2000 Valuation Actuary Symposium
Washington, D.C.
September 14–15, 2000

Session 34OF
Regulatory Topics

Moderator: Kerry A. Krantz

Panelists: William Carroll
Robert A. Potter
John A. Hartnedy
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Summary: A panel of regulators share their perspectives on valuation actuary related issues, including the hot issues from a regulatory perspective, their attitudes toward relying on the judgment of company actuaries, their assessment of how the valuation actuary concept is working, peer review, and the current areas of focus of the National Association of Insurance Commissioners Life and Health Actuarial Task Force.

Participants are invited to ask questions from the floor following brief formal presentations by the regulatory actuaries.

MR. KERRY A. KRANTZ: There are four regulators and one representative of an industry trade association on the panel. Bill Carroll is an actuary for the American Council of Life Insurers. He represents the life insurance industry in government relations. He served the Society of Actuaries as a board member and vice president. Bill will be our first speaker.

Bob Potter joined the North Carolina Department of Insurance as a life actuary in June of 1999. His responsibilities within the Actuarial Services Division include: review of statements of actuarial opinion, technical analysis of actuarial memoranda, assistance with the implementation

of the NAIC model laws and regulations, and providing actuarial support on life insurance matters to all divisions of the department. Prior to joining the Department of Insurance, Bob worked for 23 years in the life insurance industry, primarily in financial reporting. Seventeen of those years were associated with Integon Life Insurance Corporation where Bob served as the appointed actuary and ultimately as vice president and chief actuary. Bob is a past president of the Southeastern Actuaries Conference. He will be speaking on "XXX."

John Hartnedy is the Deputy Commissioner and Life and Health Actuary of the Arkansas Insurance Department. He is also a Fellow of the Society of Actuaries and a member of the Academy. He has 39 years of insurance industry experience, including the last three-and-a-half years in insurance regulation. He will be speaking on the Dallas NAIC topics.

Rod Friedy was born in Canada. He is a Fellow of the Society of Actuaries and a member of the American Academy of Actuaries. Rod has been a life and health actuary with the Louisiana Department of Insurance since May of 1994. His main area of focus is financial solvency. Prior to that he was life insurance company corporate actuary responsible for the completion of valuation and related compliance requirements. Having worked on both sides of the compliance issue, Rod Friedy is aware of the concerns of both the company and regulators.

I am the life and health actuary with the Bureau of Life and Health Insurer Solvency and Market Conduct of the Florida Department of Insurance. I spent 20 years in the insurance industry and have worked for the last five years at the Department of Insurance. I am responsible for valuation issues, and I participate in the financial examinations of domestic life and health insurance companies. Rod and I are here for questions and answers.

MR. WILLIAM CARROLL: My topic is, "Inside the Insurance Regulatory Beltway." This meeting is being held in the Washington, D.C. beltway. How many of you are from outside the beltway? Almost all of you. Our local news refers to you as the folks that really do not know what is going on in the country. In Japan, if they want to find out what is going on in the United

States, they come to visit you throughout the country. They are probably correct. This slide shows the insurance regulatory beltway. I am going to talk about organizations that establish and influence the environment in which the life insurance statutory financial reporting actuaries (that is you guys) practice in the United States.

That is my scope. This is going to be a little shorter than a similar talk that I have given before. I will tell you when I skip things. Then I am going to add to it. I am going to put in a couple of current regulatory issues, and I will tell you what they are now so that you can be thinking about them. One issue is the actuarial opinion memorandum and all the fuss over trying to get state-of-domicile filing versus filing according to the opinion requirements of every single state in which you file. A companion issue that cropped up that is associated with it is the elimination of the Section 7 Opinion.

What is the most important thing going on in the life insurance business today? That is the whole idea of regulatory reform. I am going to talk about one small aspect—speed-to-market. This is part of a total program the ACLI is considering, but it is not yet committed to an alternate federal charter. It is a dual track, and we are committed to working on improvements in state regulations to make state regulations more efficient. I am only going to talk about the speed-to-market piece. I am going to describe some of the organizations that work to develop these rules, and I am going to use two current topics to illustrate how that happens.

Let's discuss the insurance regulatory beltway. There is a relationship among the three major kinds of organizations. It is intended to be a little bit of a virtual beltway. The three kinds of organizations are governmental, professional, and industry. When I talk about them, I am going to try to tell you who they are, what they do, how they do it, and how they relate to each other. What's more important is I will tell you how you can relate to them and be involved with them. Each of these organizations has strong networking with each of the others, with members of the industry, and with the profession.

Governmental organizations include: state legislatures, state insurance departments, the NAIC, and the National Congress of Insurance Regulators. I am going to talk mostly about the NAIC. The biggest organization missing from this list is the federal government.

Let's discuss professional organizations. You are familiar with the Society and the Academy. The AICPA has been very influential at the NAIC in the process of codifying statutory accounting. It was the catalyst that made the process happen in the first place, so it is on my list.

Trade associations. The ACLI has changed its name. We are now the American Council of Life Insurers. We used to be the American Council of Life Insurance. We recognize the other organizations. Organizations important to the activities in which I am involved are the Health Insurance Association America and the National Association of Life Companies, which is an organization of smaller insurance companies. It is the organization that is bound and determined to keep its Section 7 exemptions in the valuation actuary opinion. This reveals to you the three organizations I am talking about. It is a little more concrete beltway. I am just going to focus on the NAIC, the Academy and the ACLI.

Most of what we are going to be talking about are specific issues. This is kind of a structural discussion. I am going to show you the mission statements of each of these organizations. The mission of the NAIC is to protect the public interest; promote competitive markets; facilitate fair treatments of life insurance companies; promote reliable solvency and financial solidity of insurance institutions; and support and improve state regulation of insurance. What is missing? It is something very important, which is to support uniform regulation of insurance. Read the NAIC by-laws and mission. It is just not there. It ought to be on top. That was the purpose of the NAIC being organized more than 100 years ago.

