2003 VALUATION ACTUARY SYMPOSIUM
September 11–12, 2003
San Diego, California

Session 21OF
Appointed Actuary Forum

Moderator: MEREDITH A. RATAJCZAK
Panelists: STEPHEN I. MARCO
MEREDITH A. RATAJCZAK
DAVID A. RICCI

Summary: A panel of appointed actuaries shares their perspectives and practical experiences in fulfilling the duties and responsibilities of the appointed actuary. At the conclusion, participants gain insights from practicing appointed actuaries and a better understanding of the duties and responsibilities of the appointed actuary, supporting actuaries and staff.

MS. MEREDITH A. RATAJCZAK: We received many questions in advance, and we appreciate that. I'm not sure we'll be able to get through all of the questions. I'm going to read the questions, and I've paraphrased most of them. We'll discuss each one, and if you have related follow-up questions, it probably works better if you get up after we're done and ask the questions as we go along. This is an open forum; we expect that other people have comments to make, so please feel free to do so.

On the panel today we have Dave Ricci; he has many years of experience in the industry. He's been the appointed actuary for many companies and is currently appointed actuary for Zurich Life. He currently serves as a member of the Valuation Actuary Planning Committee. We also have Steve Marco; he is the headquarters managing actuary for GE Financial Assurance. His focus is primarily on financial and product-based corporate initiatives. Before joining GE, Steve was the chief actuary at Citizens Financial Corp., and he served on various industry committees, including the Risk Management Task Force. With that, I will go to question 1.

Question 1 asks, Let's say a company is involved in a dispute with a state over a company's plan rate increase on an A&H product. Without future rate increases, the present value of future benefits would be greater than the present value of future premiums on that product. Should the appointed actuary set up deficiency reserves? For example, assume his or her company will lose in the dispute.

MR. STEPHEN I. MARCO: The approach I would take is to basically evaluate the situation and, based upon my best estimate of where it will end up, proceed accordingly. If I believe that we will end up losing the dispute, I see no way around setting up deficiency reserves. The same thing goes in setting up a model for cash-flow testing. It's your best estimate of reality, whatever that may be. Remember, when all is said and done, it comes down to how you evaluate the situation and reflect it in your opinion.

MS. RATAJCZAK: You could possibly think of this another way, as potential litigation. It's possible that the people in your accounting area, given that a large issue might exist, could look at this as a reason to set up some sort of contingency reserve. As Steve said, you have to use your judgment in determining how likely it is that you will not get your rate increases.

MR. DAVID A. RICCI: I would divide it into two issues. One might be whether the current gross premium is greater than or less than what you might consider a tabular net, a strict definition of deficiency reserve. I think in those cases you probably should go ahead and set something up. The other murkier question is what you should do in the case where you know you're going to be deficient on a statutory basis. I think you adequately answered those questions.

MS. RATAJCZAK: The next two questions deal with the revisions to the Actuarial Opinion and Memorandum Regulation (AOMR). The first is, Are you aware of which states have adopted this regulation? I believe Donna said this morning that Florida has, and there are likely eight states or so that will adopt in 2004.

The second part of the question asks, Specific interest scenarios for cash-flow testing are not specified in this regulation. Do you know what scenarios companies are using besides the New York Seven? Are they using stochastic scenarios or additional deterministic scenarios, and how many scenarios are appropriate? It depends. It depends on the nature of the liabilities that you're doing cash-flow testing on. I never quite understood what deterministic scenarios meant for variable products. For those types of products, you'll probably see people doing stochastic scenarios. It could be stochastic scenarios on a life product where there is a lot of mortality exposure. I think it depends on the types of business on which you are doing testing. Once again, the appointed actuary is going to have a lot more leeway in determining what are the correct assumptions or the most appropriate assumptions to use for scenarios, given the nature of their business.

MR. MARCO: You said it all.

MS. RATAJCZAK: The next question is, What is the expected New York State Insurance Department special actuarial opinion on memorandum requirements expected to be for this year-end? Donna Claire did an excellent job going over those this morning. I'll briefly talk about what their hot buttons are.

