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Session 1GS
General Session

Moderator: Meredith A. Ratajczak
Panelists: Colin Devine †
W. James MacGinnitie
Daniel J. McCarthy

Summary: Events such as the terrorist acts on September 11, the accounting scandals, continued volatility in the equity markets, and low interests rates have impacted and will continue to impact the industry and our profession for many years to come. Three keynote speakers, an industry analyst and two leaders of our profession, will provide their views regarding these impacts and how the industry and our profession might change and act as a result of these events.

MS. MEREDITH A. RATAJCZAK: I'm the chairperson of the 2002 symposium. I've been associated with this meeting and this committee since 1990, and I'd like to think that every year it is a better meeting. The committee had its first planning meeting back in December 2001, and again in March 2002. When we were planning for this meeting back then, and even now, I think we could all say that a lot has changed in our industry and, as a result, in our profession. We thought we would look at the changes to the industry and to our profession through the eyes of an industry analyst and two leaders of our profession.

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† Mr. Devine, not a member of the sponsoring organizations, is Managing Director at Salomon Smith Barney in New York, NY.
Note: The chart(s) referred to in the text can be found at the end of the manuscript.

Our first presenter today is Jim MacGinnitie. He is currently President of the Society of Actuaries, and he has quite an impressive resume. He is a past president of the Casualty Actuarial Society, the American Academy of Actuaries, and he will be the president of the International Actuarial Association (IAA) in 2003. He has 41 years of experience both at insurance organizations and in consulting organizations, and he also directed the Actuarial Science Program at the University of Michigan. He has worked outside the U.S., and he was active in international insurance and reinsurance for over 30 years. I'll turn the podium over to Jim MacGinnitie.

MR. W. JAMES MACGINNITIE: We meet in a post-September 11 environment. The 2001 symposium was canceled because of September 11 and then rescheduled. September 11 certainly gave us a new appreciation of risk. We also meet in a post-Enron, post-WorldCom environment, which has also given us a new appreciation of risk and professional responsibility.

In my semi-retirement, I sit on the boards of directors of three different insurance enterprises, and I chair the Audit Committee of two of those. One of the things that I've been able to do in that capacity is to encourage the Audit Committee to get to know their actuary. Historically, they focused on the relationship with the external auditor and with the internal auditor, and for those of you who have had the experience of dealing with an internal audit, you know that there's an awful lot of paper generated that seems to be designed to make sure that nobody's stealing the petty cash. Some relatively minor risks are being appropriately managed, and, in my mind, that's not the right focus.

The right focus is on the larger risks that the enterprise faces. In an insurance enterprise, no one understands those risks better than the actuary. No one approaches them with a sense of professional responsibility better than the actuary. My message goes out to not only my Audit Committees, but also to the Academy, the National Association of Corporate Directors, the Audit Committee Institute, and some other associations. I want to get the message out that if you're a director of an insurance enterprise, you need to get to know your actuary.

The dialogue that the actuary has with the Audit Committee must have a good framework. At the Society of Actuaries, we've recently been doing some market research. One of the messages that comes back from the people who use our services is that actuaries need to be better communicators. They also need to demonstrate that they have a greater sense of business savvy or business acumen. Actuaries are by and large well situated to be involved in dialogue with the Audit Committee. An improvement in your communication skills and business savvy and acumen can be facilitated. You must look hard at the models that are emerging in the enterprise risk management area that enable you to do a much better job of identifying and categorizing the risks and determining which risks need to be mitigated, managed, and exploited. This enables you to then improve your dialogue with the Audit Committee so that when you talk about a specific kind of risk, there's a framework in which that discussion can take place. Many Audit Committees are not sophisticated in the things that you're sophisticated in. Even if they're knowledgeable in accounting, they are not knowledgeable in the form of accounting that we practice in the insurance world. They need a framework to facilitate that communication. You can use the enterprise risk management models that are emerging to help to provide that framework.

Then the second tool, which is closely related, is the actuarial control cycle. This is a concept that was evolved initially by the Australians. It's now a central part of their examination system, and I believe it will emerge as a significant part of the next revision of our examination system. It is a very simple idea that shows how you can identify the risk and how you're going to deal with the risk. How do you model things? That is, of course, where the actuarial part of it becomes most important. How you select the values for the parameters in that model and how you monitor the experience and set up a feedback loop is what goes on most of the time in your actuarial work. It's not easily communicated without a simple framework that the actuarial control cycle provides.

So my message to the other Audit Committees that I'm able to reach is really very simple: get to know your actuary. My message to actuaries is: improve your communication skills. You must also improve your business understanding and your ability to communicate that to the members of the Audit Committee. Continue to exercise the wonderful degree of professional responsibility that you, as actuaries, and we, as a profession, have demonstrated over the years.

It's now my pleasure to introduce the two speakers for the remainder of this General Session. The first is Colin Devine. Colin is a managing director with Salomon Smith Barney. He is responsible for providing equity research coverage on a diverse group of North American life insurance companies. He has authored several published articles on a variety of subjects relating to the North American life insurance industry. He was ranked number one for two consecutive years in the life insurance equity research category of institutional investors all-America research team for the years 2000 and 2001. He was also named to their all-American research team in the stock-picking category.

Prior to joining Salomon Smith Barney in March of 1997, he was a director in Standard & Poor's ratings group where he covered both life and property/casualty insurers. Before that he was an officer with a major Canadian life insurer where he was involved in both investment and risk management, as well as several of the corporate development initiatives. Colin is a chartered financial analyst and a certified management accountant. He holds a Bachelor of Science degree in biology from the University of Guelph and an MBA in finance from York University.

Dan McCarthy will follow Colin. Dan is a principal with Milliman USA in New York. He began his actuarial career with the company formerly known as The Equitable and joined Milliman in 1972 where he has worked as a consulting actuary, leading a number of the firm's major projects. Many of you will know him for his expertise in the demutualization area. He served as chairman of Milliman for a seven-year period in the 1990s. In addition to his demutualization work he has been involved in lots of merger and acquisition strategic and operational reviews, design of sales compensation systems, appraisals, and product development.

