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Ask The Experts

Moderator: Meredith A. Ratajczak
Panelists: Armand de Palo
Mark J. Freedman
Charles D. (Bud) Friedstat
James P. Greaton

Summary: This open forum is an opportunity for participants' questions to be addressed by experts in the field. Questions are raised by the moderator and panelists, as well as audience members.

MS. MEREDITH A. RATAJCZAK: We've tried to put together a panel that can cover GAAP, statutory, and tax issues. Let me introduce the speakers on the panel. First is Armand de Palo, executive vice president and chief actuary of Guardian Life Insurance Company. He will focus on statutory issues. Mark Freedman is partner at Ernst and Young, and he would be considered a GAAP expert. Bud Friedstat is managing director of KPMG. He can handle statutory, GAAP, and tax issues. Our fourth panelist is Jim Greaton from Keyport Life Insurance Company. He can handle statutory and GAAP issues that specifically pertain to equity-indexed annuities and other annuities. I'll be your moderator, and I might throw in my two cents here and there. I'm a consulting actuary for Milliman USA in the Hartford office, and I will focus primarily on statutory issues.

We received 17 questions in advance. In one case, we're going to look to the audience to give us a little bit more clarification on exactly what they wanted us to focus on. We're going to go through those 17 questions and then we'll probably have time for questions from the floor.

The first question is does *FAS 133* cover deferred annuity book value surrender?

MR. JAMES P. GREATON: No. *FAS 133* clearly states that insurance contracts aren't covered by it. I'm referring to those features that are traditional features in traditional insurance contracts. For example, most fixed-annuity contracts have a floor surrender value, and if you were to price them from a capital market's standpoint, you could come up with a fair value and price them for the put that they are. However, these features have always been part of a traditional fixed-annuity contract so that they're not considered part of the floor. FASB has been specific about saying that. It has also said that some ancillary benefits, like the guaranteed minimum death benefit on a variable annuity, are also not covered by *FAS 133*. Other benefits, like the guaranteed minimum accumulation benefits or income benefits are covered by *FAS 133*. So there is some ambiguity when you get on the variable side with some of the put features. For a traditional single premium deferred annuity (SPDA) the cash surrender value is not covered by *FAS 133*.

MS. RATAJCZAK: Question two. The investment department wants to use Treasury futures to match asset and liability duration each quarter. The cash-flow testing software does not have the functionality for futures, and changing software is not an option. Is there a simplified way to account for these futures without doing a full-fledged upgrade of the software?

MR. MARK J. FREEDMAN: I think one way or another you have to find a way to model the futures, whether it's done by making modifications to your existing software or by using some kind of spreadsheet model. You have to do something.

MR. GREATON: There could be a method to avoid full-fledged modeling. If you're buying a future, you're essentially resetting your Treasury portfolio to market over a short period of time. You have to assume that this was going to be a constant strategy—you are going to buy a series of three-month futures and six-month futures and do it every six months and continue to do it out into the future. However, for a portion of your portfolio, you are creating a synthetic floater. You could probably float the coupon on a portion of your portfolio, but you'd have to get pretty sophisticated in what the strategy was actually trying to accomplish. You need to figure out what portion of your portfolio you're trying to convert to floating, and then figure out what your spread is between your Treasury futures and the corporates that you're trying to convert to floating. I think it would be very complicated to try to fit it into some software.

MS. RATAJCZAK: Question three. When utilizing the statistical methodology to examine the appropriateness of the X factors, what might be considered a reasonable rejection level for the X factors? Are you aware of any state regulators providing requirements or opinions on what the rejection levels should be?

MR. DE PALO: Let's go over the X factors in Regulation XXX. You can use the mortality data that you have in your company, assuming you have mortality data on a broader base of policies than those that use the X factor for developing your expected X factors. For Regulation XXX, you're asking for an actuary's opinion as to the appropriateness of the X factor, and then you are finding ways to support it. After you develop whatever basis you're using, your own company's experience or outside experience that you rationalize is adjusted for your experience. When you actually calculate your test each year, which is the actual claims that you've experienced versus your expected claims, you can use only the business for which you used the X factor (other than one). You might have used a lot of your business in arriving at an appropriate X factor; however, for the annual aggregate test, you're only using recently issued business, i.e., the business where you've used the X factor less than one to do the comparison to test that the X factor is appropriate for the business where you're using it in an X factor less than one. In many cases, this is only one year's worth of business for some companies, but it will grow over time. As a result, you do have the problem that you don't have enough exposure to get credibility.

Larry Gorski's paper was the one that talked about the Monte Carlo method. You can use other statistical methods. The general rule on this (and Larry has stated that this is okay with him), is it doesn't preclude the X factor from being appropriate. You can feel relatively comfortable that your X factor is appropriate, if it is within one standard deviation. However, you should reflect on the experience that served as the basis for the X factors so you can still say that the basis is still appropriate for that block of business. If you have a standard deviation greater than one, the pressure on the actuary to justify that X factor becomes greater. That's the general wisdom that I believe is currently operational.

MS. RATAJCZAK: Question 4. With respect to *FAS 133*, Derivatives Implementation Guidance (DIG) implementation issues number B29 and B15, can you provide any comments regarding the mechanics of the budget method and your thoughts as to whether it is an appropriate methodology to use?