What they've sent out that we've seen is only a draft, and the first thing they're going to require is submission by e-mail, which I think is a good thing. I think Donna had mentioned that some of the hot buttons are interim results: they want you to show interim results. They are going to be a little pickier about how you document the asset assumptions. Relying on what they call black boxes to do your projections without really understanding what the assumptions are and that are driving a projection of cash flows will probably not suffice. They want to make sure that you line up the margins, the spreads that you assume with the default assumptions; and they don't want you to assume large returns on "equity-type assets," the Schedule B, A-type assets. I think that's why they went to adding sensitivity where you assume that the return is 3 percent. They are going to require a lot more detail regarding your variable guaranteed minimum death benefit (GMDB) and living benefits. They want you to talk about your actual experience in terms of withdrawals, discuss what your transfer history or experience has been. They expect that you will do sensitivity testing on your major risk; if that is GMDB, then they are going to expect that you're going to flex that partial withdrawal assumption.

A lot of us are asking for more disclosure-oriented memoranda. They are going to ask for tables of credited rates so they can look at what your history has been. They want you to be very clear on what the risks are in your product. In some cases you would assume additional premiums on products. In this interest rate environment you might want to test not getting those renewal deposits. Donna talked about reinsurance, the hot-button areas, the GMDB reinsurance with some sort of risk-limiting provisions. I guess New York does not want to allow any reinsurance credit on those. Donna specifically cited some of the contracts that have corridors and such in them.

They want you to tie a lot of the information you put in that memorandum or used for assumptions back to actual experience. They really don't want you to rely on other actuaries. If you say that it's not possible to review everything, they don't care; they want you to do that. They want you to do it all. If you do risk-based capital (RBC) testing, they want support submitted with your memorandum. Those are the primary hot buttons. As I said, it is a draft. How it will come out—I guess they are calling it the Halloween letter part 2—is yet to be seen.

Question number 5 is, What do you think about the trend for the New York State Insurance Department requesting survey data, examination responses and other things to be included in the next actuarial memorandum?

MR. RICCI: As a prelude to that, I had a discussion with the chief architect of this October surprise memo, Mark Greene. Basically he talked a long time about these interim results. It seemed from the discussion that they didn't have any set requirement on the interim results, except that if you got bad interim results in the level scenario, that wasn't good news. Other than that, it was a matter of form and degree. They just wanted to get some more information out. To the extent that you can trust them to be able to manage that information effectively, it might be a reasonable sign that they are at least taking an interest in getting down to the real substance of it. They are not just looking at it. In terms of doing their job, I think it's a big pain for people to have to work on it. I think we're going to see a lot more of that in other states: they're going to follow New York's lead. I don't see that's going to be changing much.

MS. RATAJCZAK: I think it all comes about because New York in particular is very focused on risk management. Instead of maybe getting down into the nitty-gritty of all the assumptions that you use in cash-flow testing, they are using all the disclosure information to get a better handle around the risk of your company. I think it might make it easier to go from year to year to assess the information that you give them. As Dave says, I think you'll see more states taking more of a risk-management approach to looking at your annual filing information.

MR. MARCO: Actually I think part of it is that we're starting to see a blurring of the distinction between asset adequacy testing and solvency. Recall that when we first looked at asset adequacy, we were evaluating the ending value of market surplus at some time horizon. Now we're looking at interim periods. I think, as times goes on, you'll see more and more of a focus on their intermediate values.

MS. RATAJCZAK: Good point. The next question is, What options do companies use to address the existing state variations in their asset adequacy analysis?

MR. RICCI: In many ways, of course, I can just give the stock answer about the responsibility of the valuation actuary. I think it's important to have a fairly good understanding of the states you operate in. Exactly what additional requirements may be imposed upon you by certain states? Then determine whether you're going to handle the situation with a conservative valuation to embrace as many of these assumptions as possible. Whenever you're going to decide that in some cases, you'll just submit a different statement to the state involved. In some cases that can't be avoided. I know that, in one particular incident, a state wanted to have a line of business adequacy split from other particular lines. If you did that for every state, you'd be in a serious situation with RBC. Basically we more or less did it on that state's statement. We were able to manage that effectively.

MR. MARCO: Depending upon the impact, you may want to just do the same thing across the board, if it wouldn't make too much of a difference. Then break it out differently if you felt you had no choice.

MS. RATAJCZAK: Clearly with the revisions to the AOMR, it sounds like state of domicile would be acceptable. Maybe this will become less of an issue.

FROM THE FLOOR: At what point and based upon what information do most appointed actuaries consider reinsurance cash flows to be in jeopardy? How do most then factor any impact of expected unrecoverable reinsurance cash flows into their asset adequacy models?