What does the NAIC do? It makes model laws and regulations. It recently completed a giant project of codifying statutory accounting that involves its Accounting Manual and Annual Statement Instructions. In addition, its Actuarial Task Force puts out actuarial guidelines that have made their way into codification. These guidelines are used to interpret model laws and regulations.

What does the Academy do? I am interested in the first part of its mission, which is to ensure that the American public recognizes and benefits from independent expertise of the actuarial profession and the formulation of public policy. This is a lofty goal. This means that your Academy representatives are offering the services of actuaries free of charge to the public so that the public will benefit from what we are able to do. They are not a lobbying organization dedicated to the narrow interest of the actuary. As another part of serving the public, the Academy works to promote and maintain high standards of practice within our profession.

The ACLI's mission is to provide a unified association to advance the interest of the Life Insurance Association. That is what it says. I always used to say: what do we do? We represent the common interest of our members. What does it take to do that? It takes the process of identifying the common interest and then working for it.

All of these organizations work within committee structures. The ACLI has committees of interested member companies that get together to debate issues and develop policies. We, as staff, keep them in touch with what is going on. We bring issues up through a committee structure to a Board of Directors, which has the final say about ACLI policy. Similarly, the Academy has practice areas and committees for those practice areas. They are constantly looking for people to join. Look in your yearbook to see what committees interest you and call the chairperson(s). Committees need people to work.

The NAIC also works in a pyramid kind of a structure. There is an actuarial task force, which has health working groups. There are valuation of assets and accounting task forces and annual statement task forces that do those kinds of work. They also have interested parties that help them in doing their work. You can get in there and volunteer. There is plenty of opportunity in this environment to get in and make a difference and have an opportunity to influence the decision.

There are two items I want to talk about briefly: the Actuarial Opinion and Memorandum Regulation and the speed-to-market issue. As I said at the beginning, there are two issues involved in the actuarial memorandum regulation that is currently exposed by the NAIC task force. There is a draft exposed for comments.

The main issue is the state-of-domicile versus the state of filing question. The current rules say that when you file it in State X (Arkansas, for example), you should follow the rules of Arkansas. That has been troubling to professional actuaries and to companies. Much work has been done to encourage the state actuaries to try to find a way to suggest in their regulations that you could just follow the state-of-domicile. They have made progress in doing that. The ACLI is supportive of that. Representatives of the Academy are generally supportive of that and have worked with them to develop the language. That part of it is moving along fine.

In my opinion, what is holding it up in the proposal is the elimination of Section 7. The state actuaries have taken advantage of an opportunity (remember this is a political environment). The Section 8 opinion is a full-blown asset adequacy analysis. The Section 7 opinion doesn't require asset adequacy analysis. There are conditions, which if you meet them, allows you to file that way rather than using the full Section 8 opinion method. When the Actuarial Opinion and Memorandum Regulation was first put together in the early 1990s, the exemption was put in as a compromise between the industry and state regulators. It has been troublesome to some state actuaries ever since the beginning, and they have taken the opportunity to try to change it whenever the opportunity has arisen.

A political environment like this, when the industry has something that it really needs, offers a good opportunity for the regulators to add something that they would like. That is all that is going on here. I cannot tell how it is going to come out. I know that the small companies are most likely going to be against it. They claim that the cost of having to do a full Section 8 opinion is not worth the benefits that the regulators get. What are the benefits? Do people really get their money's worth out of it?

Last is the speed-to-market issue. This began as part of what was called an ACLI report card on the regulation of both state and federal insurance. It was a CEO level activity. There were several rounds of dialogs with CEOs. They listed things that they didn't like about the existing regulations. Near the top of every list was a complaint that the length of time it takes to bring a product to market is too long. State variations were very high on the list also, and they are also a contributing factor in the speed-to-market problem.

At the same time, there is a dual-track approach going on at the ACLI. It is not just the speed-to-market issue. This pertains to the overall regulatory efficiency question. This dual approach involves creation of an optional federal charter. If the United States government adopted the concept, a company could choose to be a federal chartered company rather than a state-chartered company. That would enable it to do business throughout the United States under what the designers hope would be one single set of national standards. I need to emphasize that that is not a commitment, and the only thing we are committed to doing so far is to draft a proposal. We are not talking with members of congress about introducing it. Our CEOs have not yet said go ahead. They have said to get ready.

On the state side, we are committed to the NAIC. Our leading officers have told the NAIC leadership that we want to work with them. We want to improve state regulation. There are several parts in that. Only one is speed-to-market. There are other things, such as company licensing agents.

We divide speed-to-market into four points. The first would be a single point of filing. That is, you would not file in 50 states or even two states. You file in one place. There would be a single set of product standards that apply across the whole nation. If you meet these standards, that policy is good everywhere. You send it to the single point of filing. There is a vague and undefined process. We believe there should be some simple, vanilla products. Some people might say all products ought to be like this, but for those that would fit this category, you would file the product at the single point of filing. You would certify that it met the standards, and you would sell the product.

The structure refers to the legal design of the single point of filing. You would have to create authority. What the single point of filing did was legal in all 50 states. We'll see whether that means changing all the state laws or whether that means making some kind of state compact. People do not know the answer to that.

Finally, let's discuss market conduct enhancements. If you are going to say just file and use and certify that you are doing it, you are eliminating a front-end scrutiny that exists today in many states. The idea is to replace that with more and better market conduct reviews of what companies have been doing. I liken this to the way we regulate traffic in the United States. We put up the speed limit, we send the police out with an idea of a speed limit that might be different than the posted speed limit. They watch to see what people are doing, make arrests, and give out tickets. We do not file a plan. I am going to leave this hotel at noon, and I am going to get as far as checkpoint one by a certain time. I will not give the police officer a complete plan of what I intend to do, and I will not ask him to pour over the plan to see if it is within the speed limit. I won't ask him if I am driving too long at one time or have him approve the plan, and then watch him not pay any attention to what I actually do. The system of setting the rules and putting the police out on the road is better.