Dan is a Fellow of the Society of Actuaries, and a six-year member of the Actuarial Standards Board. He currently serves as President of the American Academy in which capacity he's addressing us at this session. Dan's bachelor's degree is in mathematics from Fordham University. With that, I'm going to turn it over to Colin and look forward to his remarks.

MR. COLIN DEVINE: It's certainly a real pleasure to be here. It was interesting that you made comments about the board members getting to know their actuary. I think over the next couple of quarters, many of you are going to get to know your analyst maybe more than you want. I hope we're going to get a chance to get to know you. Some of the stuff I'm going to talk about has become red hot; for example, there are deferred acquisition costs (DACs) and guaranteed minimum death benefits (GMDBs). It has received a lot of investor focus, and I suspect it will receive a lot more.

What I thought I'd do is take you through our outlook of the industry. What's impacting stock prices? I'll give a view on where the industry is going, and also discuss some of the major issues out there that are challenging all of us.

In terms of the fundamentals, the demographics, in our view, still make this a great business. I'm preaching to the choir here. I look at many of the life insurers I cover and many of the large financial services companies, including the ones I work for at Citigroup. This is where I think all the money is. It's part of selling financial services to these people as they are about to enter retirement; they have about 10 years to go, and they have the cash and the motivation. It's a little odd for an equity analyst to say this, but with the down markets over the last couple years, we've all had the heck scared out of us. They're probably more motivated than ever to look at the guaranteed types of products that we can sell them.

That leads into the distribution phase of their lives, and nobody today is selling things like life annuities. I think we all look at that as a huge source of opportunity going forward.

Earnings sensitivity. I thought the earning bases were a little better balanced today, until I got a few DAC unlocks and had to discover what that all means. Now I'm not quite so sure they are better balanced. I guess on an economic basis they are. I'm just not sure the accounting has caught up to that.

I get a lot of calls from many of the major media outlets these days that talk about how our industry is facing some sort of huge crisis. I've been at this too long. I remember 10, 11, or 12 years ago the company formerly known as The Equitable. There is also the company formerly known as New England that's now obviously part of Met. What about Connecticut Mutual or Mutual Benefit or First Executive or MONY? I remember many companies that either went down or had to get merged. Other than Conseco today, I don't think we have any of those. The media thinks our industry is in trouble. I don't think it is. This is nothing like what we went through 10 years ago, despite the fact the rating agencies are again on the warpath. I think we've never been in as good a shape as we are today. We are certainly prepared to weather an economic downturn like we're in right now.

Everybody's focusing on variable annuities being down. The graphs in Chart 1 show gross sales. The top bars represent 1035s. I like to refer to those as churns, although not all of them could be given that term. Net flows are reflected in the bottom bars. It is obvious that that is what's really ringing the cash register. Considering how fast those top bars grew, I think it's fair to say that there probably is a misselling issue out there. Who remembers vanishing premiums? The SEC is looking at that. I do think our day of atonement, once they get through burning a few of us analysts at the stake, will come. They're going to come back looking for us. I think there are going to be some issues as to how those products have been sold, both within the 1035 activity that went on and probably with the age of some of the customers that were sold those products.

I also looked at fixed annuity sales. If we put fixed and variable annuities together, we'd see that we set record sales this year. Sales are probably going to be up about 15%. We think they'll hit about $230 billion. How many industries in America today can say their sales are up 15%? I think we're doing great. Guaranteed products don't look so bad when you watch that old 401(k)

balance. I've watched mine drop about 35%. I think this past quarter is the first one we've seen in 10 years in which life sales were actually up overall. There has again been a shift from variable to fixed. When looking at total sales, I don't think the picture is bleak at all.

Let's look at long-term care (Chart 2). I think we all thought that there would be a little more growth than we've seen. We're certainly not seeing the sales. In talking to a lot of the actuaries, I find that many companies don't want to underwrite it. It's probably a great product to buy, but I'm just not sure I really want the companies I cover underwriting it, especially after having seen a few spectacular failures. The group business really hasn't caught on. Perhaps the government program will change that. I think the jury is still out.

Let's look at disability in Chart 3. It's a mature business. It's certainly one that I wouldn't be putting my money on in a down economy with low interest rates. It's a tough business, and I think there are easier ways to make money, although I certainly appreciate the new strategy they have.

There are other industry issues. We are all dealing with growth and earnings. How many companies here have seen their earnings go up in the last three years? No hands are going to go up because I know the answer. None. With flat markets and low interest rates, it has been darn tough to move the needle. How am I going to convince you to pay more for a stock, if the earnings aren't going up? That's going to be one of the biggest challenges. We can throw in some DAC unlocking, which investors never even focused on before. But in a post-Enron environment, that feels like sleazy accounting. Layer on GMDBs, and that does put some pressure on valuations. You don't have consolidation anymore. I think you only need to look at where some of the European stocks trade today. Aegon was at $10 yesterday. I remember when that was $60, and it didn't split. That was only a few years ago. Investment quality is certainly back. I never thought I'd see this one again, but investment quality is certainly back front and center for the rating agencies.

I don't think September 11 has had any impact on our business, unlike the property/casualty business. I think we all certainly saw a spike up in sales and applications in 2001. That ran through the first half of 2002, but in the long term, I don't think it really changes anything. Certainly pricing hasn't changed. This is not like the property/casualty business.

On the earnings challenge, the equity market declines that I'm going to show you reflect the product mix shift. There is an interesting thing on the return on assets (ROA) versus the return on equity (ROE). I'm going to show you that ROE, in theory, drives your stock price. We all know you don't get the same kind of ROE on fixed products. You get a much better ROA, but you're not getting the same ROE. When you do a lookback over the last couple of years, throw in the extra DAC. Let's actually start, putting in the cost of the GMDBs, which most companies are just taking straight to the bottom line, I'm not so sure variable annuities have made any more money than fixed annuities in the last three-four years, but they have certainly been a lot more volatile. So maybe the shift right now will be one of the better things that has happened to us in many years. There has been a dramatic market decline. When you're dealing with that, it's hard to grow the earnings.