MR. MARCO: Well, I used to look at a few different items. First, I tried to convince myself that the reinsurer was solvent and would remain so, and that the coverage would be continued under the treaties. Another possibility would be if the reinsurer could increase the premiums, but I couldn't do the same on a direct basis. If any of that did occur, I would modify my models accordingly. In the case of an insolvent reinsurer, it is a simple modification to your model to eliminate the effect of reinsurance. If you were thinking about recapturing, the effect that would have. If the reinsurer could increase premiums, but you couldn't, that's a tough one. I never faced that. I don't know how I would have handled it if I ever faced it.

MS. RATAJCZAK: I think in some cases, depending on the situation and how important reinsurance is to the results that you're showing, that falls under the category of sensitivity test areas. You know that even if the reinsurer might have some financial problems, it clearly might fall into the category of assumptions that you might sensitivity test.

MR. MARCO: Yes, and again it's also materiality. If you're reinsuring only 3 percent of your business, then you probably wouldn't need to worry about it.

MR. RICCI: I think it might be a bigger problem down the road, particularly with regard to these variable annuities for reinsurance. You might find that there's going to be some situations in which the reinsurers might be severely strained to come up with the appropriate claims recoverable. I'm guessing at this point. I know that there is a significant amount of reinsurance business out there. Some reinsurers have already made huge adjustments in their reserves to reflect that fact, but I would be almost certain that not all of them have. So what does a reasonable valuation actuary do to determine if there's a risk involved ahead of that occurrence?

MS. RATAJCZAK: The next question is, Does the panel have any guidance or suggestions for dealing with the new standard of practice (SOP) accounting and reporting by insurance enterprises for certain nontraditional long-duration contracts and for separate accounts? Compliance could be onerous for many companies. Is there any body of opinion about what would be an adequate range of scenarios for quantifying the benefit ratios that underlie the GMDB liability for excess death claims? Realistically speaking, how frequently will companies recalculate the benefit ratios?

MR. RICCI: I don't see any way around this other than to run stochastic scenarios. In fact, it's specified in the SOP. That doesn't necessarily mean you have to dedicate 20 machines to doing it. I think, with efficient modeling and careful consideration, you can come up with a fairly compact economic way of doing it.

I believe that this requirement is not effective until sometime in 2004. Our company has run our stochastic scenarios to take a look at this. We've incorporated our product that has both GMDB and retirement income benefit, and we've taken a look at the model set of durational values. Then we've taken a look at a certain percentile of those values by duration to determine a benefit stream on the death benefit and the retirement income benefit and the premium stream. Then we develop the GAAP reserve. I don't think that's exactly how it's specified in the SOP. There are certain things that you're going to encounter along the way.

First of all, if our results are any indication, you're going to have situations where, if you take into account the full premium stream, you're going to run into interim negative reserves. This is because you're anticipating premiums out that you don't have benefits for. Obviously you have to trim the premium stream back so that you come up with a reasonable reserve pad.

The other thing is, if there's any kind of significant premium charge that you're calculating, you're going to run up the reserves to double their value or something like that, depending upon when the election periods are for these retirement income benefits. That's just a start for us. We're still working on it. I'm perfectly happy to share what we've done so far with anybody who wants to get that information.

MS. RATAJCZAK: How about the last question related to this question? How frequently will companies recalculate the benefit ratio?

MR. RICCI: Once you have the methodology down, I don't think the frequency is going to be that big an issue. You're going to want to do it as frequently as the experience unfolds, because it's going to be materially different. Right now in many cases, we're just guessing as to what kind of things are going to occur in terms of the suboptimization that's going to result from some of these benefits. You hope you try to pick a conservative value, but maybe you're way off base one way or the other. That's going to happen consistently in this kind of an analysis. You're going to want to make frequent updates based upon new information that comes down the pike on this stuff. There's no way around it.

FROM THE FLOOR: How do you decide what percentile to use?

MR. RICCI: There's a GAAP SOP, so I don't know. You could take the 50th percentile. My feeling is that probably is inadequate even for GAAP. I wouldn't go any lower than the 50th, and I think it's a matter of judgment. There's no real specification in the SOP as to what take.

MS. RATAJCZAK: The next question is, The new SOP states that the provisions of the statement need not be applied to immaterial items. Is there any guidance in terms of what level of financial impact would make an item material?