The NAIC is making a lot of progress on the speed-to-market issue and making its own issue. They have a plan that, in concept, is essentially the same as the ACLI plan. There are some stumbling blocks. The stumbling blocks are things like how you make a single, uniform set of standards that states possessing different standards will agree to and accept. Step one is the political process of making the agreement, and step two is the process of legally implementing it. If all 50 states or even all the major states wanted to do it (and many do), they would find a way to do it. We will see what happens in the next year or two. Hopefully, we will see an awful lot by December, but I think this process is going to run a while.

MR. ROBERT A. POTTER: You might have noted from the introduction that I have been working as a regulator for only a short while, having joined the North Carolina Department of Insurance just last year. I point that out to underscore that I have not entirely forgotten about the challenges of trying to develop competitive products that meet all the demands of shareholders and senior management. Having been the valuation manager and the appointed actuary for a stock company for many years, I have learned the challenges of having to argue for setting up an additional reserve that you feel is prudent. This is especially true if you have to argue that it would exceed statutory minimums or might not be tax deductible. I agreed to be on this panel so that I could share one of my new challenges with you and solicit advice and assistance from those of you who are willing to provide it. My remarks and opinions are strictly my own and should not be taken as an official position of the North Carolina Department of Insurance or of our actuarial services division.

I want to address the potential need for a guideline for the application of the XXX regulation. North Carolina has adopted the XXX model effective for policies issued on January 1, 2000 and later. Among my responsibilities will be providing assistance to our field examiners and verifying compliance with requirements of XXX when detail reserve calculations are examined. We want to maintain consistency from product to product and from company to company as to how we apply XXX. The basic idea behind it, as you are all aware, is to require a humpback reserve as a minimum for a policy that provides a level period of coverage and a level premium. This coverage could be a segment of a stand-alone policy; it could be a term rider or a secondary guarantee within a universal life (UL) product.

The application of the XXX requirement to the products I have seen in my own companies, prior to joining the Department of Insurance, seems straightforward. However, during the past few months, a number of newer products have been brought to my attention for which the application of XXX, at least with respect to the letter of the law, is not so clear.

Some of the unclear situations we have seen lately include: UL products with shadow accounts; UL products with an exchange feature; term products with premium rate guarantees tied to an external index; term products with rate guarantees provided by other products or other companies. What is unclear?

There are UL products with shadow accounts. One form of this product maintains two accumulation values: one actually drives policyholder values and another serves to indicate whether or not the policy remains in force. The death benefit remains in force as long as the shadow account remains positive. There is no specific minimum premium requirement stated, but, with the assistance of a good agent, a policyholder can guarantee himself a number of years of low-premium, level-term insurance.

The question we run into is, does the shadow account fit the definition of a secondary guarantee? In subsection 7.A.(1) of the XXX model A.1.(a) refers to a specified premium, which the shadow account product I just described does not have. A.(1)(b) refers to a minimum premium being less than a one-year valuation premium. If the shadow account uses competitive interest and mortality assumptions, the minimum premiums to keep the policy in force are quite likely to be less than that one-year valuation premium, but there is a little more confusion if you get into details.
The definition of the minimum premium is stated in terms of an account value and guarantees at issue. If you have a product with two account values and two sets of guarantees, which one do you use?

Other UL products have an exchange feature. If the account or cash value (whichever is used to determine whether the policy remains in force) becomes zero and a specified minimum premium has been paid all along, then the UL policy will lapse. However, a new policy of some sort is issued and it maintains the coverage in force at the same premium that was being paid to begin with.

There is a reference in 7.A that "the policy will remain in force." Do we have the policy remaining in force or do we have something else?

There are term products with rate guarantees tied to an external index. A speaker mentioned those yesterday. One example was cited in a recent National Underwriter editorial. It is a product for which the premium rates cannot be increased above the current scale during the first 20 years unless a particular U.S. Treasury rate falls below 3%. Suppose the policy was originally structured so that the current premium scale is guaranteed for a short period, say five years or three years, with the guaranteed premiums thereafter set high enough to avoid deficiency reserves and perhaps to minimize the basic reserves. It could be that the Treasury index features are added with a rider or an endorsement.

About all we have to go on is the definition of a gross premium and the definition of the segmentation. "Guaranteed gross premiums" are the premiums under a policy of life insurance that are guaranteed and determined at issue. The question is, does this product have an initial three-year segment or a 20-year segment? How likely is it that the five-year U.S. Treasury will fall below 3% in the next 20 years? My personal view is that reserves for the product should be calculated with the assumption that it has a 20-year guarantee.

Another category is term products with rate guarantees provided by other products or other companies. In this situation, if the writer of a term policy increases the current premium scale before the end of a specified period, a second product or second company pays the amount of the increase. Between the two products or between the two companies, the policyholder has a guaranteed level premium for the specified period. Which premiums are under a policy of life insurance that are guaranteed and determined at issue? My personal view is that between the two products or between the two companies, the sum of the reserves held ought to be calculated as if the first company had made a guarantee; we would have to decide how to split those reserves between the two.

There are a number of other product variations. We have premium catch-up provisions. This is a situation where the policyholder might have paid less than he was supposed to, but before the policy lapses, he can catch up by paying an additional amount. How should the catch-up provision be taken into account in the reserving process?

There are high-premium/high-dividend products, I am told, where the dividends are essentially guaranteed. Should it not be the net amount that is used as the premium in the reserve calculations for XXX? I am also informed that there are reentry term products for which the underwriting at reentry is not really sufficient to warrant the use of select factors. Here XXX only allows the use of select factors in the first segment.

I suspect that you can add to my list or that perhaps your product actuaries are adding to the list as we speak.

