procedures manual, are we all of a sudden subject to whatever it says without any further state action?

MR. DREYER: I think we said the presumed effective date is 2001.

MR. NELSON: I've heard that New York may not accept whatever codification is there, and other states may not go along with it either. In that case, the whole foundation is undermined. Certainly New York would be a big problem.

MR. DREYER: I'd like to put in a plug for Jim's newsletter. He has an assistant that, prior to publication, calls all around the country and asks, "What is your state doing with regard to illustrations, XXX, the Year 2000 annuity table?" It's a very valuable piece just because of the survey information that he publishes.

MR. VAN ELSEN: The thing I can't overemphasize is that there's a lot of pressure on small companies these days. I for one like working with small companies, and I'd like to see a few of you stay around. That's my source of business. You've got to get involved. The regulators are tired of hearing from me. I do my best to speak for small companies with kind of a big umbrella. I get up there, and I say I'm speaking for small companies whether or not there's anyone really standing behind me. We need more small companies who are willing to get up and say that something is being considered that is going to adversely affect them, and that it's wrong. We need people who can stand up and talk about the things that are coming down the pike. I can tell you that there are going to be more and more complicated regulations coming. If small companies don't speak up, you get what you deserve. I don't mean to be so harsh, but you are going to have to get involved. I know a few of you are, but we need more.

MR. DAVID A. DERKSEN: I'm thinking of switching from a change in fund basis to an issue year basis on some valuation interest rate for some of our annuities. Actually I mean for a new business from now on. Does anybody know what restrictions I have on that, and who I need to talk to or notify in doing that?

MR. VAN ELSEN: You're not changing the existing policies? You're changing the standard going forward?

MR. DERKSEN: It would be for businesses sold from this date forward.

MR. VAN ELSEN: My view would be to just do that.

FROM THE FLOOR: That's my view, too. I don't want someone coming in a year from now saying why didn't you tell me about this.

MR. VAN ELSEN: It doesn't hurt to tell the department you're doing something, but I probably wouldn't even do that. I would do it. Obviously, if you're going to change the in-force business, then that's potentially de-strengthening, and you'd have to talk to them about it. I'm not aware of restrictions.