Financial Accounting Standard (FAS) 97, for me, makes it impossible to forecast earnings because I can't forecast the unlocks. As bad as the last quarter was, for those of you who get the thrill of participating in the analyst's call, it's going to be a lot worse for the third quarter, and the fourth is going to be worse than that. Everybody is using this reversion to the mean pricing with one or two exceptions. Every company is at the top end of the collar at 14%. Unless markets are going up 14%, we're going to have unlocks. That means we're going to have earnings surprises. I think many of you, as you get closer to year-end and are trying to make some tough decisions, I'd certainly encourage you to consider what Nationwide's going to do. Basically, back off the reversion to the mean.

Reset the pricing assumptions down to where the Dow is going to end in 2002. Let's call it 8,000. Grow it from there because if it's going to sit at the top of the collar, you're going to have unlocks every single quarter. My peers and I are going to shred your stock because investors hate volatility. They might tolerate it in other sectors, but when they buy life insurance, they buy it for defensive reasons, and

they put a huge premium on earnings predictability. When they're questioning your senior management, nobody is going to give them any credibility if they're saying, "We're pricing for 14% market growth under a reversion to the mean." I don't have one investor who thinks the market's going up in the next 12 months. It is something to think about. That's why they're receiving so much focus.

We're also spending a lot of time looking at DAC. Look at how fast it has been expensed off. Are 20-year to 25-year amortization periods on variable annuities really practical? Frankly, I think 15 years is too long. If we look back at Chart 1, with the level of 1035 activity, it, to me, just doesn't bear any resemblance to reality. The fact of the matter is the brokers and the agents, are churning these things as soon as they come out of surrender. I don't think that's going to change.

When looking at Chart 4, you might think 1996 doesn't look too bad. That was a pretty good year if we're looking at what markets have done versus this 8-10% market growth assumption. Let's drop it to 1997 and 1998. Tell me how this is going to make money? Look at 1999, 2000, and 2001. There at least three years in which I don't believe any variable annuity sold in this industry is going to make money.

GMDBs are another favorite topic. I never thought I'd have to read actuarial guidelines. I know you guys do. I think I have 34 on my ceiling at night. I dream about Actuarial Guideline 34. That's sick, but I do. I think about it a lot more than I want to. This isn't an issue really for the Society. Frankly, you guys have it right in terms of what AG 34 is. You've got to put up reserves. The regulators got this. They make you put up reserves, and the GAAP accounting is out to lunch.

In a post-Enron environment, say a CEO has $8 million of GAAP reserves to fund this thing and $200 million on a statutory basis. How can he get on the conference call and not realize that there's a bit of a disconnect here? His accounting is clean and his accounting is legal. Again, it raises issues of credibility. Perhaps GAAP is going to catch up at the end of 2003 or in 2004.

Many companies, as far as I can tell, went to a pay-as-you-go situation. The GMDB fees just went straight to the bottom line. This is a lot about credibility, and it has been a real issue more now than ever before.

Of course, the other thing that I'm seeing is how the reserves have risen. It was nearly double last year for most companies. It has doubled again in the first six months. At the rate we're going, they are going to be double again in the last half year. That's certainly eating into companies' excess capital positions. It reduces the ability to stock buybacks or at least capital-raising initiatives or rating agency downgrades. I certainly think the agencies are starting to figure this out. Certainly the senior stat capital numbers shrink.

Why is CIGNA taking another $720 million charge? Why is that not going to blow up the rest of the industry? We don't think it is. Certainly the levels of risk tied to the different products do vary considerably in certain types of markets. It wasn't that long ago, even on guaranteed minimum income benefits (GMIBs) that I remember being at one of these presentations, and hearing you guys talk. That feature was 995 times out of a thousand, but when you have that down market scenario in the first couple years, you were a bust. It seems to me that we're kind of in that market right now.

Consolidation is not quite the hot topic it was. We are seeing the pace slow dramatically. I think there's also a lot more opportunity out there to do the intra-industry transactions. We can pick up blocks of business here and sell blocks of business there. There is a lot of focus today on just deciding what's really core to the organization and what's not. What do you need to have and what's nice to have? I certainly think we'll get more of that, but the blockbuster deals are gone. That may be unfortunate for John Hancock which, I think we all know, had sort of designs on selling itself in 2003. I don't know anybody who has the stock price left to buy it. Our stock price is sitting at 29 now versus 50 six months ago. Not that many have been a success. That's true not just in our industry, but also in a lot of these deals. How many of them have really been
home runs? Sun America seems to work for AIG. I think the jury's still out on American General. Transamerica certainly had some issues for Aegon. I think they are still stuck in some

of the non-life businesses. I'm not sure that some of the ING deals worked out that well. So if you look around for all the focus on doing deals, I'm not sure they've added a lot of value.

That said, there's not that many independent companies left. With all the talk even before consolidation, I don't see really many independent companies left that you can go out and acquire.

Where investment quality is concerned, everything old is new. I remember living through this 10 years ago when I worked for Confederation, before that company went down over bad investments and when real estate blew up most of this industry. I think the agencies have it wrong this time. I think the introduction of the risk-based capital systems has worked. The fact that we're not talking about insolvencies today shows it has worked. There are a couple of hundred million dollars here, and couple hundred million dollars there. Maybe you're going to have to replenish that much in capital, but there's nothing, other than Conseco, that has really been cataclysmic. I think that is a testament to what came out of the last time we went through this. I think it's unfortunate that the European regulators didn't pay attention to what we did here. That's why we have many of those companies today facing severe financial strain.

High-risk assets are up to about 15%. Some are down at 4% and a couple are up at 25%. Again, I don't think there's anybody that has gone crazy. We think they are pretty well managed. You see that in the account mix. You see that in how much people are holding in junk bonds. It's just not that much.

In valuing life stocks, I focus a lot on the price of the book and ROE. Europeans love embedded value. Canadians love it. Investors don't trust it. I like it as a tool to predict future GAAP earnings and to use to obtain some trends. I remember someone from Equitable asking me what number I wanted on embedded value and he could make it that way. I figured he was right. Until you get set factors that compare companies across boards, it doesn't mean much to me. What I would like is something that Manu Life recently gave to investors. It was really a source of earnings. One of the issues here is where do companies make money? Look at an insurance company GAAP income statement. I don't know what it tells you, but it doesn't tell me very much. What Manu Life put out showed where they're

making it. Are they making it on investments? Mortality? Morbidity? Lapses? Show it versus the pricing assumptions. That's when Wall Street can really understand how your business is running because right now they don't get it. What they don't get they don't trust, and that's why we continue to trade at a fairly significant discount to the market.

