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Regulatory Topics

Moderator: Sheldon D. Summers
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A panel of regulators share their perspectives on valuation actuary related issues, including the hot issues from a regulatory concern, their attitudes on relying on the judgment of company actuaries, their assessment of how the valuation actuary concept is working, comments on peer review, and comments on the NAIC Life and Health Actuarial Task Force.

MR. SHELDON D. SUMMERS: I'm the Supervising Life Actuary with the California Department of Insurance, and I'm serving as moderator of this panel. Our first speaker, Donald Pearsall, worked at John Hancock Mutual Life Insurance Company from July 1960 to July 1991. He did consulting work for MONY from July 1991 through December of 1991. He then retired for a year. In January 1993, he metamorphasized into a regulator for the Life Bureau of the New York State Insurance Department, working in New York City on Section 4228 Field Expense and Agents Compensation Limits. In 1996, he became the chief life actuary three of the Actuarial Unit in New York City. In 1998, he became the chief life actuary two in Albany. He supervises the New York City Actuarial Unit, the Evaluation Unit, and the Legal and Actuarial Policy Forms Units in Albany. As there is at this point no chief life actuary, he has Bob Callahan's old job with twice the responsibility and at one job grade lower. He is a living example of the adage "more is less."

MR. DONALD M. PEARSALL: What is the role of the valuation actuary? The role varies from company to company. The role is cast among a wide variety of actuaries. To be an appointed actuary, you must be a valuation actuary, but the reverse is not true. What regulators

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see mainly is the work of the appointed actuary. In New York, we see the work of about 100 domestic and 50 foreign companies. I'm sure that each valuation actuary sees his role somewhat differently than his counterpart in another company.

I'm going to talk about a different role—the role of the valuation actuary as seen through the eyes of a regulator, specifically, through the eyes of a New York regulator. There are four recent events at the New York State Insurance Department: (1) meetings with the New York Federal Reserve Board (FRB), (2) DFA Symposium, (3) Capital Markets Bureau, (4) fourth quarter meetings with companies. Last year was our first year with fourth quarter meetings. There were three sorts of companies for which New York has bureaus: life companies, health companies, and property companies. If you were a large company, you were invited whether you were domestic or foreign. You came in and sat down with us and told us what your plans were for the next year. If you were with a company that we thought might be having some financial problems, you would have come in and told us what your plans were for the next year. You wouldn't have given the greatest detail in the world, but the meeting certainly was good enough to have made an impression on your company. One company's CEO, in the end, even thanked us for having him. He thought it was a good idea. Our superintendent, Neil Levin, comes from the banking industry, and I think he was rather shocked to find out that the regulators and insurance never had these types of meetings in order to keep them up-to-date on what's going on.

We've had meetings with the New York Federal Reserve Board, and the good news for the regulators is that it isn't interested in regulating the insurance companies. The New York Banking Department, which still exists, works hand-in-hand with the Federal Reserve Board. They split assignments on doing examinations of banks. Sometimes it will be as a combination of them, sometimes it will be the Federal Reserve Board, and sometimes it will be the Banking Board that will get together.

The big question that they are interested in is how in the modern world do we regulate a bank such as Citigroup (formerly Citicorp) and an insurance company and securities company, like the Travelers. How are we going to split up the assignments between the New York Insurance

Department, the Connecticut Insurance Department for Travelers, and the New York Federal Reserve Board? How do we coordinate this? The big question is, there are cross-risks involved, and who is it that finally has a thing that this whole big corporation is going to succeed? It's not going to have one of its legs knocked out from underneath it so that it collapses.

The one thing we know is that the Federal Reserve Board's biggest fear is a run on the bank, and it has certainly changed how it runs its examinations in order to avoid this. They do targeted risk-based examinations of the banks, and they do them either semi-annually, annually, or bi-annually, depending on the concerns that they have with a particular bank.

The New York State Insurance Department, now in its exams for insurance companies, is going to target risk-based examinations. That means that we'll probably be getting everybody at least every three years and maybe even more frequently.

The one thing that the FRB has that we don't, but the NAIC is working on, is confidentiality. If the bank sees a problem, they go to the FRB and tell them about it all. All the books of the bank are open to the FRB. If a bank is about to have problems, the FRB takes the bank over before it hits the newspapers or the rating agencies. This is the bad news for the insurance regulators; they pay competitive pay scales with the industry. As a matter of fact, because the New York State banking department works closely with the Federal Reserve, they were able to talk the civil service into raising their salaries up, so that they were more competitive with the industry. There currently is no Federal Insurance Board, so we can't make that claim, and I think we're going to lose the battle to get our jobs upgraded to a better salary level.

The next thing we had was a Dynamic Financial Analysis (DFA) Symposium. It was held in New York City, and it was a two-day presentation made by people from outside the department. It shows a prospectus from both the life side and the property side, and the time was probably pretty well split between the two. Among those presenters were Jim Reiskytl. We had three Canadian Actuaries who were intimately involved with the new valuation procedure in Canada, two of whom worked for Ottawa in putting it together. I personally liked their approach. I think it has some good things that we could take up. I like the confidentiality. The unified valuation

system (UVS) is overlooking some good tools at this point. The UVS is actually in its infancy. We had a third presenter from Standard and Poor's, who I understand has probably been before all of you at some point or another, and that's the firm that can start a run on the bank with the insurance company by its downgrade procedures. It's based on information given to them. Maybe it's the CEO rather the valuation actuary that is giving this information.