MR. GREATON: We actually were discussing this in a *FAS 133* workshop prior to this session. Essentially, for some forms of equity-indexed annuities where you are going to change the participation rate in the future, a number of companies have a budget for what they intend to spend in future periods on options. What this person is saying is, if I know I'm going to spend this amount in my participation rate, and if other policy parameters are going to change to whatever I can spend, isn't that proof enough for *FAS 133*. All I have to do is value what I'm going to spend in the future. We thought that sounded reasonable, as long as you took into account some of the floor features in the contracts. In other words, there might be some scenarios where your budget is going to be inadequate to provide for the floor. As long as you've taken that into account for future periods, that, along with your budget, would be a reasonable approximation for *FAS 133*. Of course, the real answer to this depends on what the auditors will let you get by with.

MS. RATAJCZAK: Question five. To what extent and by what method should the default assumptions be consistent with spreads over Treasuries in periods of widening spreads to Treasuries?

MR. FREEDMAN: First, there are two separate assumptions. One is a spread over Treasury, and the other is default. If you are going to say that today's current spreads are going to continue forever, I think that means the market view of defaults are probably higher than your default assumption. I think you would feel compelled, to some extent, to at least think about raising your default assumption over time. The alternative would be just to sensitivity test the spreads normalizing to a normal range over time. That would be the minimum I would do.

MR. DE PALO: I want to comment that many states recommend that you renormalize your curve over time, but in states like New York, if a curve starts out being nonnormalized, they want you to project forward by remaining nonnormalized. That's the difference you can get between states. In my company, if we have a nonnormalized curve, we do both in the testing. If we normalized in New York, they'd come back and ask why we normalized this nonnormalized curve. Other states would ask why we didn't normalize over time. The easiest thing is just to do it both ways.

MR. FREEDMAN: The answer you get is not always intuitive. If you're in a line where you get a lot of positive cash flow, then obviously the higher spreads will help your results. However, if you're in a deferred annuity line, the spreads could go the other way, and the results can be worse with the higher spread.

MS. RATAJCZAK: Question six. Should the spreads over Treasuries be normalized after a certain time period, as well as having a select-and-ultimate default assumption? I will comment on the definition of the normal spread over Treasuries? I think we've covered this. In the cash-flow testing work that I do, I regularly look at what the current slope is. Depending on whether it's inverted, flat, or steep, I usually test at least two additional sets of interest rates while also modifying the slope. I might test out something that's flatter. It just gives you a better sense, from the standpoint of your reserve adequacy, of whether you've captured the appropriate boundaries in terms of the impacts on your results.

Question seven. What do you see for the future of the standard valuation law based upon what is coming out of the pseudo company modeling project that is performed and discussed as a basis for developing a new and improved valuation regulatory framework? I'm going to take this question. I think the individual that wrote this question is talking about the work being done by the unified valuation system team. That project started out gung-ho, and a lot of good work has been done, but I don't see us getting to that point any time soon. I think they've tried to educate the regulators regarding this approach. However, what they are proposing is so far away from the way that we do things today, that I think it's going to take a very long time before we see a system such that the appointed actuary has complete control over how reserves are set. We've been moving in that direction with some of the revisions to the opinion and memorandum regulation, but we have a long way to go before we get there.

MR. CHARLES D. (BUD) FRIEDSTAT: I'd agree with that. If you go back and you look at the days when we first started having asset adequacy analysis, there was even some discussion then about being able to demonstrate that you could have reserves below the minimum standards. We then considered dynamic financial condition analysis. I believe the unified valuation system (UVS) is an extension of that. I'm not sure when this will ultimately be required. I think it's inevitable, but I also think it's going to take longer than most people realize. The regulators and the NAIC, are not comfortable yet with giving up current methods and a minimum standards floor for reserves. There's going to have to be a lot more work with UVS and further research and analysis. There has been a lot of good work done to date, but for UVS to evolve as our statutory valuation system, we still have a big hurdle to get away completely from minimum standards. When you think of all the time that the Life and Health Task Force (LAHTF) spends on reserve issues, you realize that it's always within committees that develop minimum standard reserves and reserve methods. So in my mind it's not in the near term.

MR. DE PALO: Before that committee went into a slow down, they did a survey among the people actually attending the meetings. The general consensus was it would be a 10- to 20-year down the road issue for the whole blue book. The property and casualty companies were not interested in participating. There are an enormous number of open tax issues on it because once the reserve gets set by the actuary, you'd have to go to the IRS and negotiate a completely different way of handling taxes. Those burdens were a problem, but I do think something will come out of it. The U.S. system has always been just reserves. You're beginning to see products that deal with reserves and required surplus. You're not going to get a uniform replacement of the valuation system, but there will be some aspects for certain high-risk products. You're going to look for some additional reserves from actuarial opinions, which are on top of the formula reserves, and additional risk-based capital for those products. You might get a few products at a time, but I agree that the concept of removing minimum standards for reserves is not a near-term reality.

MR. WILLIAM SCHREINER: Armand mentioned this, but I think I'd like to emphasize it. One of the major stumbling blocks to moving to this has less to with the regulators than it has to do with the existing tax law, which is so dependent on statutory requirements. If you pull away the statutory requirements, it throws the whole tax situation of insurance companies in play, and that's somewhat scary.

MS. RATAJCZAK: Question eight. Do many companies use the provisions in the federal tax code that permit resetting the valuation interest rate every five years? If not, why? If so, have there been any major revelations or concerns about the impact of doing such?