MR. RICCI: This fact of materiality crops up in a number of different places. I think you have to take a look at its impact as a percentage of the reserves, as well as percentage of surplus and what it does to RBC. There's not one particular answer; it falls under the radar. For most of those, I think you can more or less say it's immaterial, but you have to be prepared to support that.

MS. RATAJCZAK: The next question is, Does the panel have any thoughts about whether company pension plan liabilities that are not liabilities of the insurance company should be included in the purview of the company's appointed actuary?

MR. MARCO: I think of this as a similar situation to having debt at a holding company level. Realistically when you're forming your opinion, you're forming it on the basis of the insurance company itself, whether the assets are adequate at that level. However, reality would tell you that if you think that the debt is burdensome, or this potential liability could somehow threaten the solvency of the company, you may want to make a statement about it. However, I'm not sure that you're required to do so by any standard.

MR. RICCI: You have an obligation, and for anything you think may have a material impact on the financials of the company, you should be able to determine exactly what that impact is going to be. Sometimes you might be stepping on the toes of somebody else who has the same kind of obligation. It's a difficult call. It's like the reinsurance question. In some cases, how much rigor should you apply to that personally to make sure that your company stays out of danger?

MR. MARCO: The bottom line is it comes down to your opinion as the appointed actuary.

MR. RICCI: Yes.

MS. RATAJCZAK: The next is a series of questions on how actuarial practice has developed with regard to questions about interim results in asset adequacy analysis projections. The early practice notes put out by the Academy concluded that our SOP on actuarial opinions did not require the appointed actuary to evaluate results at intermediate points in forming his opinion. However, the new version of the AOMR calls for a discussion in the Regulatory Asset Adequacy Issues Summary (RAAIS) report of any interim results that need be of significant concern to the appointed actuary. The first question is, Does the Academy plan any updates to the SOP concerning interim results? I believe they have already changed the SOP to talk about it, at least considering interim results. So they have.

Could the panel speak to the types of interim results that should be commented on in the new RAAIS report? I think we touched on that briefly. I think, at least if you look at what New York is requiring, they want to see the interim results at each point in time. If you consider your company, if you have scenarios that show you going bankrupt early on, those are the types of scenarios or interim results that you want to comment on. Clearly, if you have interim negatives that are material in the level scenario, that would be a real problem also. Therefore, I think it's in the actuary's judgment to at a minimum provide the interim results, comment that you can consider the interim results, and talk about what you've seen in the interim results. In the case where the interim results are materially negative, describe what you're going to do about that. If you don't put up additional reserves to cover those interim results, why you don't think you need to?

MR. MARCO: The real question is whether there's any benchmark out there that you can go by to determine at what point you have to perform some action. I'm not sure that there is right now. One answer might be to look at your available surplus and see whether the shortfall is more than what's available. Then you're talking about solvency and not asset adequacy.

MS. RATAJCZAK: They are all connected.

MR. MARCO: Yes, they are.

MR. RICCI: I'm sure there are some management actions that can be taken on interim results that probably aren't reflected in the cash-flow testing process. If that has a material bearing on the results, then you might delve a little into that and discuss that.

MR. MARCO: One thing you might do is consider changing your investment philosophy going forward in order to mitigate some of those shortfalls.

MR. RICCI: Yes.

MS. RATAJCZAK: Then you have to really document that.

MR. MARCO: Yes, and be sure to get buy-in from your investment manager.

MS. RATAJCZAK: That is correct. Get a signed statement from your investment people.

MR. MARCO: Preferably in blood.

MS. RATAJCZAK: I think we've covered the last part of the question. Here's a situation: Your results look fine on a present value basis, but you have interim result issues. The question is, Are there patterns of interim results that would require additional reserves to be established? We've stated that there are no set guidelines as to when you put up additional reserves, if you're going bankrupt early on. In the level scenario you would probably say you'd want to consider doing something to take care of that. It's going to be in the actuary's judgment to determine where they would need to hold additional reserves.

MR. MARCO: This sounds like something that would be worthwhile considering as part of a practice note.

MS. RATAJCZAK: Good suggestion. The next question is, To your knowledge, has there been any company that has had an insurance department specify methods and assumptions for asset adequacy analysis that haven't been requested of all companies within that department's jurisdiction?

Clearly yes. A lot of times it happens as follow-up after the department has reviewed somebody's asset adequacy testing, and they feel that in certain areas they want a better handle on what the risks are. Clearly I've seen it happen pretty much to every company that I've worked with.