Why don't we in the insurance departments get that same information before it comes out in the papers, before there's the downgrade, and before there's a run on the bank, so we have a chance to step in and find something out? I think some of that has to do with confidentiality.

When I worked in compensation, the worst, most hideous plans of compensation came in and the ones that fought the hardest for it were the companies that were in trouble. Once a company is in trouble, they're doing everything that they can to hide it from us rather than let us work with them to bring it out and to see if there's a solution that can end in something other than what has happened with General American or ARM.

Finally, we have a new Bureau in the New York State Insurance Department. It's the Capital Markets Bureau. We brought in an investment banker with great knowledge of the capital markets to start it. We had to fight to get the position. I believe it's probably an exempt position, which means it's not under civil service. We also have a new capital markets position. He is the person who put together the Dynamic Financial Analysis Program for us. I felt badly because they called it that, rather than the Dynamic Financial Condition Analysis, but it was the property actuary that brought it to his attention.

We already had some positive results in our regulation when Hurricane Floyd was coming up and about to hit Florida. We were getting all sorts of e-mails from him on the problems that they were having with the market. For a change, we were kept up on something when it actually didn't hit at least it didn't hit, down in Florida where everybody expected it. I believe there is one casualty company that did have very heavy investments, and it could have a dynamic effect on it in the downward area.

What I want to know is how do you handle derivatives? How do you measure the strength of reinsurers? You know, these are things I'm looking for from a valuation actuary in the future. Are you getting readings on the possible effects of the doomsday scenario? Are you running scenarios? Are you sensitivity testing? What could put you under rehabilitation?

We still cannot do in New York what Missouri did with General American. We only have two solutions if a company comes to us. We can put them in rehabilitation or we can liquidate them, but we can't be a shelter for them to hide in.

In looking at the traditional role of the valuation actuary, what do we get? We get minimum statutory formula reserves, which are the basis for telling risks for small companies. In New York, this has been, in the past, the main focus of our reviews. Currently, Actuarial Opinions and Memorandums from the past were sort of the leftover items. We actually did spend a lot of time on them. We have some very good AOM reviewers, but that wasn't the main focus. Because we have staff restraints that we didn't have last year, our main emphasis is now on the AOMs and not on the formula reserves.

One of my compatriots, a fellow up in Albany, recently made a remark to me. I wish all companies were Section 8 companies. He said that the big problem with companies is they all have been Section 8 companies. The Section 7 companies haven't been giving us a hard time other than with occasional lack of quality in their opinions, and that's mainly on the AOMs.

What we do with the AOMs is referred to by the industry as a peer review. We have followed the Actuarial Standards of Practice (ASOPs). We check to see if they have followed the ASOPs, have done our seven scenarios, have used rational assumptions, and so on. We send out letters concerning our questions and get their answers normally. We tell companies what we want to see next year, and we get it in most cases. Occasionally, we don't get proper responses from the companies, in which case, when we send out the next letter, it has been copied to his CEO. Most of the time, it is with poor results for the valuation actuary or the appointed actuary.

In the past year, we've started using the threat of the ABCD. Would the fear of the ABCD improve what they gave us? It seems to be working. This is based on information that I've received from Lauren Bloom who said that this is a better way to go.

Paul Schoener asked two questions. One of them was, did their companies do dynamic financial condition analysis? Did top management review the results of their asset adequacy analysis as a management tool? I've yet to see the final results of the survey, and maybe I will one day. We asked the same question at a few of our fourth quarter meetings with companies in 1998. I was not always impressed with the response. Some of the top officers of some large companies didn't even know what an asset adequacy analysis was. Obviously, in some companies, there is a lack of upward communication of the work that's being done by valuation actuaries.

I thought I didn't have enough information to keep you going. We see new roles in product development for the valuation actuary. They should be taking a look to see what the risks are. What are some embedded risks that they have in their policy forms? Do they have a mismatch of assets and liabilities? They're always supposed to be doing that, but are they doing it? Are they taking a look at how we have this new program? It has some risks to it, and we can accept those risks, but only at a certain production level. We can't assume that we can go over and have 50% of our business in something highly risky. Maybe we can only sell 5% of our business in this area. Is the valuation actuary really getting over into that area, taking a look at the development of the products, the possible marketing, where they're going, and what they expect to get out of it?

Products are not generally developed in an ivory tower. I know from having worked for a company that there is tremendous pressure from the marketing area for highly competitive and innovative products. I'm just sort of wondering if the first company that came up with the MGBDB, which I can't even remember whether it was guaranteed death benefit with the variable annuities, realized how risky it was? Did the valuation actuary actually get involved with it? Did the company take a look at it? I just don't know that stuff. I assume that it reinsured its product, and I don't know if it knew how solvent that reinsurer was or whether the reinsurer was handling it properly. Then the question really becomes, is it the valuation actuary or appointed

actuary who closely dissected the product for embedded risks? I doubt it. But do you know? Another valuation actuary or appointed actuary should be able to tell the marketing people to not go there and to say you can't sell this.