MR. FRIEDSTAT: Surprisingly enough, this was not one of the topics that people wanted to talk about at the tax workshop that I chaired. Let me provide some background. As I think all of you know, the interest rate that you have to use for tax purposes is prescribed in the Internal Revenue Code. Since 1987, this rate is the greater of the applicable federal rate or the so-called "state prevailing rate" (the highest state rate that's permitted for valuation purposes for a given type of policy by at least 26 states). When the applicable federal interest rate came in, there was some concern on the part of companies because many of the products being value were long-term products. If you had one interest rate for tax purposes over a longer term, especially when it was such a high rate, generally higher than the statutory rate, some relief needed to be provided. The proposed solution was the five-year election provision. Let's say that you have made the election, and you're in 1998. You are allowed to revalue your 1993 issues based on the new applicable federal interest rate for 1998. The state prevailing rate would stay the same, and the rate that you'd use would be the greater of the applicable federal rate or the state prevailing rate. You would be allowed to revalue only if the change exceeds 0.5%. There are a lot of potential benefits to this. First, let's take the situation that we have now. Interest rates have been declining. This would *not* be a ten-year spreadable event, and the entire increase in reserve would be reflected in earnable income all in one year. Many companies are finding this more attractive as years go by. There has been much more discussion recently. The question is, when would you want to do this? We've talked about this, and if you are the tax director of a company, and you're within five or ten years of retirement, you're probably going to want to do it, because you're going to be a hero. I wouldn't necessarily want to be your successor when interest rates start going up and you try to explain to your senior management the decreases in the reserves are all hilling in one year.

There are companies that have made this election. I know of about six companies that have implemented it. The type of situation that you're looking for is a case where the potential gain from a decline in interest rates is relatively greater than the potential loss if interest rates go up. If you're in a multi-corporate environment, you might have some additional flexibility. If you're writing only products in an entity where there's very little risk, and you expect little change in the reserve if interest rates go up (e.g., where the cash value floor comes into play), you might get a benefit and possibly should consider it. There are other specialized situations. I will just say that companies that I'm familiar with that have done it probably couldn't have chosen a better period to do this. They actually keep track of it and are very proud to tell their management how much money they've saved the company over the years, and how much this revaluation of the business from the five prior years is going to be.

One thing I'll add that might not be readily known to people, is the applicable federal interest rate (AFIR) for 2002 issues has now been determined, and it will be 5.71%, which continues the significant decline of recent years. If you do some projections, and if you think that interest rates aren't going to soar in the near future, you may see a small drop in 2003 because 2003 would replace 1998 in the five-year averaging for the calculation.

If you do implement or plan to implement something like this, you really should do a thorough analysis. Determine what will happen if interest rates go up. I always like to ask, in any management decision, what's the worst thing that could happen? If interest rates go to 8% or 9%, what would be the worst thing that could happen? Measure that against the potential gain if interest rates remain the same or decline.

FROM THE FLOOR: If you make this a five-year election for one year, do you need to do it for all the years?

MR. FRIEDSTAT: I should have added that. Once you make this election, it is *irrevocable* without the approval of the Treasury. I think you have to make the election with the idea that it's going to be permanent.

FROM THE FLOOR: Wouldn't alternative minimum tax (AMT) mitigate, to some extent, the impact of making the five-year election?

MR. FRIEDSTAT: The companies that have done it were not in that situation, but certainly that should be part of the analysis of doing this. That's why it's hard to generalize. You have to look at your particular company's tax pattern and the types of products that you write. The companies that I'm familiar with that have done this have not been impacted by AMT.

FROM THE FLOOR: What is the definition of irrevocable?

MR. FRIEDSTAT: What did I mean by it's irrevocable? Once you do this, you have to use this process for subsequent years. So every five years, you're going to be revaluing the policies issued five years prior if it was part of your election. You have to keep doing this into the future.

Once you do it, it's in place for all future years. Let's say that 1998 is the first revaluation year, and the first time you do it. So when you get to the 2003 return, 1998 reserves have to be revalued. In 2004, 1999 reserves will be revalued, and so on. When you get to the sixth year, you're going to be revaluing the business issued five years ago and ten years ago. You have to keep doing this into the future. It's only the business that was not involved or the business that was in place before you made the effective year of the election that may be locked in. Everything in the future is revalued.

FROM THE FLOOR: The election has to be made on all lines of business?

MR. FRIEDSTAT: It's on a company-wide basis. If there are questions, I'll get into it in more detail. When an election is made, one of the situations might be among a multi-corporate environment where you have some control over which entity has which blocks of business.

FROM THE FLOOR: What is the impact in an acquisition situation when one company makes the election and another one does not?

MR. FRIEDSTAT: There are some unanswered questions on this. If the company goes out of existence, there's not a specific question on that. I don't think that has been addressed. If an acquiring company is still a separate entity, it maintains its own elections. So if Company A bought Company B, and Company B made that election and is still an operating entity, I believe that even though it might be part of a consolidated return, you have that election for the purpose of determining your separate company taxable income.

I would think that in a merger situation, if the surviving entity is a company that has made the election, that would be my initial reaction. If the surviving entity has made the election, those elections also would survive.

MR. FREEMAN: If you were worried about new business, you could put that into a separate company?

MR. FRIEDSTAT: That's without getting into specific company situations. I feel comfortable saying yes. Some of the companies have been involved with multi-corporate environments, and some have been involved where there was very little downside risk compared to upside benefit.

There are other reasons why you might go into this sort of situation, but those relate to specific company fact patterns.

MS. RATAJCZAK: Question nine needs some clarification. It reads, how should reinsurance reserve credits, which are greater than the respective direct reserve, be handled? Should they simply be calculated and posted? Should they be capped at the direct reserve? If they're capped, should it be in the aggregate or on a policy-by-policy basis? When we discussed this question yesterday, we didn't know whether it was specifically geared toward a particular AG 34 application. We're just going to answer it based on what we think they were asking.