How do you pick the stocks? We look at business fundamentals, earnings predictability, and potential catalysts. We don't have a lot of deals out there, so there's not a lot of catalysts. I think fundamentals are good. As for predictability, if you are getting the pressure on the DAC and the GMDBs, there's a huge premium paid in life stocks. You will not get any credit for beating your numbers, and Wall Street will kill you for missing them, and a DAC unlock is not an excuse.

There's a huge flight to quality. Just look at where companies that have issues are trading today. The MONY group has a huge discount to book. All America is at 40% of book and dropping. Conseco, of course, isn't even in business anymore. The money is going to the highest quality stocks, and they always associate that with the most conservative accounting and the most predictable numbers.

I mentioned how these things get valued. There's price-to-book and ROE. You can get a pretty good r-squared on that. That is what you have to do to drive the stock price. Today, it's more important to hit the numbers than to have the highest ROE. I think the best advice I give is dial back the ROE a little bit. That means selling some more fixed products so you make the numbers each quarter, or go with a little more conservative accounting.

I think the demographics are great. I think earnings aren't going anywhere fast, and that's going to make it tough to move it from the entire group along with the rest of the many sectors. As for the rating agencies, Fitch is about to downgrade about two-thirds of its universe. Moody's and S&P has given everybody in a negative outlook. Investors do pay attention to that. That said, I think we have great growth potential. This is not a mature industry, and certainly our view on this sector is to overweight it, and not to underweight it.

MR. DANIEL J. MCCARTHY: When we talked about this session and began planning for it, it was very clear that we wanted to focus both on professional issues and issues related to the industry. Colin gave you an extremely useful industry outlook with a fair number of professional pointers in it, which you should not ignore. Jim had some really important things at the outset about places in which actuaries can improve. In that regard, you probably noticed that the program for this symposium has some sessions on communications. I know that's not core credit stuff, but it really is important. It is important to improve our communication with people in a language that they understand, even if, or especially if, they are not actuaries. That's something that we all ought to take a look at and think about.

I'm going to focus here on implications, not so much of the economy changes but of Enron, which has really become shorthand for accounting/corporate scandals of one sort or another for actuaries who are either employed by or consultants to the life insurance industry.

Professions are really in a kind of an anomalous position if you think about it. It's very clear that professions are created and identified to be in the public interest. Nobody identifies work that actuaries or lawyers or doctors or accountants do because they want those people to get paid very nicely. It's done because there is presumably some public purpose to it. Yet, if you think about it, it's anomalous because who pays the bills? By and large, it is not the public in a direct sense.

Actuaries, in particular, are paid by commercial entities. For 75% of the actuaries who are employed in the United States that means the bills are paid either by insurance companies, directly or indirectly, or by sponsors of employee benefit plans. That's a very important dichotomy, and it's important to keep it in your mind. Know that, by and large, the reason a profession is created and the way professionals get compensated don't exactly line up. Many of the rules and issues that we deal with come about because of that anomaly. Since the anomaly is not really going to go away, we need to learn how to deal with it.

Now let's speak specifically. Actuaries have things to worry about. Blatant fraud is not the major issue. First, that's not very subtle. Second, it really isn't actuarial. If you think of Equity Funding, for example, what do those folks do? They created policies that didn't exist. They were very creative, but anybody could do that. There have also been cases involving actuaries that have not been as well publicized. One you might look up, which is very interesting, is a company called National American, which was basically a wholesale asset substitution, by which worthwhile assets were replaced with worthless assets. We have examples of fraud that are out there, but I don't believe that those are the issues that we need to focus on primarily.

Nobody needs to tell you that fraud is wrong, and for the occasional people who behave in an outright fraudulent way, somebody will catch up with them sooner or later. Is it embarrassing? Yes. Is it a black eye? Yes. Is it a core issue? No. In fact, if you look at the rise of litigation against actuaries, and I regret to say that it's there, you'd see that the allegations really don't have to do with fraud or conspiracy or anything like that. The allegations, for whatever they're worth, have to do with sloppiness or a contention that the work wasn't done right or wasn't done competently. Those are important issues, but they don't have anything to do with outright fraud. They aren't the Marvin Frankel kind of thing.

What are the issues? Let's take Enron and the other examples that we've had recently. It's worth looking at similarities and differences between those cases and the insurance industry where, by and large, most of us are employed or make our living. I want to look at those similarities and differences, and I want to look at the societal reaction. What is U.S. society doing in an organized way in response to all these things? Let's take a look at what has happened and what might happen to insurers and actuaries and bring that into the picture. That's sort of where I want to go.

If you look at the scandals we've had now, who claims to be hurt? By and large, these are investor-related issues. They are, for the most part, not customer-related issues for two reasons. First, the products and services that the companies in question sell are things that are delivered right on the spot. If you have, for example, an MCI service of one sort or another, you're getting service on an ongoing

basis. It's not based on a future promise. There's a distinct exception in the California energy market, but for the most part, the products and services are there. They're delivered. Customers who bought them actually got them. Second, the pricing occurs right at the time you buy the service. If you buy a car, for example, you might get a warranty, but most of the value of the car occurs when you get the car and you pay the money on the spot. So the current scandals are not primarily customer issues; they're primarily investor issues.

Who are the targets, and what are the contentions? The first target is management, and the contention is (#1) cooking the books in one form or another and, (#2) underlying all that, personal profit as the motivator, as the goal for doing that. The second target is boards of directors. Jim alluded to Audit Committees. You probably know that Audit Committees have been moved into focus. Why? Because the contention is that boards were asleep at the switch, that boards were not empowered to do something, or didn't feel empowered, and that they were not "independent" enough. I am skeptical about the word *independent*, and I'm not sure it's the best word, but, for better or worse, it's the word that's used in United States society.