Was the pricing stress-tested? How soon should the profits be recognized on your books? Should you wait for a period of three years, five years, or ten years in order to build up a fund in case you are having some adverse experience so you can take care of these things without going back to the general surplus of the company? When do your profits really evolve? I know that this is totally contrary to the fair value idea, but I'm just wondering if the fair value idea takes in what's going on. When you look at these things, do you have a risk management expert? We were talking recently with a large New York company, and it had a newly hired risk management manager. It was a big company. It's something they probably should have had 10 or 15 years ago. Maybe your company handles that itself. Maybe the valuation actuary or the appointed actuary acts in that capacity. However, the whole concept of being a total company, a total entity risk management person is just coming up.

Why don't we move on? Finally, have you, the valuation actuary, been stress tested? How many of you are willing to go to your boss and say, "I can't give a clean opinion on the company this year." In late February, when you finished your AOM and you've sent it in, go to your boss and say, "The way we're going, I'm not going to be able to give us a clean opinion next year. We're going to have to make some changes." That's really what your job is. An appointed actuary is there to keep the company solvent. Why is a regulator interested in keeping a company solvent? If we don't have solvent companies, we're not going to have jobs as regulators.

We have the formula reserves and the AOMs. As I mentioned, we're switching over and putting more of our emphasis on the AOMs. We would like to see projections for at least three years. I know if you're a company of any size, you have projections. We have the confidentiality problem. The UVS, at least for the interim, will end up just putting on projections. At the end of last year, you were sufficiently solvent to take care of the business that you had on the books. What's going to happen in the next few years when you have new business, and when you change the complexity of your business?

We're really interested in both solvency and liquidity. How does your company know it's going to remain solvent? Suppose you're a separate account company. Are you investing the general account assets in investments that are going to make enough money to keep the general account from going down to zero or a negative? It sounds like an esoteric question, but we did have a problem with the company, and the parent company had to throw in about $6 million or $7 million in order to keep the New York subsidiary liquid or solvent. Suppose you do get a downgrade from Standard and Poor's or Moody's? How are your policyholders going to react? Do you have some big policyholders that might bail out on you without a bailout provision? Have you really matched your assets with your liabilities? How closely do you look at that? Are you a game player? The insurance department doesn't like game players. We like people that are very honest and open with us. Don't give us interest scenarios on your asset adequacy analysis that couldn't possibly come true in a million years and expect us to accept your AOM.

I just had a few brief remarks on the unified valuation system. They started off with a blank piece of paper. They were told to develop something by the NAIC's Life and Health Actuarial Task Force (LHATF) Committee with the aim of developing a new regulatory tool for the actuary. The ACLI turned out to be against it because they didn't want us to know what they were projecting. It would have some sort of a projection part in it. They wanted it for a management tool, and I respect them for wanting it as a management tool and for trying to get a new management tool, but it isn't what their charge was from LHATF.

I have a different read on things based on Jim Reiskytl's talk given at the DFA Seminar. He says that the dynamic financial condition analysis is absolutely the same as dynamic financial analysis whether you're a property/casualty company or a life company. It was also the same as the viability analysis. I wasn't at the last UVS meeting, and I don't know exactly what Jim presented as a viability analysis report, but he had something.

There are problems in development. The blank piece of paper did away with the mandatory minimum statutory formula reserves and the whole industry turned red-eyed and came at the XXX Committee with a real passion. The companies were in the process of trying to keep up their required interest for Section 7702 of the IRS Code. They had great fears of the tax

consequences. What do I see? The big question is the confidentiality issue that I've brought up before.

What do I see going on? There has been slow progress over the last three years. There's going to be slow progress over the next six years. That's my prediction. The companies are asking for a "trust me" statement on the UVS. They sent it in. It will be a black box; trust me. We don't trust. As a matter of fact, a member of the industry got up and said, "You trust the accounting firms? You take a look at those, and you trust them?" We don't trust accounting firms, and I hope you don't. There's also the question of the reviewing actuary. My take on that is that it's going to be the regulator in the state or an actuary hired by the state that will do the reviewing of the dynamic or UVS for that particular state's domestic companies.

The AOM nonguaranteed elements are going to be discussed at the next NAIC meeting. There's going to be a sample viability report. I guess that's where it's coming in, and there is going to be heavy reliance on the Society of Actuaries.

Where do you valuation actuaries see the bailout provision? Does your company sell bank-owned life insurance (BOLI) and corporate-owned life insurance (COLI) with bailout provisions? Does your company sell COLI and BOLI without bailout provisions, but with side letters that are not part of the contract that have bailout provisions? Do you know what your company does? Do you mention in your AOM that your company has such things? If I were to take a look at the company, would I find that those risks are actually examined? How do you in your company expect to be able to stop the runs on the bank on your company if you get a downgrade? I'd love to hear some responses to that. If you had been at General American or ARM, how would you have handled it? Would you have handled it differently or would you have done the same thing? Have you changed because of these items that have come up recently? My final question for you is, do you still love your local regulator?

MR. SUMMERS: Our next speaker, Stephen Neill, is a senior actuary with the Texas Department of Insurance. He has been with the department since 1991. He has prior experience as an insurance company actuary and as a consultant.

MR. STEPHEN K. NEILL: Speakers in previous sessions have told us that the unified valuation system is on the horizon. We don't know how far out it is on the horizon, but it is on the horizon. In preparation for that, I want to challenge you with an ever greater need for diligence in your judgments that are brought to bear on areas in which the regulators have an interest. I'll also discuss a couple of topics that we're currently working on.