I had this experience with one company. I don't know whether you would consider specifying methodology and assumptions, but in this situation with Section 7 companies, the department came in and said, "You have to do a Section 8." It kind of falls under the same category. Definitely yes.

What do companies do about annual statement data that change at the eleventh hour and that can't be run back through asset adequacy testing?

MR. RICCI: Perhaps look for another job. I'm assuming here that the results are material, obviously. If they're not, then there's no reason to go any further. I think any part of a good asset adequacy approach should be something that involves sensitivity testing for data that might be variable. You should be able to have a reasonable idea, based upon what the data change was, how that would impact asset adequacy. If it's at the last hour, I don't know what else you could do. Basically you're relying on somebody's opinion for the data quality. That doesn't mean you can pass the buck. If the information is made known to you when you can make the adjustment, then an adjustment has to be made. The adjustment may be fairly heavy-handed in order to protect your interest and the company's.

MR. MARCO: I think what it ends up meaning is you're doing some sort of Excel worksheet-type adjustment at the last minute to your cash-flow results, and hoping that it has the rigor you need to be able to justify your conclusions to a regulator if asked to do so later.

MS. RATAJCZAK: If it was material, you couldn't sign your opinion, because you talk about there not really being any material events from the time of the opinion to when you do the testing and when you sign the opinion. If they are material, you have to do something about them. If it has to be kind of stretchy and back-of-the-envelope, so be it. You couldn't find an opinion otherwise.

MR. RICCI: Does anybody in the audience have situations where they've had their backs to the wall regarding this data adequacy or quality issue?

FROM THE FLOOR: I wouldn't say that, but I don't think it's abnormal for materialization to occur between December 31 and late February.

MR. MARCO: I think you need to make a distinction between changes that occur prior to year-end and changes that occur afterward. You're testing as of year-end. That doesn't mean that you ignore what comes afterward, but I'm not sure that that has to be part of your formal testing. I think commenting in your opinion would probably be adequate.

MR. RICCI: I agree with you. I think you really should have some kind of plan if a cataclysmic or even subcataclysmic event occurs between the end of the year and when you're submitting your opinion. You obviously should take that into account. The assumption here is that, for some reason, sometime in late February, somebody realized that the data at the end of the year were wrong for some reason, that we weren't given the right information. Now what do you do? That goes back to the very base opinion involving the end of the year.

FROM THE FLOOR: I think Dave asked whether any data quality situations may have had an impact on the opinion materially. In my review in terms of auditing certain things, I would say that there are situations, and immediately what came to mind were A&H companies or managed care organizations, where the data aren't as rigorous, aren't consistent with prior periods, or you don't get as much data as you need. It's been interesting the few times that I've seen that, how other actuaries handle the wording of the opinion. In most cases they've gone to lengths to not issue a qualified opinion, but to express their concerns on the data quality. That's what you're weighing, I think. You add a caveat to your opinion, or you just say, I just can't reach a conclusion.

MR. RICCI: Yes, it's a real tough call. A qualified opinion is not very desirable, particularly if your client is involved. If the company is doing what it can to provide the most accurate information possible, it's just a matter that the data can't be scrubbed to the extent that you allow it. I think you can go with questions concerning the availability of the data. Maybe establish a reserve relating to that. However, you still won't be satisfied totally that you're where you need to be.

MS. RATAJCZAK: The next question is, How do most companies handle rolling up the work of evaluation actuaries handling specific lines of business and possibly even performing the asset adequacy analysis for the lines of business, for the corporate-appointed actuary? What kinds of certifications are used, and which are included in the actuarial memorandum? Can the certifications include wording about the opinion of the line-of-business actuary? For example, can they include the opinion wording about reserves only or line of business but not the whole legal entity?

MR. MARCO: Well, we've actually had this situation occur. We've gotten pushback from New York and Illinois in the past. Our appointed actuary received, in effect, actuarial opinions from each one of the individual actuaries performing the work. The word we got back was, don't give us opinions. You can give us something along the lines of data reliance, in which you tell us that the reserves are calculated correctly according to a certain basis: for example, if the reserve basis is 80 CSO 4.5 percent Commissioner's Reserve Valuation Method, and that it is correctly calculated that way. However, they want you as the appointed actuary to put it all together and form an opinion. We'll be making changes this year to reflect that. The certifications cannot contain opinions about the reserve adequacy. They can only contain comments about the reserves being calculated correctly according to a certain basis.