If I take a step back and look at these products, they seem to me to be designed to make the policyholder feel comfortable that he has purchased coverage for the period of time desired and that the current premium scale won't increase during that period. Incidentally, that view seems much clearer when I take a step back in time to when I had just passed the old Part 4 Mathematics of Life Contingencies and before any of my on-the-job training in "Word Games 101." But XXX describes the methodology for calculating the reserves for what the policyholder thinks he has. The challenge I feel I have as a regulatory actuary, and the challenge I want to share with you today, by asking for your assistance, is to provide actuarial guidance that results in XXX reserves for the coverage the policyholder believes he has. As long as I am being idealistic, I will also say I would like for us as regulators to adopt uniform guidance in whatever form that guidance finally takes.

Possible alternatives to pursue, apart from doing nothing and relying on the regulation itself, would be an actuarial guideline, possibly an actuarial standard of practice, or perhaps amendments to the regulation to make it more clear. My first try has evolved into an attempt to draft an actuarial guideline.

What I would like to do now is present some of the thinking that has been done so far and some of the problems that have arisen in the process so that you can think about them. My hope is that enough of you will start thinking about the situation so that together we will come up with a good

workable solution that provides a level playing field in terms of reserve requirements. I am trying not to attempt too much at once. I focused just on shadow account products, hoping that if we could come to some consensus on shadow account products, we could work out the rest of them.

What I wanted to try to do here is to come up with some way to have a level playing field in terms of reserve requirements. I wanted to clarify that shadow accounts are included in the category of products with secondary guarantees. It seemed reasonable to me that products with explicitly stated guarantees and products with equivalent, implicit guarantees that have to be calculated, ought to have the same minimum reserve requirements, as long as the terms to qualify to keep the policy in force have been met. I also wanted to try to take the actual premium history into account.

Some of you might have seen my first attempt. If, on a basis that is guaranteed in the policy (1) a level gross premium can be determined, such that the policyholder can keep the policy in force for some period of years, and (2) the level gross premium would not otherwise be sufficient to keep the policy in force for that period of years (based upon minimum interest, guaranteed maximum mortality costs, and guaranteed policy loads), then the policy has a secondary guarantee. This was my attempt to pull in shadow accounts.

The reserve involved the following four things. First, start with the shadow account balance. Then determine what sort of a level premium the policyholder would have to pay from there on to keep the secondary guarantee in force—trying to cover the most expensive guarantee in terms of reserve requirements that the companies made. Next, determine the implied net premium. Finally, calculate the minimum reserve. Several issues have been pointed out with this approach.

First, there was an inconsistency with the UL model regulation. The UL model regulation uses guaranteed maturity premiums and calculates them just one time; they do not get changed again. There is an R value involved that ratios the benefits around to match what has been paid in, but I had taken an approach that keeps the benefits the same and changes the premium, so I had an

inconsistency there. It was pointed out that XXX Section 7 does not currently require consideration of actual premiums that have been paid. It also allows for a single segment of increasing premiums with no level premium requirement there. My approach was sort of adding something. I am not sure you can do that within a guideline. Maybe we have to go another route.

The retrospective nature of the reserve, starting with the shadow account balance, might cause tax reserve issues. Someone pointed that out to us. If the gross premium changes, does a new segment start? We are getting into the details and mechanics of XXX again. With all of that in mind, we made a second attempt.

Here we tried to define shadow accounts a little more broadly. Policies with provisions, under which the policyholder is able to pay specified premiums that will maintain coverage in force with the original schedule of benefits, but which otherwise would be insufficient, fall within the description in the model. We next had to define what we meant by specified premiums.

Specified premiums were the smallest gross premiums determined at issue that will keep the policy in force under the provisions of the shadow account. The smallest gross premium calculations will use the shadow account cost factors. We are trying to clarify here that you would use the shadow account in coming up with these gross premiums as opposed to the base policy account.

This approach dropped the level premium requirement and maintained better consistency with both the UL model and XXX. It seemed to me and to others to fail to level the playing field in terms of the reserve requirements for shadow account UL products that have and do not have stated level premiums.

One company offered a third approach for our consideration. (People at the NAIC meeting only had a few minutes to look at it.) If, on a basis guaranteed in the policy, by a rider, an endorsement, or in any means whatsoever, the policyholder can keep his policy or his coverage in force for a period of years through payment of premiums, which would be insufficient in the absence of this guarantee to keep the coverage in force, then the policy has a secondary guarantee.

This definition attempts to address most of the recent product variations I listed earlier, including shadow accounts. Note the use of the word coverage rather than policy to encompass the two products to company situations.

The associated approach to establishing reserves for products with shadow accounts is a somewhat different level premium approach than I had suggested. It potentially addresses some of the problems that I mentioned in my original proposal. It still involves the potential redetermination of a level gross premium each year, if the shadow account structure is such that the amount in the account affects the level of premiums that have to be paid in the future to keep the coverage in force.

If there is more than one secondary guarantee, the minimum reserve is based on the secondary guarantee period that produced the largest reserve. A couple of things this approach took into account were, once you have set an initial segment, you do not change it, even though you end up recalculating another gross premium. The difference between this approach and mine, in effect, takes the shadow account balance and determines the level premium that gets you from the point of issue to the current account balance. It might recalculate another one if the policyholder has not been paying a level premium. There is also a recommended method for handling catch-up provisions. This particular approach got into a lot of the details.

Where are we now? I think we are still struggling. I think we need to do more "what if" analysis of the suggestions we have so far and solicit additional ones. We need to analyze any other reasonable approaches that you all might suggest. Some of you suggested that XXX is clear enough as it is. I would like to see us clarify things a little better if we can so that we can come to some understanding that is uniform.

I understand there will be another Life and Health Actuarial Task Force conference call on XXX scheduled for early to mid-October. During the call, alternative guidelines could be presented and discussed. If you either have some suggestions for how we might proceed, or if you have a proposal you would like to put in the form of a guideline, I suggest that you e-mail it to Mark Peavy at the NAIC. He could distribute it to the task force prior to the conference call. I am not sure when the call is scheduled, but it will be held in early to mid-October of 2000.