MR. DE PALO: I'll start. Say the following situations exist. First, you're paying your reinsurance on an annual basis. Second, your product is on a monthly basis. Third, you have a different deferred premium asset. Finally, you are getting a difference in terminal reserves. Should you take credit for a terminal reserve that's greater than the reserve credit? If it's a variable contract, on AG 34, you have to reflect the terms and conditions of the reinsurance and the calculation of your reserves as they flow through. The answer is independent, to some extent, of what the reinsurer might be holding. That's why we were a little confused about this question. Our view on a straight reinsurance agreement is that you can't take a reinsurance credit greater than your reserves. We were very confused about this question.

The one conclusion we reached was that if we look solely at the reserve side on an individual policy, we would find that the reserve couldn't be less than zero after reinsurance. In a situation where you're holding cash surrender value, you might be holding something less than cash surrender value with reinsurance.

MS. RATAJCZAK: Question ten. Is codification's impact more than financial reporting through its references to using actuarial guidelines. For example, could codification require XYZ type nonforfeiture values on universal life (UL) policies?

MR. DE PALO: Codification does require the adoption of all actuarial guidelines, except from a financial point of view. For example, Actuarial Guideline XYZ is a nonforfeiture regulation, which is a state-approved item. When you file your policy forms, this is not a reserve or liability item; it's a state-approved item. A state can choose not to follow AG XYZ in setting the cash values for secondary guarantees on UL. If you do have the secondary guarantees on UL, it falls under XXX, which was adopted, in effect, as a minimum floor in all states that govern the reserve. This is an interesting point that people don't realize about XXX. XXX becomes the minimum floor, but if your state hasn't adopted XXX, whatever other rules they have are still the governing reserve on statements filed in that state. As an example, if XXX was adopted, you can actually hold lower deficiency reserves on whole life. However, if that state didn't adopt it, XXX becomes the floor on term products, but you can't really get the relief on deficiency reserves for permanent type products until all states adopt XXX. That's a problem. These nonfinancial related items still revert to the states. This is a policy approval item and not a financial item.

MR. FRIEDSTAT: I would agree. There is no direct impact from codification. There may be an indirect impact because of the nonforfeiture values, and it might have minimum cash value requirements. There is also the fact that the statutory reserve has to be at least as great as the cash surrender value. So there is an indirect impact.

MR. WILLIAM SCHREINER: I want to take issue with what Armand said about the application of individual states relative to XXX. All states have adopted codification. Codification requires the use of XXX in the preparation of your annual statement. To my knowledge, since XXX came out of the blue, there are no contrary requirements in the states; therefore, there's no override by individual states on XXX. I think the best posture is that XXX is required by all states. As such, all the privileges of XXX are available in all states.

MR. DE PALO: I know that's your opinion, and we've discussed this before. If there's a regulation on a book that's calculated differently, I am not convinced that codification being adopted and becoming the minimum standard overrides a higher standard by a state.

MR. SCHREINER: There are no conflicts in state laws with XXX.

MR. DE PALO: When we wrote XXX, we clearly included level premium variable life and level premium whole life. Then, once XXX was adopted in all states, companies cannot only use it for term products or products that have level premium segments, but also come in and adopt an X factor for whole life business and second-to-die policies. This was a big issue because many companies' second-to-die products had gross premiums less than the net premium, but they were level premium contracts. In effect, at least from my company, we have not felt comfortable in applying an X factor to those contracts, but that is not because New York State hasn't adopted. New York State has adopted Regulation 147. It has more to do with the fact that these other states did not adopt XXX. It's clear that the other states that did not adopt XXX now have to at least hold an XXX type reserve in filing in those states. The question that I really have is are you able to take down reserves to an XXX standard in those states. That's the question that I still think is open. I'd like it to be Bill's answer.

MR. SCHREINER: I would characterize your point of view as a belt-and-suspenders-type approach. If every state adopted XXX, there would be absolutely no question, but I think the proper interpretation is that all states have XXX.

MS. RATAJCZAK: Question eleven. Is there any problem with referencing the prior year's actuarial memorandums supporting an asset adequacy analysis as opposed to representing all of the assumptions and methodologies utilized? For example, can they be simplified and simply reference older documents provided. I think the question is, is it acceptable to refer to work that was done in a previous year as the basis for your opinion. I would say that there's nothing that precludes you from doing that. There's nothing in the AOMR that says you can't do that. I think you need to be comfortable relying on work that was done a year ago based on assets and liabilities from a year ago and based on the changing interest rate environment. Can you be comfortable that what you did a year ago is an appropriate representation of the way things are today. Given the volatile environment we're in these days, I would be hard pressed to find situations where last year's work would be reliable for this year's work, especially if you're testing business like UL or deferred annuities. It's possible if you're doing your asset adequacy testing on a noninterest-sensitive block of business, that you might be able to come up with a demonstration to make yourself comfortable that it is an appropriate reliance. I think the key is, if you rely on prior information, you're going to need some words to satisfy whomever is looking at your memorandum. You need to show that you have gone through that exercise and tell why you believe that it is still an appropriate representation of where things are a year later.