I'm not sure *independent* is the best word because, for the most part, whether you are an employee or a consultant or a board member or something else, it is difficult to say that you are independent in a pure sense from somebody who pays your bills, whether that payment occurs in a salary check or a consulting payment or a board honorarium. Objectivity would probably be a much better word, and I suspect it's what is really being sought. Because nobody quite knows how to define objectivity or how to get at it, we use the word *independent* as a kind of shorthand. Although I don't think it's the right word, it's the word and concept that's in use, so we might as well get used to it.

Who else comes after management and the boards? There is a whole list of professionals. What were the contentions? Lawyers were too cozy with management. They didn't alert people when things started going wrong. You'll see, by the way, how each of these was addressed societally. Accountants are too cozy with management and too rule-driven to find ways through the fine print. In the worst cases, there is outright false attestation.

Finally, as Colin mentioned, there are securities analysts. The contention is they are too cozy with management or conflicted by the other interests of their firms. I'm not making the case in any of these as to how widespread these are, what the problems are, or whether they're true or false. Those are the contentions that we're looking at. Those are the contentions that U.S. society is reacting to.

What has happened? Management has had a public hanging. Of course, I don't mean that literally; it's just an expression. Nonetheless, it does appear that along the way some folks are likely to go to jail. So, for egregious cases, criminal prosecution has always been a route. But I think there's a recognition at the same time that criminal prosecution is not a route to changing accepted norms of behavior in society on a widespread basis. So, in some cases, there will be criminal prosecution of people in management, but, more importantly, we've now seen that managements of public companies will have a specific obligation to vouch for the financials. No longer can it be said, "I didn't know," "I didn't understand," "I didn't ask."

Jim said he's on some audit committees. I'm sure he's independent or at least he's objective. Audit Committees are very definitely in the hot seat, and boards have identified obligations now for knowledge and for review of financials and independent directors, outside directors of boards, to an extent they didn't have before.

Let's discuss attorneys, whether on the company's payroll or on an outside counsel. I'll read from the Sarbanes Oxley Act, but I'll paraphrase because it's a long quote. Attorneys have an obligation to report material violations, violations of the securities laws (which is an investor focus) to the chief counsel of the company or to the CEO of the company and, if there is not an adequate response from them, they must report to the Audit Committee of the Board. Whether somebody is employed by the company or retained outside, if they have that knowledge, that's their obligation. By the way, it's interesting, if you look at this, to see what obligation they are not given. They do not have the obligation to report it to the regulator. There was an understanding that there are client obligations. This act is saying that if you create a truly independent committee of the board, that's where the counsel ought to go. The act also has, for

egregious cases, whistle-blower protection, and that's important, too. In dealing with the primary obligations of professionals, it said you ought to be able to work through the organization. That includes people from the outside who are at the top of the organization.

Securities analysts. The act says that either the SEC or the National Association of Securities Dealers (NASD) will adopt specific rules concerning conflicts of interest. I have no idea what those rules will be. Unlike Colin, I'm not a securities analyst, so I can't claim to fully understand the state of play, but they are, like a number of other people, in the headlights at this point.

Accountants. The Public Company Accounting Oversight Board was created by the Sarbanes Oxley Act. The law has two objectives: 1) to oversee the audit of public companies, and 2) to protect the interests of investors and the public. If you have any interest in this subject, I would encourage you to read the law. It makes very interesting and informative reading because, in my way of thinking, it is the best catalog we have right now of how U.S. society reacts to the particular events that have unfolded. What can the Board do? The Board will register accounting firms. An accounting firm that wants to be an auditor for a publicly traded company will have to register with and therefore be subject to the board. The Board will adopt rules. The Board will investigate and discipline, and the law basically says, do whatever else you have to do to get this thing done. It includes very broad powers.

You realize what that means. The accounting profession, with regard to possibly its most significant activity, the auditing of public companies, is now going to be from a governance or behavior point of view, subject to an entity that is not operated by the accounting profession. I'll come back to the implications for us. The law specifically says that accountants can be on the Board, but only two of the five members can be accountants. All of the Board members, however, must have integrity, reputation, commitment, and understanding. That means that accountants can have that, but other people can have it, too. That's good. The Board can form advisory groups that can be created by the accounting profession, but those advisory groups are just advisory. The SEC has oversight authority, and what that really means is that we now have two outside entities: the SEC and the Public Accounting Standards Board, each with an obligation. Each is looking at it and each is looking at each other.

The law specifically says that FASB standards apply. However, the Board has the obligation to study a "principles-based" system and to report on whether, in effect, we would be better off with a set of accounting standards that weren't in quite so thick a book and enunciating the principles so much. That is in reaction to the fact that a number of accountants have said that in certain chapter-and-verse situations, they were in compliance with FASB requirements. People have said, at the end, that may be so, but is that fairly stated? I personally think a principles-based system is not necessarily a be-all end-all approach. It raises as many questions as it answers, but it's important to take a look at it.

Interestingly, look at the Actuarial Standards of Practice that apply in the United States that are issued by the Actuarial Standards Board. In the last 15 years, you'll see they have gained considerable authority with regulatory agencies and courts. I would contend that, for the most part, they are principles-based, certainly in contrast to the chapter and verse of FASB standards. From time to time, the Actuarial Standards Board (ASB) was criticized for not writing more chapter and verse. It's kind of nice in a way to see that what goes around comes around.

But what is the effect of all this? There are the requirements on management, the requirements on boards, the requirements applicable to analysts, the requirements applicable to attorneys, and the requirements applicable to accountants. This is a typical American way of reacting to these kinds of things. It basically says you guys can't be trusted, and therefore, we are going to construct a rules-based environment in which you will operate with a lot of oversight. I don't say that to say that it's necessarily good or bad. I think it is a natural societal reaction in the United States, but what it has done is built more infrastructure and more rules. Interestingly, you sometimes see that after a period of several decades, some rules that were thought to be important go away. Gramm-Leach-Bliley, for example, removed some rules that were thought to be very important in the 1930s. It took 65 years, but it happened. So, what is happening today will not necessarily be the end of the story. People will take a look at whether this stuff is working. Is it too much? There'll be other chapters. The chapter we're looking at right now is the particular societal reaction to issues that have confronted the United States and that Congress felt compelled to act on in virtual unanimity.