For those of you who are inclined to help, I will close my remarks with an observation I have made. The process of developing a clarification for how to apply XXX sometimes seems to me to be very much like parenting a teenager. For example, when my 16-year-old son began driving and dating, my wife and I gave him an 11:30 p.m. curfew. I thought we all knew what that meant. To me it meant that my son should drop off his date early enough that he could be safely back at our house by 11:30, so I could get a reasonable night's sleep. My son's solution, however, was to find a girlfriend who had her own car and no curfew, so the two of them could be back at our house by 11:30 and she could drive home later at whatever hour suited them. So we had to clarify the rules so I could get a reasonable amount of sleep.

MR. JOHN A. HARTNEDY: I stand before you, probably representing the organization that has done more over the last decade to create actuarial jobs than any other organization—the NAIC. Some of the things we have done include the Actuarial Opinion and Memorandum Regulation (AOMR), XXX, risk-based capital (RBC), and Variable Annuity Guaranteed Living Benefits (VAGLBs). Let me touch a little bit on some of the discussions that we had recently at the NAIC. I will also touch a little bit more on XXX.

One of the things that was discussed at the Life and Health Actuarial Task Force meeting was a *National Underwriter* article dated August 28, where it basically talked about your conscious corporate evasiveness and your lack of trustworthiness because of the things that you were doing to avoid XXX. We brought up the question of why do people try to get around it? If regulators are going to draw a line in the sand, and it is perceived as an unnatural constraint, then you will most likely try to get around it.

Some of the regulators asked whether or not they should just disapprove any product that you file if it is not in the spirit of XXX. Then the question came up about what would happen at a hearing. Technically, we would not be following the law. Therefore, maybe we would not fare that well at a hearing. Of course, part of that depends on whether you would call us to a hearing or not. (I do not think as much of that is going on now that I have left Golden Rule. But, we have done that more than once, and we called regulators to hearings. I actually think it did make some things better.) Some of us regulators have a tendency to go beyond the law as far as what we think should be done.

What you have to decide when you try and get around XXX is whether your obligation is:

- to follow your perception of what the spirit of the law is;
- to follow what you perceive our perception of the spirit of the law is; or
- whether you should be more concerned about your professional obligations to hold proper reserves—namely, signing or the AOMR.

Personally, I am quite satisfied if you can sign your opinions, assuring me that there are adequate reserves. In all honesty, I will not look at what you did with regards to XXX. As such, my opinion is in the minority among regulators. We also discussed what is really needed, such as better principles and better guidelines. So more actuarial leeway can be provided as has been done in GAAP and as is being suggested in UVS. The objection to that was that there is not sufficient actuarial accountablity in some of the recent things done. If you are going to be allowed to make judgments, then there should be accountability. You should be required, in some ways,

to check your exposure, to review your experience, and to let us know that, in fact, your assumptions are reasonable. I think it is safe to say we resolved virtually nothing at this NAIC meeting. There was discussion about a level playing field. There was discussion about whether we needed a further guideline (some saying yes, some saying no) or whether XXX is sufficient in its own right. There was concern expressed that an X-factor that cannot be decreased creates artificial deficiency reserves, especially at the older ages.

I have a suggestion for you if your company is one of the companies that has developed a product being used to accuse you of avoiding XXX. Do you believe you have done the best for your consumer in setting the most competitive price? Do you believe you can sign your actuarial opinion and that, in fact, your reserves are adequate or more than adequate? Then I guess I want to know why you have not written an article in response to the *National Underwriter* article? Do you believe you are wrong in what you've done? I do not think a lot of actuaries feel that way. I think they feel they've done the right thing.

There is a public article out there that is accusing the insurance companies of basically being untrustworthy, but nobody has responded to it. I think that it is your obligation to look into that, if you have developed such a product. You should respond that your customers are safe, and that you have looked out for their best interests. After all these years, I am a little tired of how many times we become whipping boys for the media. The media cannot go wrong picking on the insurance companies because nobody will respond.

We discussed AOMR at the Life and Health Actuarial Task Force Meeting. We made a few minor changes. Net deferred and uncollected will be on the list of things upon which you have to opine. That was only done to make it consistent with the annual statement instructions. We made a minor change also in separate accounts. It said that you use page 3, line 27, which included all types of things in the separate accounts. That has been changed to page 3, lines 1–3, which means you only have to opine on reserves. This has been in the draft for quite some time.

The detailed instructions are out. For example, the seven interest rate scenarios are not listed per se. What you are to do will be addressed in the Actuarial Standards of Practice (ASOPs), primarily 7 and 22. As Bill discussed, the valuation law requires that you have to file your opinion based on the state of filing, and we felt we couldn't change that without a law change. The Commissioner has rather broad authority, and he can accept things like codification. If you have compared your reserves for your domestic state with codification requirements, he could accept that. I personally think that he also could accept the fact that your state is accredited. Why could he not accept those reserves? I would encourage you, as members of the ACLI, that when this model comes out (and I think it will), that there be some wording that is developed by the ACLI and that is given to the Commissioners on a state-by-state basis that will conform with the Commissioner leeway permitted in the model and be consistent throughout the country. You might have to do some personal delivering and encourage your commissioners to support verbiage that would allow you to file in accordance with your domestic state requirements. It makes an incredible amount of sense to me to do that; I think it will take some coordination, which you could do through the ACLI. The burden is going to fall on you to see that that happens.

The proposal provides for no Section 7 opinion. There is an exemption in there—the Commissioner can exempt single state companies from asset analysis. That is viewed differently from multi-states because of the obligation to the Commissioners of another state. That is consistent with what we do in accreditation. There is concern about the cost if the smaller companies have to do a Section 7 opinion. There is concern about the availability of actuaries to do that many Section 8-type opinions. What will we really learn from a gross premium valuation on a particular small company when you can't even have or use its own assumptions? Have we prevented any insolvencies through the use of Section 8 opinions? I do not know. I do not know how we would even study that.