MR. FRIEDSTAT: I think that because the majority of companies do asset adequacy annually, I don't think you see this as often. I predict, with the elimination of the Section 7 opinion, you will see some smaller companies attempting to reduce the amount of work that they have to do each year and still comply with asset adequacy analysis. I don't know if this is what this person was talking about. For example, I can see a situation where a company does a fairly detailed gross premium valuation in year X and in year X + 1, it modifies certain experience studies. It also looks at actual-to-expected ratios for a block of traditional business. As Meredith said, it gives all the reasoning of how you reach your conclusion, but it relies primarily on the work that was done in the prior year and gives an analysis of experience for the current year to support that. Of course, if current experience does not support today's situation, all bets are off. I think that's one of the ways that smaller companies might attempt to reduce the amount of fiscal work that they do each and every year.

MR. FREEDMAN: That was the rationale of the Actuarial Standard of Practice. The idea was to find some way to give relief but not really give relief. Many people, when they do their cash-flow testing, will use a date of September 30 instead of the year-end. Then, they try to build a case for why that's appropriate. The thought is, if you can build a case for why something done five years ago is still appropriate, why shouldn't you be able to do that?

MS. RATAJCZAK: I had a situation a year ago where we were looking at a block of health business, and we went through a pretty detailed gross premium valuation. New York State said that you could rely on work that was done a year ago, if you could say that certain conditions were met. We were able to satisfy the conditions indicated, and we looked at this and this made sense. Even in that case, they would have allowed reference or reliance on previous work.

Question twelve. Are risk-neutral or realistic types of scenarios best for each of the following types of modeling: cash-flow testing, market liabilities, pricing, investment and crediting strategies, stochastic unlocking, and business planning?

MR. FREEDMAN: I've seen risk-neutral scenarios in the area of fair value and in option pricing and investment strategies. In most of the other areas, I tend to see more realistic types of assumptions, but I've seen people that argued both.

MR. GREATON: I'll echo what Mark said. If you're doing fair value of liabilities, or if you're trying to come up with a price for an option or trying to construct an investment strategy with backing assets, or assets that have options or assets that are options, then you ought to be using the risk-neutral approach. If you're trying to do some sensitivity testing on your pricing or cash-flow testing as to what worst-case scenarios might be, realistic scenarios are fine.

MS. RATAJCZAK: Question thirteen. In this volatile marketplace, where has practice evolved with respect to future equity assumptions for DAC amortization, and what is the GAAP justification?

MR. FRIEDSTAT: There has been a lot written on this. It was actually even mentioned at the GAAP issues panel in a question from the floor.

Many companies are trying to modify their methods for GAAP to help alleviate some of the concerns. For example, let's say that a company was assuming 8% growth in equities forever out into the future. If all they did was take into account the negative 20% this year without altering their future rates, it could have a very significant impact. Some companies, in an effort to dampen that impact, have adopted other procedures. There was a paper titled "Managing the Volatility of GAAP Earnings" pertaining to this issue by Louis Lombardi in the *North American Actuarial Journal* of the Society of Actuaries. Alastair Longley-Cook, at the last two Valuation Actuary Symposia, has talked about some methods that he was looking at for his company. Even our GAAP textbook has some documentation on this. The one thing that I require when I'm looking at companies goes right back to *FAS 97* and the basic concept. You have to be able to state that your assumption, as far as future returns on your separate accounts, is your best estimate. I think you need more than just a simple mechanical method or to claim that it is your best estimate. You have to comply with GAAP accounting. While there has been an increased emphasis on this, there have been more questions from analysts in our experience. At a previous session, it was mentioned that there were some questions from the SEC to companies on this. I think you have to go back to what's written in *FAS 97* and comply with the best-estimate assumption in whatever you do and deal with your support for your approach.

MR. FREEDMAN: I totally agree with you, but, in practice, I see that almost every company is building this mean reversion type of thing into their future margins. I've seen it as low as a three-year mean reversion. If you had an immediate mean reversion, you'd have absolutely no volatility. That's kind of hard to stomach. Three years is probably about the limit of what I've seen, but there are a decent amount of companies that have even done that.

MR. FRIEDSTAT: I would say that even that would be superior to saying, if we were on a 10% annual assumption, and we had a negative 20% in this year, would we make up that 10% return over the next three years by having mathematically higher rates? Over a three-year period, it would average out to the 10%. I feel really uncomfortable about that. I feel a little bit better about a mean-reversion technique that would take into account, in some way, historical returns. At the end of the day, you have to be able to make a case to your auditors and to the SEC, if you're questioned, that your assumptions, as far as future returns, are your best estimate.

MS. RATAJCZAK: Question fourteen states, does codification and the use of best estimates in claim reserves eliminate the ability to have moderate margins for adverse deviation?

MR. DE PALO: Claim reserves, in actual practice, should contain reasonable margins for events that are not unreasonably adverse or slightly adverse. That has been the practice and codification has enough leeway in it that you can continue to hold the reserves that have a margin for expected and moderately adverse, but you cannot hold excesses above that.

MR. FRIEDSTAT: I think that's correct. There is something interesting behind that, which gets more into the codification process. There is an interpretation that came out called 01-028, and it deals exactly with this issue. It's only about three sentences long, but it really says a lot. Realize that whatever is said here is not meant seriously in an A & H context. The principles of codification for claim reserves for A & H and for property/casualty are virtually the same. They also have different wording in terms of their actuarial opinion. On a note aside from this, I believe there is a question of how codification standards compare to the tax basis for claim reserves, which is "fair and reasonable." Is there a difference in what we're required to do for the annual statement? The interpretation I'm talking about basically acknowledges that conservatism has been a part of the normal claim reserving process. The wording and codification that you use for your best-estimate claim reserve is not meant to replace the normal claim reserving process. The last sentence in the interpretation is also very interesting. It does not appear to require you to have some conservatism in your claim reserve that you might not have had before.