Sarbanes Oxley says that auditors must be "independent," and there's a definition of what you can own and what you can't own. But what's most important is there are also some specifics as to what the auditing firm of a public company can or cannot do for that company. For the most part, what's in the law follows in headline terms a rule that was adopted by the SEC almost two years ago after some very prominent hearings that were held by Arthur Levitt, then chair of the SEC. The SEC published these headings with about a page of explanatory text so you would know what the requirement does and does not mean. In a couple of cases, it expanded on the headings and did not include the explanatory text.

One of the things the Accounting Oversight Board will have to deal with is exactly what these requirements mean. That will be important certainly to members of our profession who work for audit firms, as well as to others. It has also been very clear among people I talk to, without regard almost to what the Board says they mean, that Audit Committees, management, and, in some cases, outside counsel are taking a much more restrictive reading as to what they mean than would have been the case in the past.

I don't know where that will go in the future, but what it says right now is that auditors might not provide "appraisal or valuation services for companies that they audit." *Valuation* in that context does not mean actuarial valuation as we would think of it. It means putting a price on something. Also, they can't provide fairness opinions, and you can't design financial information systems, and can't provide actuarial services. If you read the SEC description of that, it means it is basically insurance actuarial services. There are significant exceptions if the services are essentially ministerial rather than judgmental. They can't take on internal audit outsourcing, and can't provide investment banking services. A final publication is not in the SEC rule. It is newly added in the law. It says that auditors, meaning anybody in the audit firm, cannot provide legal services or expert services unrelated to the audit. They can provide an expert service if they're testifying about the audit work, but not about something else for that client.

Where will the piece of this go, by the way? I have no idea. But one thing you might note is this: One of the names that has been floated very prominently as a potential chair of the board is John Biggs. John is a very prominent actuary, economist, and soon-to-retire CEO at TIAA-CREF. If you read John's testimony in the SEC hearings two years ago, you saw that on issues of auditor independence he is, I would say, a hawk. He has a very strong view that auditor independence is, among the available options, the best way to deal with some of these questions. He has a very specific view, and is very clear in his testimony as to what he means by that. So the underlying message is that they (and there are various "theys" including management, boards, and professionals) can't be trusted, so we will write lots of rules, and will create lots of oversight.

For the insurance industry, the investor issues, and Colin talked about a good many of them, are essentially the same in a very broad sense. People who invest in the insurance industry have investor concerns like people who invest in anything else. Some of the specifics are quite different. The DAC example is an excellent example of that. In fact, you might think, particularly in the life insurance industry, that since life insurance companies probably have a higher ratio of assets-to-annual revenue than any other industry, there is perhaps more room for balance sheet mischief affecting earnings than in many other industries. Nonetheless, the investor issues are still the investor issues, and the societal reaction governs publicly traded insurance companies just like other publicly traded entities. However, the customer issues are different.

Why are the customer issues different? First, the product is about promises. There is no instant gratification in an insurance product. It is designed for some future purpose. Often those products and promises are very long term. Furthermore, there is discretion in the pricing. There is discretion, particularly in health, property/casualty, and disability, in settling what is a valid claim. How will that claim be recognized? The customer issues are really much more in the front for the insurance industry than for most other industries.

This isn't new. This has been building for a long time. We have rules. We have rules about sales practices and disclosures. Did we disclose what the promises mean and what the promises don't

mean? Did we disclose discretion, meaning interest rates, dividends, and all those kinds of things? There are rules about the statutory balance sheet. Colin was very flattering about some of those rules, and he points out that, in many respects, the regulators have dealt with some of these issues better than the GAAP basis has been dealt with. Nonetheless, those are rules, and they are about ability to fulfill promises.

There are rules specifically about the application of that discretion in some cases. In health coverages, it is about pricing at the point of initial sale, repricing, and whether that means changes in interest rates or dividends or rate increases or whatever it is. Again, it's discretionary. There's a focus on it. There are rules about it. Of course, particularly in the health area, there are rules about claim settlement and appeals and that sort of thing. This has been building for some time. I believe that that trend will continue. This is not a time, in my view, in our society, in which we're likely to have fewer rules.

Some of these are applicable to actuaries. The illustration actuary was created in a partnership between the Actuarial Standards Board and the regulatory community as a reaction to some of the sales practice issues, regarding pricing and repricing, many of you know that insurance regulators require specific disclosure. There are laws, and there are filings required. Of course, there are statutory liability opinions are the core of what the valuation actuary symposium is about. There are many rules.

However, there are some things that haven't happened yet. First, we haven't lost our ability to create our own standards of practice. By and large, we have not lost any self-governance in the actuarial profession. The Joint Board for the Enrollment of Actuaries has an important role in the pension area. The Academy meets with the joint board regularly, and they have a very cooperative relationship. The Joint Board relies on the profession to do its own policing, although it has the power to do some policing, and, in some cases, it has done so. There are some exceptions in some special areas, but we have not yet seen independence requirements applied to actuaries who carry out some of these rule-based functions I talked about before.

We have seen mandatory peer review, which takes a lot of different forms. In Canada right now, it is

taking the form of a requirement that a company must obtain outside peer review of the work of its appointed actuary. In some states, we have seen either detailed reviews done by the staff of insurance departments, or in some cases, and New York is a good example, we've seen peer review contracted out to an independent entity. Statutory valuation has had a rule mentality. There's always a debate about where are you going to get rules? Where are you going to get judgment? The needle will continue moving on that. The more we write detailed rules, the more we have the same FASB concern. The more that judgment is wide open, the more that we are exposed as a profession and have to stand up. Finally, there is some discussion in some countries of specific whistle-blower requirements that would create not only protection but an obligation for reporting. I am somewhat skeptical about those, except in the general sense that there's some obligation to report crimes when you know about them; nonetheless, this is what's emerging as we go forward.

Fortunately, there is good news. Although you may not always think so in your day-to-day work, the rules that have been developed and the way actuaries interact with those rules have not been adversarial. You might have a filing issue or a liability issue or something that you find to be very contentious with a particular regulator. That's not the same thing as somebody creating a public board of people who are not members of this profession to oversee it. I would say, by and large, we have worked in a reasonably cooperative relationship in terms of developing the rules and the framework and even in the application on a day-to-day basis. Maybe we've just been lucky, but if that's so, let's not count on being lucky.