Being from the Texas Department, I feel I'd be remiss if I didn't say a few words about Y2K. The Texas Department, for about the last two years, has taken a leading role in reviewing regulatory compliance on Y2K. We had the audacity to send out a letter to all the licensed companies in Texas, not just the domiciled companies, asking what they were doing and what they planned to do. We followed up if we didn't get a response or if we received a response we didn't like. In many cases, we followed up with an on-site visit. The department also practiced what it preached on this, and we spent a lot of time over the last year or two making sure that our systems are Y2K compliant. The other agencies in Texas have been doing the same thing, and based on all the reports we get, we believe the insurance department was at the forefront early on.

Actually, Texas A&M University took a rather novel approach to the Y2K situation. They went into all their programs and changed all the Ys to Ks.

If you've been involved in your company's efforts towards Y2K compliance, you found that it's not just an exercise in looking for problems that weren't there. We got good cooperation from most of the companies, and I want to express the department's appreciation for your work in this area.

There was a time when most of the actuary's reserving work dealt with following a set of detailed formulas that were specified in the regulations, but that has been changing for a number of years, and it's likely to continue to change. The changes have given you more freedom to use your judgment in a lot of areas, and I think it has made the work more interesting.

At the same time, it involves a greater responsibility to make sure that you exercise that judgment appropriately when you're dealing with areas that we are concerned with. Some people welcome

that responsibility more than others. In general, how you meet the challenge on this responsibility is going to go a long way to determine the pace of change in the future.

There are a number of areas where you currently have freedom to use your judgment in the work you do. Probably the one that has been around the longest is health claim reserving. It's an area where you're relatively free from regulatory constraints. There are standards of practice that you must follow, but from a regulator's standpoint, the basic requirement is that the reserve be adequate to cover the claims and to cover the claim payment expense. It does require judgment. It's both an art and a science, but it's not really rocket science, and the techniques have been in place for a long time. I can't tell you how many times we've gone in on examination, looked at health claim reserves, and found they're deficient by 20%, 30%, or more.

I'm currently working with two companies that are 100% deficient. They set-up a reserve of one and they're going to pay out at least two. I talked with the actuaries, and I talked with the companies that are involved and they tell me, "The data did this, or the data did that, or I didn't understand some of the things the company was doing in their claim payment process." You're responsible for knowing what the company is doing in those areas. You're responsible for getting data that you can understand and use to get an accurate reserve.

We're seeing this problem more among the HMOs in Texas than we are among the insurance companies, but we are seeing inadequate reserves in both places. The HMOs in Texas have lost close to $1 billion over the last three years. If they don't have accurate reserves to base their cost on and accurate predictions of what the claims are going to be, how can they possibly manage their business properly? Quite frankly, there are some regulators that say if the actuaries aren't handling something as basic as this, a monoline situation, how can we reasonably expect them to handle something like UVS if it comes in the future?

Another area where you have latitude and judgment is in equity-indexed annuities. The NAIC has done a survey for the last couple of years looking at what assumptions you're using in setting the reserves. The assumptions are, basically, the S&P 500 yield, the risk-free rate of return, and the applied volatility in the options.

A survey conducted in 1998 (and I've seen some preliminary results from the survey), indicates that the results kind of vary all over the lot. Some of the actuaries are handling this well, and some of them aren't. Part of the work in this is a certification that the assumptions used to value the options are reasonable. When we do a survey and we talk to the companies, some of the actuaries don't know what the assumptions are. We're kind of puzzled when we see this. We don't know if it's just that, for that company, it represents a small reserve and there just wasn't a whole lot of attention paid to it, or there could be a lack of knowledge. If it gets the assumptions from someone else, they might not really understand what they are.

Another area that we've had experience in for several years now is asset adequacy analysis. In fact, most of the analyses are quite a bit better than what they were a few years ago. But we're still getting some that look like just a mechanical process, and people are not really spending the time to exercise judgment on it. In general, if you're only doing the required scenarios, that's probably not enough, unless you have a very stable book of business that's really not sensitive to the changes.

When we review the memorandums, some of them look very good, but some of them looked very mechanical, like they're only doing it to satisfy the regulators. Most of the time, we can tell by the types of scenarios that have been run. If they're very mechanical, we're not really impressed. If they seem to relate to the company and the company's business and what's really going on, then it looks better.

The other area that actuaries need to work on is the reliance statements and the reliance on other people's work. What we see more often than we like is reliance without any apparent review of the work done by the other person. Realize that the whole asset adequacy task is not about additional reserves. It's really about assisting the companies in getting the investments to match the liabilities.

We're going to have Regulation XXX. There are a lot of complex, mechanical formulas in it, but there is also a new area for you to exercise judgment. We're breaking new ground on deficiency reserves with the X factor, and there will be a lot of scrutiny of this, because, quite frankly, we

don't really know what to expect. But you need to choose the factors appropriately, and you need to document the basis for your choice.

The other area in Regulation XXX that comes to mind is we've become aware just recently on secondary guarantees on universal life that there's a new type of secondary guarantee. It used to be that if you paid the specified premium, the guarantee was that the contract wouldn't lapse regardless of what happened to the fund value.