I would like to mention something to you that we did in our state. Until 1968, we had allowed the sale of something called stipulated premiums. I do not know if this is unique—we did not

have to hold reserves for stipulated premiums in our state. They were level premium whole life policies with no cash value. Just think about that. The law said no reserves. I have a number of small companies that have this product. The basic question is, are they solvent? The answer was: nobody knew.

I was very pleased with what the AOMR allowed me to do. Basically, my Commissioner could demand a Section 8 opinion from any company. We demanded it for these companies. All had to do Section 8 opinions, so they basically needed a gross premium valuation to figure out whether they had enough reserves to cover their stipulated premium business. I was quite surprised and pleased to find out that these companies are solvent. They objected to having to do this. They were very concerned. They came in, and a number of them met with the Commissioner. We insisted that they do this, and at least one of them is currently very grateful. They do understand where they stand and the fact that they will not have to go to their owner for future money to keep this company going. They honestly did not know. The AOMR was a great benefit. Did it prevent anybody from going insolvent? I can't say it has.

I can see why some are objecting. Some of the larger companies are saying we need a level playing field. If we have to do it, so should the others.

Some of the people representing the guaranty associations believe that the AOMR says more about the solvency of the company. I personally believe that. The guaranty association, for its own benefit, believes that everybody should have to do a Section 8 opinion. I will say that, from our point of view, it makes little difference to me, and it will make little difference to our small companies in our state. I feel you can do a very legitimate Section 8 opinion on nothing short of maybe two pieces of paper. If you have a small enough company invested, for example, in Treasuries (and we have some—I have a credit run-off operation), a detailed gross premium valuation or cash-flow analysis will tell me nothing about that operation. But I would like the actuary to take a look at the assets. I think an actuary ought to do that. I would like the actuary

to assure me that his reserves are being reasonably released, at least over recent years, and that they are enough to cover the mortality costs. They are small and that might be hard to do. That is why I said, "a number of years." To me, that kind of analysis would be close to a Section 8 opinion on the company that I am talking about.

If you could count on your regulators to look at Section 8 in that manner, you will have to do more as actuaries, even the small companies. It certainly does not require cash-flow analysis, unless you have somebody doing some awfully adventuresome investments. I think there are ways to work with that.

I said, in another session, that I am not sure, that I would not stand with the small companies if I was in the industry. That is because there are going to be some states that are not going to allow you to do what I just said. They are going to make it difficult. They might even demand cash-flow analysis, and that is not reasonable on a number of small companies.

Doug Doll gave a very good summary in the opening remarks of the things that we talked about. As you can see, I am picking out some of the flavor of our conversations and some of the other issues that can be talked about. One other thing that I want to mention is UVS.

The only comment I am going to make about that is the S-curve. The S-curve is basically going to provide for a very small likelihood of something really bad happening: your assets will be sufficient to cover your liabilities 95% (or some percentage) of the time. If it is not, maybe you will conclude that you need reinsurance or you need to set some type of policy limits. These are things not caught by risk-based capital (RBC). More research needs to be done so that we will have the tools to actually do UVS.

There will be a seminar November 8, 2000 in Philadelphia that will cover the approach to fair-value balance sheets and to corporate capital. I think the Valuation Actuary Symposium should have a session on UVS every year. I think it is that important. Let me tell you why I think that way. Look at the progression of what is happening. We created the AOMR, and that gave you

more judgment. We created RBC. RBC took it out of a strict number thing. We began to move to a more dynamic type of item. It is clearer when you look at what happened with the C-3(a) risk. You might be required to do scenario-type testing, depending on your C-3(a) type of risk.

Now we are moving back to XXX, and you are going to develop experience X-factors. The logical progression of this is UVS, followed by liquidity, which is being discussed at the NAIC, followed by viability, which is a broader perspective of what will happen with UVS.

I have a side comment on liquidity. What heated this up was what happened to General American. I went to the first liquidity session at the NAIC. The comment I made was that the system was not perfect, but it worked. The reason I said that is the law allowed General American to stop payments. It probably had a very minor impact on any person because the people who wanted money out of General American were the big pension plans. They wanted it out for one reason, and that is that their rating had dropped. I do not know the details, but as far as I know, nobody got hurt. Metropolitan bought them, infused cash, and everybody got paid. Was the system perfect? No. Did the system work? I propose to you that yes, it did, and there was nothing else that we necessarily had to do. This was my opinion.

Now some of the industry came up to me afterwards—they didn't stand up and support this idea and say, "That was great." I haven't been back, but it's not because my feelings are hurt. I have just been too busy working on other items and nobody seemed to be interested in pursuing something like my suggestion. We have to evolve and develop even more regulation. But I am not comfortable that your position is always presented. I know you have a lot of meetings to go to, but I am concerned about what we do on the regulatory end. The ACLI and the Academy, in many respects, do an excellent job of representing your interests. I am not sure it would not be helpful to have even more of you professional and knowledgeable actuaries come to the NAIC to help keep us on the straight and narrow.

I listed this progression of events for you: UVS, liquidity, viability. Why do we need to progress in this way? Product development: some of you might have put out an equity-indexed product, and you know a number of states did not approve your product. I question whether that is a role for us as regulators. In our state, the companies that were doing this were big, stable, strong operations. You are the people that we want experimenting with things like this. If something goes wrong, you can stand behind it. You have got the wherewithal to do this. You are the ones that ought to be doing this type of thing. We approved that. What we looked at was your advertising. I reviewed a few advertisements and then stopped and said to our rate and forms people, "Why don't you do it? You do not want to know if a technician can understand it. Have the clerical staff review it. If they can understand it, then it is good advertising." I have to tell you folks—you are doing a good job. I am proud to be part of your industry; and I am pleased at the kind of stuff that we are seeing, at least in our state.