It did not take very many cases to raise all of the investor issues that gave rise to the Sarbanes Oxley Act. It took roughly half a dozen. How many publicly traded companies are there? Thousands. So, luck alone isn't going to do it. Jim talked about professional responsibility, and that is the core. Interestingly, what that means is that each of us has, you might say, more responsibility than the ratio of one to the number of actuaries in the United States because it doesn't take very many people abusing it to bring us all down.

So what's the recipe? Let's not forget professionalism then because of the same issue. If a few of us

blow it, we blow it for everybody. Don't forget the business context. Jim talked about focusing on communicating business issues in business language to business people. An area in which we have not always been strong is in being able to communicate that what's right is also, by and large, what is smart. I've been in consulting for a long time. Most of the contentious business issues I have seen have, by and large, been more communications issues than technical issues. If you can find the right way to explain the issue, you are three quarters of the way to the solution.

One more thing. My wife is a very skilled baker, and, as a baker, she is very focused on recipes. She tells me that although having the right recipe might get you the right result 99% of the time, it doesn't get you the right result 100% of the time. I say, "Why shouldn't it happen all the time?" Sometimes the ingredients aren't quite right or the oven temperature isn't quite right, and there is a difference between the person who only operates by the rules and the person who is really able to function. The functioning person knows what to do when the rule doesn't work. That person has, in the back of his head, not only the skill and the responsibility to be able to follow the rules, but also the ability to deal with situations where there is no textbook. I hope we never have such a cut-and-dried profession that everything is laid out for us in the recipes and the rules. So focus on the recipe; focus on the fact that any one of us can do far more harm than you would think one person can do, and, focus on thinking through the underlying issues when the rules just don't deal with the situation at hand. That, in my mind, is what makes us professionals.

MR. GODFREY PERROT: I have a comment. It's really directed to Colin, but it takes off on what Dan said. I hope you would take your comparison of GAAP and stat reserving for guaranteed annuity benefits up to Norwalk and explain very loudly why they need to get their act together. I think there is a risk to the industry in what's going on. You expressed the right amount of scorn, and I hope they hear it.

MR. THOMAS A. CAMPBELL: I just wanted to get your thoughts on what you see as the future of guaranteed benefits for variable annuities. Do you see any changes to these benefits? What do you think is going to happen going forward?

MR. DEVINE: On the guaranteed benefits, I think the biggest reason for the change is it actually costs money. Everybody assumed markets were going up 20%, so what was the risk? I think we've all learned. Certainly CIGNA learned. I think Hartford, Nationwide, and ManuLife all knew it because they gave all the risk to CIGNA. There's risk. I think we'll see that turn back dramatically. A couple of rough conference calls will certainly achieve that as well. But I also think, where the regulators got it right is with the increase in the GMDB statutory reserve because that has begun to materially impact people's excess capital positions. That also is probably making a few CEOs, and a few CFOs, come back and say, "Hold on! What's this? Are we getting paid for this? If I'm about to take a downgrade from S&P, the capital models don't look so good."

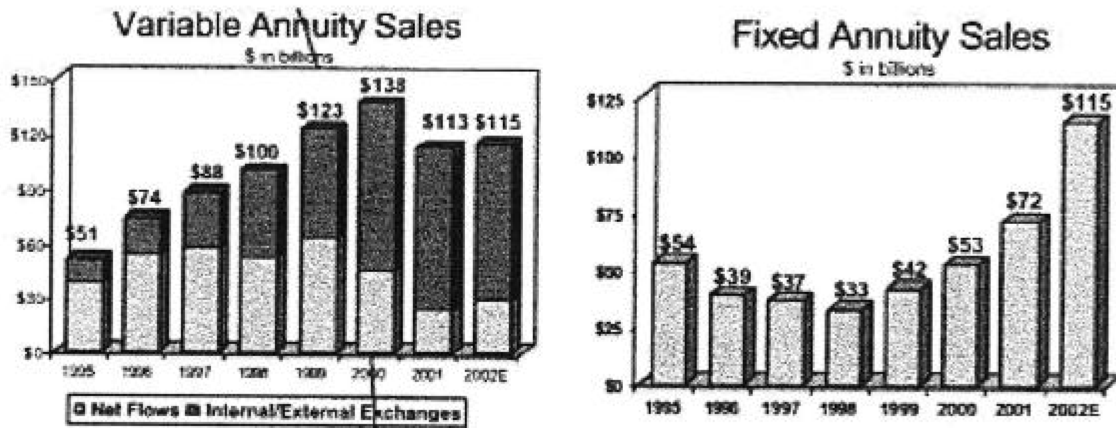
The other one that keeps me up at night is guaranteed minimum income benefits (GMIBs). There was an earlier comment about the accounting profession being completely out to lunch. Explain to me how you can write this product that is basically against the rules under GAAP to put up a reserve. I don't get that. I also think the product has received some fundamental complaints and has sales practice issues. I can't understand how you can sell a policy and not have to put up a reserve when there's an annuitization option. I think there's going to be a lot more focus on what the real cost of some of these benefits are as you get a few more earnings surprises.

MR. MCCARTHY: If I could add one more thing about that. Colin's comments point to the fact that some of this stuff was underpriced, and it was underreserved, at least on a GAAP basis. Yet, the other side of that is having a market that wants certain kinds of protection. It doesn't necessarily follow that the product will change in benefit terms. Pricing will certainly change. In many respects, the industry has set itself apart from other money managers and other investment forms by actually putting insurance into this. Of course, as Colin says, if they give it away, it will be hard for people to buy it. The real question then is, can those features, which are really valuable features, be sold at a price that can bear the freight? I don't know what the answer to that is, but I don't assume automatically that the features will go away. I think we'll see very different pricing.