More recently, things are being referred to as phantom accounts or shadow funds, which take the actual premium paid, accumulated at the guaranteed interest rate, and then subtract the cost of insurance charges based on the current cost of insurance charges at issue. These charges are guaranteed not to change for this phantom account (calculation). By doing that, you can calculate a guarantee period over which the policy won't lapse regardless of what happens to the account value and regardless of what happens to future premiums.

We're getting some actuaries questioning whether this type of guarantee is covered by Regulation XXX. You don't really want to go there. The answer is, yes, that type of guarantee is covered by Regulation XXX, and the intent is that Regulation XXX covers all secondary guarantees, regardless of how they're structured.

Another area where you have an opportunity to exercise judgment is in disclosure. There's not a whole lot to say on this, but I wonder how many of you are involved in the management discussion and analysis that your company includes in the Annual Statement. Do you know what goes into it? Has it been reviewed, particularly in the area of liquidity and asset/liability matching?

The other area is your statement on nonguaranteed elements. Some of those are pretty slim and don't really tell us much. If you review it, make sure it fully describes what the company is doing in that area.

The regulators take all of these areas seriously, both for what you're doing now and as an indication of what we might be able to expect if something like UVS comes along in the future. So I encourage you to take every opportunity to demonstrate your willingness and your ability to exercise judgment appropriately to justify our reliance on it.

One of the current concerns at the NAIC is GICs and funding arrangements. You may have heard this in other sessions. For several months now, we've been looking at GICs with ratings downgrade provisions, whereby, there can be early termination at book value if the ratings drop or if another event occurs, such as a default on payments or a default on guarantees.

There are two areas involved in this. One is the public policy question, and the other is the solvency or reserving question. The public policy question revolves around the preference issue as to whether or not these contracts, which tend to be large and tend to be owned by sophisticated policyholders, have a preference if they can cash out at book value on a ratings downgrade, withdraw the funds prior to any action by the regulators, and leave less liquid assets for the other policyholders. Does this put these policyholders at the front of the line in an inappropriate manner? When we talk about it, we say GICs, but the corporate-owned life insurance (COLI) and the bank-owned life insurance (BOLI) quite often have a similar arrangement.

The NAIC is discussing this public policy issue. The Academy is dealing with the reserving concerns. There's a draft report that will be presented at the upcoming NAIC meeting that will give at least the initial work on this area.

What they're looking at basically is the liquidity or concentration risk. It's still a real question as to whether there's a way to handle that with reserves. Must we cash-flow test or is it a risk-based capital (RBC) requirement? Are there limits on the amounts or a variety of things to deal with that situation? Like I say, this has been going on for several months, but the recent General American situation has served to heighten the interest in it and broaden the scope of it. I think that the General American situation should serve to cause the market to be more concentrated among the larger companies than it is currently.

MR. SUMMERS: Our next speaker has worked 20 years in the insurance industry. The last four years he worked at the Florida Insurance Department as an actuary for Life and Health Solvency. He was chairman of the SOA Computer Science Section Organizing Committee and First Section Chairman. He currently reviews Exhibit 8 work and issues certificates of valuation. He also participates in the Triannual Field Examinations.

MR. KERRY KRANTZ: I'm going to speak very briefly on what the Florida Department of Insurance is doing in the area of the new codification. Recently, the Florida Department of Insurance organized an internal working group to review the Accounting Practices and Procedures Manual as the codification practices are called. The manual is based on codified principles to be effective January 1, 2001.

The working group is tasked with comparing the codified accounting practices and procedures manual with current Florida statutes and the Florida Administrative Code and to identify any conflicts or discrepancies between the two documents. The working group comprises members from each of the four solvency bureaus. The solvency bureaus are life and health, property and casualty, specialty insurers, and managed care. This wide range of expertise was pulled together in the working group in order to effectively analyze the various Statements of Statutory Accounting Principles (SSAPs) and their relation to Florida laws and regulations.

The department's legislative agenda does not currently include codification for next year's legislative session. The work is being done in preparation for the future effort to pass codification if requested to do so by the legislature and to enable the department to respond to any other initiatives that are taken during the legislative session.

As the actuary for the Life and Health Solvency Bureau, I have been an active participant in the process. For example, some of the SSAPs that I personally have reviewed are number 51 life contracts, number 52 deposit type contracts, number 54 individual and group accident and health contracts, number 59 credit life and A&H contracts, and number 61 life deposit type and A&H reinsurance.

Our goal is to provide clear guidance to senior management on the issues and conflicts that may have developed prior to the upcoming legislative session that runs in Florida during the months of February and March. Currently, we've had one walk through of all of the statutes and rules and reviewed all of the SSAPs. We divided them up amongst the various bureaus and people in the bureaus read them and their supervisor then reviewed their write-ups. The committee that I am a part of would then review the write-ups and we determined which SSAPs might have conflicts or discrepancies with the statutes in the Florida Administrative Code.

About a week or two ago, we started on the second round, which is to go back and look only at those SSAPs that have conflicts and begin the process of determining whether we feel that the statute or the rule should change or whether we should simply not adopt those SSAPs.

MR. WILLIAM J. SCHREINER: On a number of occasions during your presentation you mentioned the issue of confidentiality. Let me share with you an observation on the Insurance Department receiving confidential information. The question is, what are they going to do with it, who are they going to give it to, and what is that person going to do with it once they receive it? With 51 jurisdictions, I might trust your superintendent, but I might not trust the Commissioner in Florida, or I might not trust your next superintendent. Do you have any comments on that? The concern is the potential variability of proper treatment of confidential information.