In an actual company situation, I think what we're saying is that the rules haven't changed. We always look for consistency from period to period in terms of your approach to setting claim reserves. It appears that codification hasn't changed those rules and guidelines for the basic claim reserving process.

MR. ANDREW F. BODINE: There was a codification presentation on Statutory Accounting Practices (SAP) 54 and 55. I felt that there was a strong distinction made between claim reserves in SAP 54 and claim liabilities in SAP 55. SAP 54 includes references to Actuarial Standards of Practice (ASOPs) and other NAIC regulations. ASOPs include this margin for adverse deviation. So for an existing disability claim, there is some margin for adverse deviation. As for claim liabilities, meaning amounts due and payable as of the statement date, SAP 55 addresses the liabilities and best estimates, but SAP 55 makes no reference to ASOPs. Best estimates are not mentioned in 54.

MR. FRIEDSTAT: I appreciate your making the distinction. Again, it is my understanding that this interpretation, and the way it was written, was focused on property/casualty reserves. You're exactly right. My comments and the interpretation pertain to SAP 55.

MR. BODINE: Yes, and I agree with your comment on the interpretation that was finalized in October.

MS. RATAJCZAK: Question fifteen. What is the status of the Actuarial Opinion and Memorandum Regulation (AOMR) regarding Section 7 opinions? It's my understanding that there will be Section 7 opinions this year-end. Not all the AOMR is part of codification, so the states have to go through an approval process in order to make these revisions part of their AOMR. This won't be something that people need to be worried about until 2002. Depending on how quickly states move, it might not be all states.

MR. FRIEDSTAT: I think that's the question. Let's say the State of Hawaii adopts the AOMR revisions later. Would they be able to do a Section 7 opinion in 2002?

MS. RATAJCZAK: I would assume if they write business in other states, then they would have to follow the most conservative approach, which would be not to do a Section 7 opinion.

MR. FRIEDSTAT: I think that is relevant. I think you're going to see some states like California and New York require it, even if the home state hasn't done it. That would apply if you're going to do business in that state. It will be very interesting to see what happens in that particular case.

MR. FRANK M. AMRINE: With all due respect to Meredith's comment, I would say that if you're not currently doing Section 8 opinions, you might want to start worrying about them now. A year from now would be a little late. The other comment I have is that I've heard a number of comments pertaining to this AOMR change with regard to ASOPs 22 and 14. Those aren't in effect now right, are they? I've heard comments at this meeting that ASOP 22 and 14 have been changed. They haven't been changed. They change on April 15, 2000. I think some people are confused about the timing of ASOP 22 and 14 just as they might be confused about the AOMR.

MR. FRIEDSTAT: I think you have to deal with it on a case-by-case basis. Meredith was right. It depends on what states you do business in. Some states are probably going to be more lenient in granting that and other states might take a harder stand. It will be interesting to see what happens.

MS. RATAJCZAK: I know a lot of the back and forth regarding the revisions to the AOMR have dealt with state of domicile opinions and such. I believe that the language exists such that you could go to your commissioner and ask for special treatment. I'm sure that's a consideration that they put in the back of their mind when they put that in there. I would like to clarify that. If you do have to do a Section 8 opinion for the first time in 2002, you probably don't want to start thinking about it in 2002. Start on it as soon as possible.

Question sixteen. When should the appointed actuary set reserves higher than minimum standards?

MR. DE PALO: The actuary has a lot of discretion on this because the law defines minimum standards that you have to hold. Within those minimum standards, you might be holding extra reserves on some blocks of business and not on others. You might conclude for a particular block of business that you need to hold more reserves than the minimum standard. However, you might have some other reserves elsewhere that are higher to cover this shortfall. In arriving at your opinion, as long as your minimums on each block meet the minimum standard, and you have a margin in the aggregate to cover the extra reserve that the actuary feels is appropriate, the margin does not necessarily have to be on the block where it should be. But you can run into certain problems. Let me give an example. If you have one growing block of business, for which you believe you need to have more reserves, and another shrinking block of business for which you have the extra reserves, you're probably going to be faced with a current and future modeling question. I think you're obligated to adjust your reserves and can't just look at this point. I think you have to look at it as if you were doing your cash-flow testing going forward. Would you still be adequate? You do have some discretion in taking credit for excesses elsewhere to cover these. It's always nicer to put up the reserves on every block you think is appropriate, but sometimes you do want to use the margins that you don't want to take down on other blocks to cover them.

MR. FREEDMAN: I think many actuaries have asked this. In some cases, the actuaries might not be management. It's okay for management to set reserves. The appointed actuary is merely performing an attest function. The appointed actuary doesn't always have the say in what reserves go into the statement. If you go negative in some future year in cash-flow testing (for example, say you have losses in some years), you have to consider that in forming your opinion. You don't necessarily need to have gains in every single year.

MR. DE PALO: Some companies used excesses on old blocks to cover deficiencies on new blocks. Those excesses weren't getting any larger. They were going down, but they continued to write new business and produce deficiencies. When you use the aggregate test to eliminate deficiency reserves, it can reverse on you very rapidly. You can end up with a nasty surprise, even if it's appropriate at the current points in time that the surprise jumps out in the future. If you're looking at it as a closed block, I think the actuary would have to consider that when deciding when he starts having to put up additional reserves.