If you want to compete out there with banks and the other financial industries, you are going to have to be able to get to the market quicker, and if we are holding you up because there is not a reserve standard in place, you need something changed. My suggestion to you is you need to look at UVS very carefully. There are national treatments being talked about and Bill talked about that. UVS has more to do with national treatment because we are going to be the same from state to state. We do not have XXX here and not there. We do not have VAGLB here and not there. We would have UVS, and hopefully we would stop developing special reserve formulas like XXX, VAGLBs, and all those types of things. We would be much better prepared for national treatment. We would be much better prepared for international competition.

I am not sure how many companies require that you separate life, property and casualty (P&C), and health. Think of all the different formulas that we have. We have a very complicated system. I am not sure it seems that way to us because we grew up with that. That is all we know. Why does life have to be separated from P&C? A UVS system says you are going to analyze your liabilities and your assets. You could have one reserve system. Why can't you have a company license that covers all three of those major lines that I mentioned? The major thing is whether management and actuaries have the ability—to do that kind of job. That is where we are going. UVS is the step to take us there.

What do you need to do? I think you need to teach your management. What I am disappointed in is what you do with your AOMRs. By the way, I am very pleased with the ones I get. I review the Section 8 opinions that we get in the State of Arkansas from our domestic companies. A few years ago, you were learning the work that you did wasn't always impressive. You do a good job with the AOMRs. I am very pleased with the work that I have seen.

I had to tell one actuary that I was going to discuss how he went about it with the ABCD. After that we came a lot closer to agreement. That is the only situation, and I wouldn't even call that difficult; we worked that out. Teach management. Show them the projections that you are doing. Show them the value of what you do. It sounds like I am being critical. I live in a glass house, and I'm throwing stones. When I left Golden Rule, we were doing full cash-flow testing. I never made a presentation to management, let alone to the board. I left there six years ago; I hope you are smarter and more successful at that than I was. It's a valuable tool.

You need to develop your skills. You are doing a good job with AOMR, but you are not ready for UVS. That is why I suggest that you need to keep up with that item. Meet with your Department of Insurance. Raise the trust level with them. Merrill Lynch Life is our biggest domestic company. They come in twice a year. We sit down with their top management team, and tell us what is going on. I am not sure you can do this with every state. I think you can do this in the majority of the states. You can sit down with your domestic regulator, and raise the trust level about you as an actuary and about your company. It works wonders. Merrill Lynch did a couple of things that created red flags at the NAIC level. When we received a notification, we were ready. It was just a misunderstanding about what they did and what it meant. We responded to the NAIC. Our commissioner had a letter out to the NAIC defending that company and explaining why they do what they do because we understood them.

You need to educate your department about UVS, which means you probably have to educate yourself first. You have to think of ways to police your peers. Talk to your buddies. Talk to the people who are doing XXX products that do not meet the requirements. I don't mean you should

criticize them; rather, understand why they are doing what they are doing. If they are doing something that they shouldn't be doing, tell them so because we'll develop another darn law or regulation to stop them. If they are doing something right, support them. Encourage them to publish an article. Say something about why you do what you do. Defend what you do. You should be proud of your actions. You do a good job.

Have you ever calculated appropriate risk-based capital for your company? I do not mean 200% or 300%. What is the right level for your company? If you do not know, then you haven't done all of the cash-flow analysis, and you haven't done the viability test on your company because maybe only 200% is appropriate. You do not want to be below that for legal reasons. On the other hand, maybe 400% is appropriate for you. Do you know? Have you done that type of work? How involved are you with UVS? I believe it's the wave of the future. It's the way to go. Unfortunately, I do not believe the current Life and Health Actuarial Task Force would pass UVS. If you think it's a good idea, you probably should be talking to some of us. You ought to be educating us. You ought to be raising our comfort level so that UVS can happen.

MR. KRANTZ: It is now time for questions and answers. The first question is, Condition VI in the ASOP says that the X-factor specifically taken into account increases in expected mortality and lapse rates due to premium increases. What demonstrations and/or facts are needed to satisfy Condition VI in the ASOP?

MR. POTTER: I am not exactly sure what would be required. By saying the X-factors specifically take into account increases in expected mortality and lapse rates due to premium increases, we are trying to deal with antiselection when the rate increase takes place. I think that is the reason the actuary is going to need to make a judgment call, at least early on. I am not sure where you would find specific demonstrations or facts. Perhaps large companies might have tracked that. Probably my company had not gotten to the end of the level premium period to be able to measure mortality antiselection. Some of the larger companies might have that kind of information or your reinsurers might have it.

MR. KRANTZ: Next question is from Pete Hitchcock of Motorists Life. The current draft of the ASOP does not specifically mention any methods to validate X-factor credibility. Monte Carlo methods and others have been suggested. I am a small company actuary. We will not have credible data, and I plan to rely on reinsurers and quarterly monitoring of early claims experience to assure that underwriting practices are being complied with. Is this a reasonable approach? I think it's a reasonable approach.

MR. POTTER: For a small company, I think the best thing to do would be to look to a reinsurer for additional experience. I think the suggested approach is very reasonable.

MR. KRANTZ: Another question is, what is the appropriate reserve treatment for a term product written with a 20-year level, 10-year guaranteed premium, that promises that if the premium rates are increased in years 11–20, then one year's premium will be refunded to the policyholder?

MR. POTTER: I do not think that XXX clearly addresses that issue any more clearly than it does some of those that I have pointed out earlier. If it were me, as I mentioned in the introductory remarks to my presentation, I think I would try to do something I thought was reasonable, but on the conservative side. In the absence of a direct standard, all I have done in the past is use a GAAP reserve, and I calculate what I think my best estimate is for the amount I am going to have to refund. That is something that could be built up and then released later. I do not think it's clearly addressed by XXX at all.

MR. KRANTZ: That premium would probably have to be treated as an endowment.

MR. POTTER: There is some sort of a pure endowment.