MR. PEARSALL: I understand your concerns. Somehow this has been worked out with the Federal Reserve Board with its changing board of governors and people working there. I think whether you have a trust or whether the particular commissioner or superintendent is trustworthy, it isn't a crap shoot. In New York, it is a political job. I've worked under each of the three superintendents under both major parties' administrations. I have been careful to handle this type of situation and wouldn't consider exposing confidential information. I don't know how the other superintendents or commissioners are chosen, but I would say, in New York State, they are very careful. The people are not political hacks. Neal Levin, who was mentored by Senator D'Amato, is one of the brightest guys that I've ever seen come in there. He understands things at a very high level, and when he doesn't understand something, he will admit it. Ed Maul was his

predecessor and he came from the property side. He had a good insurance background and he knew the rules. I can't speak for the other states. I've met Rider. He seems like an honorable guy. I've met Terry Vaughn. She seems honorable. In the Catholic church, if you confess to a priest, he is supposed to keep your confession secret. I think most priests probably do keep confessions secret. I think you have to have the same trust in us.

MR. NEIL J. BRODERICK: A question for Mr. Pearsall. I do both Canadian and U.S. valuation. You had mentioned Canadian valuation during your presentation. I was just curious as to which aspects of Canadian valuation (either the valuation technique papers discounted or dynamic capital asset adequacy testing or some other method) you would find appealing and would like to see incorporated into U.S. valuation somehow.

MR. PEARSALL: If I were to make a particular comment at this time, it would be ill advised, because I was speaking in a general sense. I was not going through the particular items in my mind. Terry, did you have some comments on the confidentiality?

FROM THE FLOOR: In one of the cases, a Section 7 company was in a certain condition, and I requested that they do a Section 8 opinion. The actuary made a gross premium valuation. That company was not familiar with the confidentiality aspect of an actuarial memorandum. So I told the person that it was confidential, and I told them as soon as I received it, I would stamp each page individually with my "privileged and confidential" stamp. I think you'll be safe in Florida as long as I'm there, but I don't guarantee I'll live forever.

MR. STEPHEN L. WHITE: I have a question for Kerry about what he said about codification and reviewing Florida laws with respect to them being in conflict with codification and how you must decide whether you want to go along with codification and change those existing laws. The first part of the question is, how much of a conflict is it to the codification, in general, if each state decides which piece of the codification it's going to accept? The second question is, when you try to make those determinations for Florida, which treatment is better: the Florida treatment or codification? Or, is this codification proposal something that Florida can live with?

MR. KRANTZ: I report to the Bureau Chief. She's a policymaker; I'm not. But when I make my recommendations, I will present pros and cons as to whether or not we should change the statute or whether we should leave the statute and simply not accept the SSAP. There's a general rule of law that says that if there's a conflict with something like a rule as opposed to a statute, that the statute overrides. The SSAPs in the codification are called "The Practices and Procedures Manual." Current Florida statute adopts the 1991 "Practices and Procedures Manual" at the NAIC and all subsequent editions as long as they are not materially different or something along those lines. I mentioned the fact that this new "Practices and Procedures Manual" cannot be deemed not to be materially different. There's always a possibility that the policymakers in Florida will decide not to adopt it. I doubt that that's going to happen, but it might. If it's adopted, the statute will have to be changed to adopt this particular manual.

We did have one incidence so far where there was a conflict with a statute. One of the recommendations I made was to consider whether to adopt the SSAP without paragraph 25, which was the conflicting paragraph. I said that might mean we'll have to change our rule that adopts it every year if, for some reason, they renumbered that and it became either 24 or 26. So my recommendation is to consider whether we would adopt all of the SSAPs without that whole one and then adopt that SSAP and write out every word that we agree with and exclude that one paragraph as an alternative.

As far as the conflict between different state variations, that's something that I've always been concerned with and the reason I'm an advocate for the UVS system. I don't think the differences between various states, the different dates of adoption of tables, and the different interpretations of how to calculate reserves, are really that material and cause trouble for companies. I believe that market conduct might vary by jurisdiction because of the attitude towards how much protection should be placed for the consumer as opposed to marketplace regulation. Different areas have different opinions, and we have state regulation.

I don't think solvency is a local issue. I think if you're insolvent in California, you're insolvent in Florida. If you don't have the money to pay your claims, it doesn't depend on what state you're in.

The issue of the codification though is one of state sovereignty and the NAIC might try to say that you cannot be accredited unless you adopt the codification manual. The state legislature might just adopt it and pick and choose the parts it wants to adopt.

MR. BRADLEY D. LEONARD: This question is for anyone who wants to answer it. As a group, you're financial regulators. There's another group that isn't at the podium right now that deals with health rate increases. Will we see a trend, as many companies do, of not getting approval for health rate increases at the level that might produce the best health for a block of business? I'm just wondering how you feel about the interaction of the financial regulators with those who approve or disapprove rate increases? That's an action-oriented thing that improves the health of companies.