MR. FRIEDSTAT: I generally agree with you. I think you have to watch one thing. I think you could not use pluses in an ordinary lifeline against future negatives in a health line. I think the minimum A & H reserve standards would require you to look at A & H separately, so that's maybe one exception. In actual practice, a lot depends on the company environment and the company actuary. I'll give a concrete example. Let's say that you wrote a ton of immediate annuity business in the 1980s and interest rates have declined. Let's also say that you probably have margins elsewhere in other ordinary life and annuity blocks of business. I think that you might be able to make a case for not requiring additional reserves. I know that some companies have looked at the income-paying annuity line of business separately and set up additional reserves. There's a lot of latitude in there.

The one thing that hasn't been talked about is disclosure and what reserves you're holding as it deals with codification. A very controversial interpretation, 01-026, has come out, which, depending on whom you talk to, might still spark further discussion. It deals with disclosure. I don't think anybody disagreed about the interpretation of codification. You had to disclose situations where your reserves were less than minimum standards, but the interpretation that I'm talking about will require you to disclose reserves that are in excess of minimum standards. There are some issues about how much disclosure is enough, how specific you need to get, and what aggregation there is. That interpretation was adopted by the Emerging Issues Working Group, despite the strong support of the Life and Health Actuarial Task Force and the industry. I wasn't there, so I don't know what their thought process was. They might have been swayed, because this group was probably comprised, at least in part, of professional accountants. They are looking at GAAP issues and some of the elements of "managing earnings" issues that have taken place in publicly reporting companies. They might have been swayed by trying to keep codification consistent with the GAAP principles. I'm not sure what formal process is needed. Maybe Bill has some comment about what the industry is doing to possibly change this interpretation at the NAIC meeting that's coming up soon. It is something that you ought to be aware of. You are going to have to disclose reserves that exceed minimum standards because codification implies the minimum standard reserve.

MR. DE PALO: Is that only for issues of this year going forward?

MR. FRIEDSTAT: The effective date would begin for 2001 issues. So it isn't quite as onerous as it might seem at first, but it might prove onerous down the road.

MR. STEPHEN STEINIG: What criteria are appointed actuaries using to determine whether reserves are adequate?

MS. RATAJCZAK: I'll talk about it based on my experience. We have internal guidelines at my firm in terms of being an appointed actuary and what we can sign and who needs to look at it in certain situations. I need to look at the interim results and take into consideration whether there are material negatives that would infringe upon the surplus of the company. If, based on the prescribed seven scenarios that we still have, I'm going to sign an opinion with failure in one of those, I need to go through that with my national director. I need to make him comfortable that a clean opinion is appropriate. You're opining to these seven scenarios. If you fail two out of seven, that puts you way below any sort of acceptable threshold level of reserves that you see in any of the new guidelines coming down the pike. If I'm going to sign one, I need somebody to say that it is okay to do that.

UNIDENTIFIED PANELIST: I think this becomes even more significant where you have discretion. Take a managed care organization or where you have a lot of health insurance liabilities. Ultimately, the determination of the number that goes into the financial statement is going to be the responsibility of management. You, the actuary, are opining on the reasonableness of that number. There are various numbers that might prove reasonable. There's no one number that might be more reasonable than another. If you look at it that way, which is consistent with what Meredith is saying, you know that these are the numbers that management is posting in the book. It's your responsibility to issue an opinion on those numbers.

MR. DE PALO: I think you have to answer it from this point of view. Obviously, it's nice to put up extra reserves as your management would like to do. It makes your life easier. You have to ask whether most other actuaries would require that extra reserve. If you think your numbers are so much more conservative than what another actuary doing a proper professional job would require, you have to question whether your reserves are too conservative. They can replace valuation actuaries' numbers; on the other hand, the valuation actuary who is taking over has to talk to the actuary who is leaving to determine why he felt the reserve was appropriate. Judgment is needed in this area.

State laws vary on aggregation. New York State is by major line of business. Some states allow almost full aggregation across the whole blue book. So if you are using aggregation or reserves, you better be cognizant of what different states that you're licensed in allow when you verify that you're in the aggregate and complying with other state laws.

MS. RATAJCZAK: Should you sign an opinion if two scenarios are small negatives or the results are just above zero? It's complicated. I do a lot of sensitivity testing too. If it only takes a very small change in an important key assumption to make that number go negative, that might make me talk to somebody about my results, even though they are positive. That's why we do the type of sensitivity testing that we do. So the answer to that question is not a simple one. You could say, it depends. You have to look at the complete picture, and you have to do enough flexing of your assumptions to put boundaries around how bad is bad. If it takes just a tiny little change in lapses to swing your results very wide, getting comfortable looking at your results under one set of lapse assumptions probably isn't the best bet.

MR. FRIEDSTAT: I think whether you pass them all or whether you fail three, you will ultimately have to determine whether there is a reasonable chance of the company failing in the future. For whatever reason, if you fail a test, you can see how it affects your particular company and lines of business. Even though it is one of the prescribed tests, you might be able to determine that it is really a rather remote possibility. Your cash-flow testing and your asset adequacy reserves aren't supposed to cover every possible thing that will happen in the future. You might reach a conclusion that's very remote. It's difficult to state rules. I've seen companies set-up additional reserves that passed all their tests. I have also seen companies not set up additional reserves that fail three tests. They could have justification for both actions in all situations. I would also say that, with the decline in interest rates and with the yield curve the way it is, this might be more of a practical question rather than a theoretical question for this year-end.

MR. FREEDMAN: I've seen cases where companies failed two scenarios. That would pretty much talk them into doing some kind of stochastic testing. It's a question of what your confidence level is.