MR. KERRY A. KRANTZ: I'm going to be taking part in a session on advanced regulatory topics. One of the things that I want our audience to talk about is moderately adverse deviations. I would like to see a system that is principle based and not so much formula based. I have trouble when it comes to terms like that. You know a best estimate when you see it. It's the thing that happens most of the time. If you don't have the best estimate, then half of the time it's a little bit worse, and half of the time it's a little bit better. That's something you can see, and you know it when you see it. But how do you know moderately adverse when you see it? Are we just going to have to trust in actuaries that when they design something, it's going to be so unique that they're just going to have to have their impression? Or are we going to have a reviewing actuary concept where they're going to have to be able to say this is what I think, and I can explain it to other people and convince them that what I'm saying is reasonable?

MR. MCCARTHY: At least we know which side of best estimate moderately adverse should fall on. That's a start. I actually think that it's an excellent question and something that we have not focused on as precisely as we should for a long time. I think the tools are better today than they've ever been. I think that stochastic testing has really come into its own. You can define moderately adverse in quantitative terms, and you can have a conversation about the underlying assumptions that went into the stochastic testing. I think we're better prepared today to do that kind of analysis and to talk about the underlying assumptions than we've ever been. I agree with the comment that we've used that phrase, and all we really knew was, in liability terms, it was higher than best estimate. We had to work hard to figure out how much higher.

CHART 1
U.S. Annuity Sales



Source: Salomon Barney estimates.

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CHART 2
Long Term Care Sales

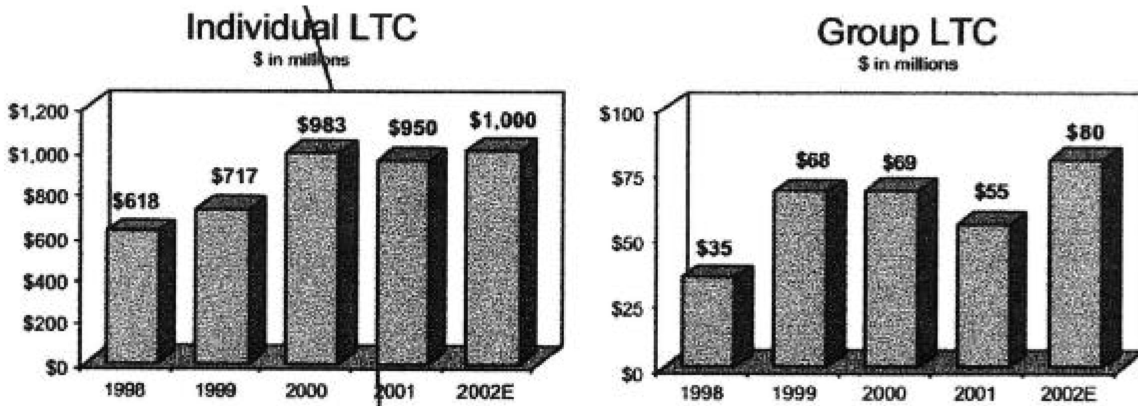

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CHART 3
Disability Income Sales

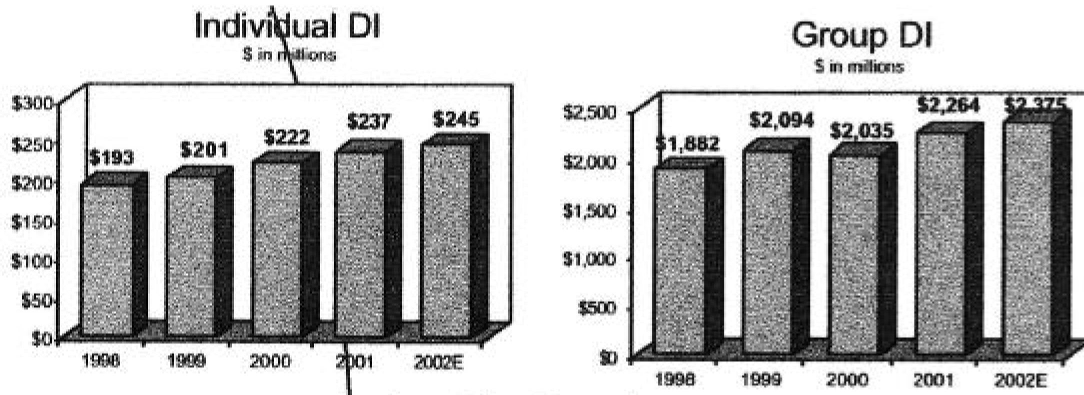

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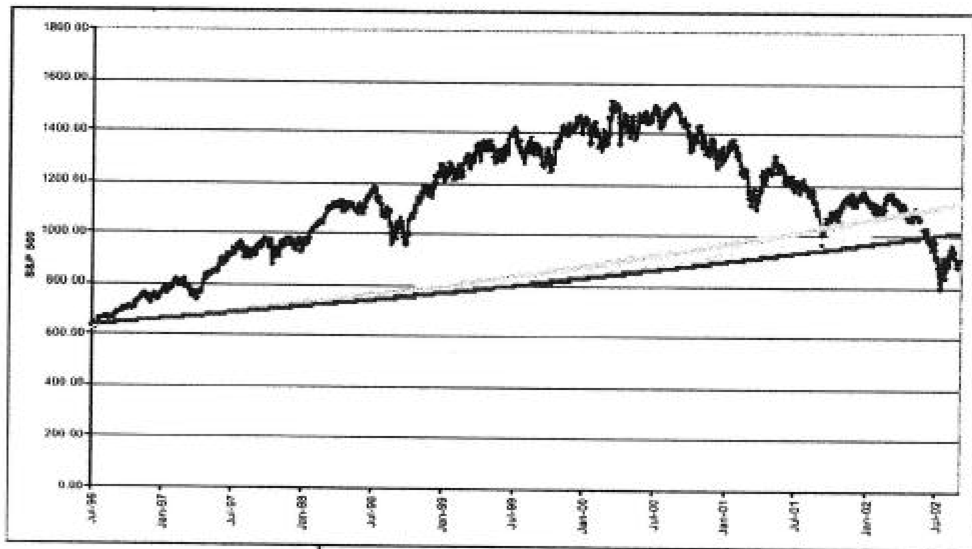
CHART 4
July 1996 to Present Actual S&P 500 Performance vs
8%, 9%, and 10% Assumed Growth



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