MR. KRANTZ: Since this isn't a court of law, I don't have to worry about hearsay rules. Florida, as everyone knows, is not the best state for getting quick approval without any conflicts. I'm not involved in the Bureau of Rates and Forms, but I work closely with them. I believe one of the concerns they have is companies that underprice their products, realizing that if it's guaranteed renewable, they can come again later and ask for rate increases. I think the philosophy is that the company should price their product fairly at issue and try to achieve a price that will reduce the need to have huge rate increases. I believe they are aware that in times of high inflation, high rate increases are inevitable. They don't like the idea of a company not raising their rates for several years to keep the policies in force and then come up with a huge rate increase. The idea is that insurance has level premiums so that you pay higher premiums when you don't need to pay them, so that later on, you can pay lower premiums when your claims exceed the premiums. I think it's that philosophy that our Bureau of Rates and Forms actuaries adhere to.

MR. NEILL: Yeah, I think it's a good question. The two areas are separate in Texas, but we've seen a good bit more interchange between the two areas lately, particularly for HMOs, because we are quite concerned that the industry as a whole has been losing a lot of money in Texas for a long period of time now. We're also doing it with the filings from the insurance companies, so

there is more coordination and consideration of solvency issues as well as the typical issues that are considered in rate approval.

MR. PEARSALL: In New York, the Health Bureau is totally separated from the Life Bureau which handles life and annuities. I guess on the AOMs we take care of the health stuff, but we really don't see any of the filings for rate increases, so I can't comment.

MR. THOMAS A. CAMPBELL: The proposed changes to the Actuarial Opinion and Memorandum Regulation will allow states to either accept the state of domicile opinion, with or without conditions. I guess I want to ask each of you where you see your state going as far as the conditions would they put on it? If you're not comfortable talking about your states, then can you comment on what would you want to ask if you were the commissioner of your own state? What conditions would you put on it?

MR. PEARSALL: In New York we are limited by the Standard Valuation law, which says that if we do the work to assure ourselves that the company is in compliance with us through its own state's standards, we could accept the state of domicile. That's an awful lot of work for a very few people. In New York, we have 100 domestics (they have to do it our way), and only about 50 foreign companies. As such, the impact, although, it's on some big companies, isn't all that great numerically. There aren't many small companies in New York that are impacted, and we don't have a lot of small companies from outside of New York. To me, whether we would do it or not is almost a nonissue, but we don't have the people to go through and make that type of testing under the current standard valuation law.

If I were to design my own (and this is my own opinion), I would try to get the company to do the work and demonstrate that their laws are in compliance with ours. We would probably accept the state of domicile results for that company if it were a Section 8 company, where we're lessening our interests in the formula reserves. Perhaps they could show that the company could come up with the same opinion over a few years, if the same level of reserves were required under the New York's current state and of the state of domicile.

MR. NEILL: I don't really know what position Texas would ultimately take on this. My personal opinion is to take something like the standard codification provisions and show us how the reserves compare to that, so we have some kind of benchmark. I don't know whether it's codification or whether it's some other benchmark. I personally think that is probably the best way to handle it, but that's not necessarily what everybody else in the department thinks.

MR. KRANTZ: I was following that issue, and I've been busy with other things. I believe the Standard Valuation Law says that the opinion of a nondomestic company needs to be substantially in compliance with the reserves required by our state. I think that there's some room in there to come up with some kind of a compromise. I know Frank Dino, who is the chief actuary of our Rates and Forms Bureau, and the member of the Life and Health Task Force has been more deeply involved in that issue than I was. But I think there is some possibility. I think the best thing to do would be to adopt the UVS and eliminate state variations. Baring that, perhaps the current standard valuation law could be changed so that the actuary would give an opinion based on state of domicile, plus codification differences. Shirley Shao is the chairman of the Academy committee, and those are the things that the committee has discussed. In the past, I've sort of been a stickler for the letter of the law and the law says "state of filing." I believe if the reserves aren't in compliance with the laws of the state filing, there's a problem. As I said earlier, I think there's something in there about being substantially in compliance, and there is that little bit of wiggle room.

MR. SUMMERS: There are three alternatives that are currently being proposed for the Actuarial Opinion and Memorandum Model Regulation. The first is that the state of filing prescribes certain written standards and conditions and the foreign company would submit an opinion saying that the reserves meet the laws of the state of domicile and the written standards and conditions. The second possible alternative is that the foreign company requests prior approval from the state of filing to submit an opinion based on the state of domicile. The third alternative is basically one of disclosure where the foreign company would file, in the state of filing, an opinion that's based on the state of domicile, but which also discloses what the gross reserves would be if they were calculated according to codification standards.

I would speculate that California, assuming that this proposal is adopted, would either stick with the state of filing requirement or would go with the first alternative, which is state of domicile plus meeting the written conditions and standards that would be put out by California. Again, this is my own personal opinion. It doesn't necessarily reflect that of the California Insurance Department.

One thing I wanted to mention is that, as it currently stands, this proposal would apply to companies that do the asset adequacy opinion. These are alternatives that a state can choose to allow for a foreign company. They are not alternatives that the companies would choose.

MR. JOHN C. DI JOSEPH: I was just wondering how the members of the panel might see the regulatory environment changing in response to the banking deregulation and the potential threats of federal preemption of state regulation.

MR. NEILL: I've tried to follow the progress of HR10 and Senate Bill 900 on the Internet. Lately, there doesn't seem to be a whole lot going on. I think a month or so ago Senator Phil Graham (R-Texas) issued a statement that's available on the Internet that you can read. I think there's a lot of politics that are involved now that are not related to HR10 that are taking the attention of our esteemed representatives and senators. The differences between the two might not be resolved because they don't feel it's important enough to take their time this year, which would be a sad thing, because it's going to be a lot harder next year.