MR. KRANTZ: Is Monte Carlo testing of X-factors compared to company experience without any additional calculations both necessary and sufficient to satisfy Conditions IV and V in the proposed ASOP? IV relates to the present value of future benefits using X-factors being greater

than the present value of future benefits using company expected mortality. V relates to X-factor mortality being greater than company expected mortality for each of the next five years. If such Monte Carlo testing is not sufficient, what else should be done? Is a simple listing of X-factor mortality and company-expected mortality necessary and/or sufficient to satisfy condition V?

MR. POTTER: I will take a shot at that question also. I am not sure, depending on the company's circumstances that Monte Carlo testing is necessary. There might be another means of hypothesis testing. As I looked at this aspect of XXX, the first thing I did was I pulled one of my old Part 2 texts off the shelf, and I went back to try to rediscover what hypothesis testing was all about. I suspect a number of you were in that same situation.

MR. KRANTZ: Nobody wants to argue about whether we should retain the Section 7 opinion or get rid of it? So I guess you are all in favor of eliminating the Section 7 opinion? Good. What else do I want that you'll approve by silence?

MR. HARTNEDY: These things were mentioned by Doug Doll, but they could have a very direct impact on you folks. Guideline IXA has been exposed for comment. What this is going to allow is substandard annuities. They'll allow something additional to the mortality rate. This will be for your structured annuities. It doesn't sound like it's going to be complicated. In fact, it will allow you to reduce your reserves. If you have an opinion or a concern about this, then it's actual Guideline IXA, and it's coming into an exposure period. You might want to comment.

One other thing that is out there is variable annuity guaranteed living benefits (VAGLBs), which is a mess. They've discussed a Keel method. What they are trying to do is figure out a way to reserve for this. They have had a terrible time coming up with anything. If you sell these kinds of benefits, it is going to be complicated. Talk about creating an additional actuarial job. I think we've done a yeoman's job in this particular case. You should be concerned. It's not out for exposure; it has been referred back to the Academy for further work. I honestly do not know

what else they can do with it. They've kind of come to the end. The Keel method doesn't work for everything; they are leaving it up to valuation actuaries to do exactly what you have to do. That is where it is right now. You may want to input that because, if you do not, you could end up with some very complicated calculations. There are hoops that you have to jump through for these types of products. Keep it in mind.

MR. CARROLL: I would like to put one other topic on the table and that is the new CSO mortality table, which is now under construction. The Society of Actuaries has promised the NAIC that they will have an experience valuation table by the first quarter of next year. The Academy of Actuaries is then going to load it to turn it into a Commissioners Standard Ordinary (CSO) table. That is going to create the same kind of discussions that we had with regard to XXX.

All the questions about XXX had to do with choosing the X-factor. One of the things that is going to come up is, to what extent should the individual company be able to vary from the CSO table based on the experience of the company. This will have to be thrashed out when they put in the loading. The characteristic today is that company mortality varies much more widely from one company to another than it did in the days when the 1980 CSO was put together. Loading the new CSO table to make sure that there are enough reserves for nearly all of the companies is going to be burdensome loading for many companies. That is going to lead to reasonable arguments and companies need to be allowed to have leeway in applying the CSO. That is going to raise all the questions about XXX up to another level. As actuaries, you have an interest in how it comes out, so you all need to pay attention to this. These things are going to be argued within the Academy, at the NAIC. Tom Foley, who is the chair of the NAIC Life and Health Actuarial Task Force, is heavily involved in the Academy's task force, and it will be discussed at a special meeting at the NAIC winter meeting in Boston.

MR. HARTNEDY: There have been four hours allocated at the Boston NAIC meeting for the Life and Health Actuarial Task Force to discuss what Bill is talking about. If you have an opinion, it would be an excellent time to get in on how we should load that CSO table, develop select factors or anything else to do with its development.

I would like to clarify one other thing that we discussed. The XXX methodology or X-factors cannot be used in variable life or variable universal life. Some companies have raised a question and the Life and Health Actuarial Task Force has taken a very definite position on that.

The Health Reserve Guidance Manual did come out. It is a guidance manual that has been recommended for adoption. It's going to suggest how you might set health reserves. If your examiners are using it, it might end up being more than a suggestion. But all we intended it for was guidance. I think it's too late for comments on that. Is it exposed for comment or was it recommended for adoption?

MR. CARROLL: No, the Health Reserve Guidance Manual is exposed, and I think they wanted the comments within 30 days of the meeting. They have a contingency plan for a telephone conference call if they get comments that need discussion. The goal is to adopt it in December.

MR. HARTNEDY: If you have comments from the health reserve point of view, get them in. It's a guidance manual only. We have an initial draft of a guidance manual for long-term-care insurance. There were some major changes made in that. If you are in long-term care, you are probably aware of this. They've moved away from initial loss ratios. Basically, you can set your premium where you want it to be. The hooker is if you want a rate increase, you'll be subject on the increased proportion to an 80% loss ratio, and you will then be subject to a 58% loss ratio of your initial premiums.

MR. CARROLL: That is 85% John. There is not much room for expenses. It makes it foolish to file an inadequate premium and rely on a future rate increase.

MR. HARTNEDY: That is it. The goal was to prevent rate increases, and that is what they are accomplishing. There is more disclosure. Your rate increase history will be part of what is required disclosure, so that is one of the things that is very much in the works, and a lot of that has happened. The rate increase thing is approved and will be taking place.

MR. KRANTZ: At the federal level, the Commerce Subcommittee on Finance and Hazardous Materials (I never thought of insurance as a hazardous material so maybe it falls under finance) had a committee hearing. The president of the NAIC and a couple of other people were speakers before them and that was on the congressional Website. Those who are interested can go look that up. I posted a copy of Congressman Bliley's comments on the Society Website. I also posted a notice from that committee about how there will be a second round of testimony coming up. They are going to continue talking about insurance regulation and the possibility of a federal role. In his remarks at the last hearing, Congressman Bliley hoped that there would not need to be one, but he is keeping his mind open, so you might want to watch out for that. I think that there might be a live broadcast on the Internet. I am not sure if that is true or not. When I read what I saw on the Website, it was not exactly clear to me.