MR. FRIEDSTAT: Exactly. Failing two or three scenarios would call for more work and more testing. Stochastic scenarios might be beneficial. I have seen a company that did additional work and failed three scenarios, but it made a reasonable case that it didn't require additional reserves.

MR. FREEDMAN: You've got to take a hard look at how you're doing your stochastic scenarios.

MR. DE PALO: My only comment is I think some companies might want to start disclosing reserves greater than what is considered minimum. There might be some advantage to doing that with your rating agencies. That's why I think any company would want to do the extra work, I agree that the definition of the minimum is not always 100% clear.

MS. RATAJCZAK: Codification has brought out these particular issues in various sessions. As we get deeper into implementation, more and more of these questions are going to come up, and they'll be addressed as they become bigger issues.

Question seventeen. With the new CSO table, do we need XXX, and what's holding up adoption?

MR. DE PALO: There are really two questions here. One is what's holding up the 2001 CSO table? The second question pertains to XXX. The basic table is not in question, but the loadings on the table are in question. The regulators agreed with the loadings that were there, and they view that as a compromise that there's not going to be a separate standard and preferred table. They went along with a lower load. The prior tables are loaded about 50%. This table is loaded on average about 15%. When they looked at the data, they asked the question of how many companies that submitted the data had mortality at the loaded table. They found out that about a third of the companies had mortality higher than that. When they realized that the companies had submitted data, even though there were several companies, the vast majority of the data were represented with two companies. They opened the question as to whether the loading is adequate. The Academy has sent out a report that said it thinks the loading is adequate. It gave a report showing what it is recommending. The regulators are saying we'd like to revisit that question. The Academy said that if we want to revisit, we should give it another assignment, separate and apart from the question it is wrestling with it.

For regularly underwritten business, is the table adequate enough for the regulators to say this is a conservative table? Last time there was a table with a 50% load in it, and you didn't have an actuarial opinion. You now have a table with a 15% load and an actuarial opinion. The other question they're raising is the mortality that goes into the table is underwritten business. Is the table adequate for guaranteed issue or less than full underwritten business, or should there be another table for this business? Some regulators have actually suggested something I find very unreasonable. They say to continue to use the aggregate 1980 CSO for all business that is not fully underwritten and adopt the new 2001 table for fully underwritten business. That would create tax problems on prevailing tables and nonforfeiture problems. That's not a reasonable answer, but it's bouncing around as a suggestion. This is all going to come to a head at the December meeting, and they'll move forward. This is the base of the question. Some people feel that the answer can simply be, if it's not fully underwritten business, you can't use the select period of the table. We don't know where the regulators are going to end up on this. Most people hope that they finally accept the table as presented, and that it will be adopted early in 2002.

We need XXX because it is where the X factor lies, even though the 25-year select table is substantially lower than the ten-year select table in the 1980 CSO. It's not as low as the mortality assumptions that are being used by people in establishing deficiency reserves when they apply the X factor (which is closer to a company's own experience). Because different companies have different products, some are well below the average. On the preferred and superpreferred products, the X factor is still needed. What will happen is you still need all the old tables for all the old business that's not on this new mortality base. One way or another, you'd have to carry it forward. There is something you wouldn't have, and this is a major help to the industry. We would just adopt a 25-year select table as the new appendix. In effect, you'd have a separate table in XXX, separate from the 2001 CSO. We would also have to preserve the X factor. The current discussions on this indicates it is unclear whether you can't use the select factors in the table after the first segment or after re-entry. That's unclear. It's clear that we have to preserve that the X factor can only be used in the first segment. I think this will come up as an issue also.

Because XXX is a regulation, I think it would be important to package it with the 2001 table, and that it will go out to the states at the same time. I'd hate to have to adopt the 2001 CSO, and then have to go through the steps of having a regulation adopted at a different date.

FROM THE FLOOR: I have a question pertaining to the reporting of results in Exhibit 8 versus Exhibit 8A. I have three examples. One example is the deficiency reserve, which changes because you reset your X factor. Another example is when the 2001 CSO table is adopted. The third was a more general one of setting up additional reserves because of asset adequacy testing. What flows through 8 and 8A?

MR. DE PALO: My general read on most of this is a lot of it goes through exhibit 8A, or it goes through surplus and it doesn't go through operations, because you're not adopting a different interest rate (i.e., change in basis) tables. I think you have some discretion because it's unclear. If you wanted to put it through operations, you could justify it, but I think the general belief is things like X factor changes follow very much like cash-flow extra reserves. I understand that the general thinking is you can put those changes through surplus or through operations, but it is not a change in business.

MR. FREEDMAN: When asset adequacy requirements were first adopted, the change came through surplus because there was a basis change (there were never asset adequacy requirements before). After the first year, if asset adequacy requirements caused additional reserves or lower reserves, I think the change comes through income, because there is not a basis change (asset adequacy requirements continue to be part of the "basis"). An analogy can be drawn to deficiency reserves. This would mean that once a company computes reserves using X factors, a change in X factor is not a basis change, so changes in reserves should come through income.

MR. FRIEDSTAT: The cash-flow testing question has come up. Initially, I thought the answer was going to be, if you set it up through income, then you take it down through income. That wasn't the answer. I'm not 100% sure. What I recall matches what Mark said. It would go through income, even if you didn't want to take it through income. Again that's just my recollection, and I'm not 100% sure of that.

MS. RATAJCZAK: I know in terms of setting up additional reserves for asset adequacy testing, states don't like putting it through Exhibit G. They would prefer it to be in Section 8B and run through 8A, if you're doing annuity-type work.