MR. SUMMERS: I think I'll take the opportunity to mention some topics that the Life and Health Actuarial Task Force is currently dealing with. The first one is variable annuities with guaranteed living benefits. The acronym is VAGLBs. These are variable annuities that provide a guaranteed minimum return on investment to the policyholder. You might have heard of guaranteed minimum income benefits (GMIBs) and guaranteed minimum accumulation benefits (GMABs). A GMIB provides a guarantee as to the minimum account value that will be applied to either guaranteed or current payout rates at annuitization. The GMAB provides a guarantee as to the minimum account value at the end of a specified number of years. This latter guarantee does not require annuitization.

There's an American Academy Work Group that's currently working on developing reserving methodologies for these types of products. At this time in California the Insurance Department is not approving them because it believes that there's no specific authority for these products in the Insurance Code. We've received a couple of letters from consultants asking about this issue. Our response has been that we don't think these products are authorized, but if they disagree, we are willing to review their analysis of the California Insurance Code with respect to this matter.

The second topic has to do with nonforfeiture requirements for equity-indexed deferred annuities. The question came up regarding language in the standard nonforfeiture law, which defines the minimum nonforfeiture amount to be an accumulation of a percentage of premium. In the case of a single premium annuity, the minimum nonforfeiture amount, ignoring policy deductions and loans and withdrawals, is 90% of the premium accumulated at 3% interest, plus additional amounts credited. The additional amounts credited language is the heart of the issue. The Academy of Actuaries, at the request of the Life and Health Actuarial Task Force, formed a work group that studied this issue. The response from the work group was that there's really no clear-cut answer, but they identified four possible alternatives for interpreting the law.

This example illustrates the issue. The product is a $1,000 single premium equity-indexed annuity. It's a seven-year, European design with a 75% participation rate. The value of the index at issue was $1,000. At the end of the seven years, the index value is $1,400. The minimum cash value during that first seven-year period is 90% of the $1,000 single premium accumulated at 3%. I'm ignoring the policy charges that can be deducted. At the end of the seven years, based on the 3% accumulation, the value will be $1,106.89. Because the index did well, it went up 40% in seven years, a result of applying the participation rate to the index results in a value of $1,300. At the end of the first seven-year period, there is $193.11 more than would have been provided by just the 3% accumulation.

The question is, what would be the minimum cash value at the end of the eighth year, assuming that the policyholder renewed this contract? The first of the four possible interpretations is that excess interest, which is $193.11, would be added to the accumulation of the single premium. In this example, 90% of the single premium accumulates at 3% for eight years, and to that result,

you add $193.11. The second interpretation is that the excess interest should accumulate with interest. In that case, the ending value was slightly higher because you have 3% interest on the $193.11. The third alternative is that you also apply a surrender charge to the excess interest, so the ending value is lower than in the second example. Finally, the fourth possible interpretation is that the excess interest is not figured when you calculate what the minimum nonforfeiture benefit is. So at the end of the eight years, the minimum would just be 90% of the single premium accumulated at 3% for eight years.

How many of you think that option one is the most appropriate? Two? Three? Four? How many haven't thought about it enough? The Life and Health Actuarial Task Force has not made a final decision on what the appropriate interpretation is, so this issue will be on the agenda for the next NAIC meeting.

The third topic is also a nonforfeiture matter. It deals with universal life products with secondary guarantees. The task force is currently considering a proposed guideline, currently known as "XYZ." In the case of a 30-year no-lapse guarantee, the guideline would require that the nonforfeiture benefits during that 30-year period be no less than those required for a 30-year term policy that had a guaranteed premium equal to the specified no-lapse premium. The guideline requires a segmentation approach for nonforfeiture benefits.

The fourth topic, which you've heard about a lot, is Regulation XXX. The latest information I have regarding state action is that 32 states have committed to adopt the regulation and, of those, 24 intend to make it effective on January 1, 2000. In California, Senate Bill 374 was sent to the governor for his signature. The bill adds language to the standard valuation law in California that gives the California Department the authority to issue a bulletin to adopt XXX. The Bill requires that such a bulletin be replaced by a regulation no later than December 31, 2002.

You've already heard about phantom accounts. I would like to share with you some wording I obtained from a rider submitted for filing in California. Under "benefit" it said, "this policy will not enter the grace period provided the shadow account value, less any policy debt, is greater than zero." As mentioned earlier, the phantom or shadow account value is determined by a separate

set of interest rates and cost-of-insurance charges. Even if the policy fund value goes below zero based on the credits and charges that determine the account and cash values, the policy will stay in force if the shadow account is positive.

The rider states that the Shadow Account value is not used to determine the actual cash surrender value, and it is not used to determine the death benefit amount provided by the policy.

The last item I had, which I already covered, had to do with the Actuarial Opinion and Memorandum. Right now, there's that proposal to provide three alternatives and the task force continues to work on that. Are there any final questions?

MR. SCHREINER: I just want to make one comment on your review of the interpretation of the individual annuity nonforfeiture law. It's only option four that is consistent with the practices in the marketplace that have been established over the last two decades.

MR. SUMMERS: It's probably true that most equity-indexed annuities that are currently being sold do not comply with any of the first three options. This is possibly true for some other forms of annuities as well.