MS. RATAJCZAK: What rationale is normally used to assess materiality for determining the rigor used in the block of business analysis?

MR. RICCI: Obviously the failed scenarios are important to look at. Much more important additional rigor is required on the deterministic side if you're using deterministic scenarios. Then there's stochastic: obviously you're going to develop stochastic scenarios, if you're doing enough work, that are going to fail. You have to examine those and examine them very carefully. If you've determined that within that failure universe you basically have some very realistic scenarios that could occur, then it's a red flag. Also, I like to do historic forward/historic back, and similar types of interest assumptions to kind of a semibasis in reality. If those things don't seem to work out, then you have to be satisfied that this is a special circumstance. What are the odds of it happening, and that kind of thing? Interim values are essentially important, as we've discussed before. Then you have to determine when aggregation is appropriate in terms of the various lines of business and what level you're going to aggregate to smooth out the results.

MR. MARCO: I read this question to mean when you're doing your static validations, how close do you have to come to some of your metrics? For example, on a small block of business, would you need to be within 1 or 2 percent to have confidence in your model?

MS. RATAJCZAK: The question Dave was answering is, Is the criteria for asset adequacy now an assessment of whether additional reserves are required? The question is, What rationale is normally used to assess materiality for determining the rigor used?

MR. RICCI: Did I answer the wrong question?

MS. RATAJCZAK: Yes, you did. In the block of asset analysis.

MR. MARCO: In my prior life when I was a chief actuary, we had seven or eight different blocks of business. Depending upon the size, I had different requirements for how close my static and dynamic validations would have to come before I had confidence in the model. If it was a fairly large block or a major line of business, I'd want it to come, let's say, within 2 percent on metrics like in-force premiums, reserves and cash values. For smaller blocks that really didn't matter very much or that were not particularly interest sensitive, it was 5 to 8 percent. How fine-tuned did individual plan codes have to be? You'd use the same kind of logic. If it was a major seller for you, you'd want it to be within 3 or 4 percent. If it was one of those odd plan codes that you lumped everything into, and those of you who have done modeling know that you always end up with one or two of those, then if you're within 10 percent you probably consider yourself having done a good job. I think the bottom line is, when you roll it altogether, you find yourself within a tolerance that you feel comfortable with, and for me that was 1 or 2 percent.

MS. RATAJCZAK: I'm not sure what the intent was, but the question might also be asking what do you consider in terms of whether you're doing cash-flow testing time analysis or good premium valuation. That's kind of the way that I looked at this question. So I'm going to answer it that way.

I think as the appointed actuary you need to look at the risk inherent in your business on the liability side and on the asset side. I think, in some cases, a gross premium valuation is probably fine if interest rates and your investments do not drive the results. It might be a better test to do gross premium valuation flexing the key assumptions, which are driving the liability side of the house. I think today, because of technology, you'll probably find more and more people using more sophisticated techniques for doing their testing, and I think some people probably find it's easier to use one system to do everything because it's easier to roll it up. I think it depends on the nature of the liabilities, and you have to consider the asset side of the house also.

MR. RICCI: If you're trying eventually to develop some feel for the optimum adjusted cost or the asset liability matching, you are eventually going to have to do the whole block anyway. It's even more important to get away from the gross premium valuations for some of the business now, particularly in this day and age when so much volatility is incurred. Ten years ago you said, Okay, it's just a term block, so we can worksheet at gross premium valuation, and that will be sufficient.

MR. MARCO: Another thing you want to consider is that the generally accepted practice is cash-flow testing. If you want to do a gross premium valuation, you'll have to justify why you chose that approach over the standard practice. If something goes wrong down the pike, there will be a lot of fingers pointed at you asking the question, Why did you do it that way?

MS. RATAJCZAK: Good point.

MS. RATAJCZAK: Does the new revised AOMR permit the use of stochastic scenarios only, or will the rules for discussion of the material changes require learning the old New York Seven scenarios also? I think what they are asking is, are you still going to have to run the New York Seven, because if you are determining whether your changes are material or not, you're going to need to know how much impact that makes. I could see that at least the first time, if you go totally away from the New York Seven, then you might want to comment on that. I think probably for a little while, people have stuff set up to do the New York Seven, or more people are doing stochastic scenarios. I think the practice is in terms of what scenarios being tested have been evolving. Therefore, I think it's yet to be seen if people are going to throw out deterministic-type scenarios altogether and go to stochastic. I think not.

MR. RICCI: I think deterministic scenarios serve a purpose. Maybe not the New York Seven, but certainly some do, in that you have historical reference and you can use it. Obviously that's just one of an infinite number of possible outcomes. Doing some kind of testing using the volatility that you've experienced in the past on a deterministic basis is not stochastic, but it might give you a different attitude on it.

MS. RATAJCZAK: I want to raise a question, because I think it probably will be of importance to everybody, so you might hear the answer again tomorrow. On this whole issue dealing with the IRS not allowing Guideline 33 for tax reserve purposes, can you comment on that a little bit?

FROM THE FLOOR: I think the question that Meredith is asking is that the IRS seems to have taken a position at public forms, and also in relation to a few recent technical advice memorandums, on the application Guideline 33. Their interpretation is that Guideline 33 applies only on a prospective basis. For annuities issued at the beginning of 1995, there's no question that Guideline 33 is the tax basis for that. If you were doing something different for annuities issued prior to 1995, and you change your basis of evaluation, that is not going to be allowable, and you will not get the increase in reserve and a 10-year spread. They are trying to come up with a black-and-white rule that does not apply in all facts and circumstances. There are certain situations where that might be inconsistent with other revenue rulings. If your mistake and your change were due to using the wrong interest rate, there are other rulings that do permit a 10-year spread.

Let me mention one other thing here. The majority of companies and the majority of products are probably going to be better off with their prospects with that answer. If you have a traditional declining surrender-charged product, say, declining over seven years, you will get to the account value by the end of the seventh year. You don't want to spread the increases over 10 years on a present value basis. You will not get as good an answer. There are other companies for which the retrospective application is going to be very important. There are certain products with long surrender-charge periods, certain annuities, etc., where that may not be the right answer. I think what they are trying to do is establish a black-and-white rule rather than looking at every situation separately and making a judgment on the facts and circumstances.

MR. RICCI: Has there been any kind of IRS movement on the guaranteed benefits?

FROM THE FLOOR: Are you talking 39 or 34?

MR. RICCI: I'm talking about the expression by some people that Guideline 33 requires that if you have a dollar-for-dollar benefit, then you have to basically assume that everybody cashes out at the time of valuation. What you have is just a paid-up death benefit.

FROM THE FLOOR: To my knowledge, the IRS has not come out with that. Again, this has not been an issue for years that have come under audit. This is mainly been brought up in the last couple of years. If you just apply a literal wording of the rule, the rule says you're suppose to use the interpretation of the Commissioner's Annuity Reserve Valuation Method (CARVM) in place of the date the contract was issued. Right now, dollar-for-dollar withdrawal is not part of CARVM. I think people would agree with that. If and when the NAIC comes up with something different, whether it's for this year-end or the 20 percent rule, that is one of the things that you'll have to deal with. If so, it may affect policies issued the beginning of the year of adoption. It would be unlikely, in my opinion, to affect policies issued before that became part of CARVM.

MS. RATAJCZAK: Thank you. The next question is, What process do you use to determine what rules apply across all jurisdictions? Take Regulation XXX, for example: there are a number of states that have adopted XXX; the remaining states will be subject to XXX recodification unless they have a rule that states otherwise, which should then be documented in the Life and Health Valuation Law Manual. Is this similar to the process you use to analyze these types of situations?

We were talking about this one this morning. I think some companies might take the approach that they will look at what the most stringent reserves are and use that methodology for calculating reserves. You know, there's no reason to say that I'm sure the evaluation systems have certain coding regarding different state variations, so you would calculate them differently. I think the whole state variation issue complicates the whole financial reporting process. If there are ways to simplify that and that are acceptable in terms of the financial impact on the company, then they might take that approach. Are there any comments on that?

MR. MARCO: We had a situation a number of years ago, where we were licensed in one state that had adopted the Universal Life Model Regulation. We decided to just hold those larger reserves. It was a small additional amount and really didn't make much of a difference to our bottom line. We never faced the issue of what we would have done had it been material.

MR. RICCI: Regulation XXX may be outside of that ballpark.

MR. MARCO: Yes, it would be material.

MR. RICCI: It would be material almost in all cases. I think the situation might exist where your state of domicile hasn't really approved XXX, yet you're working in jurisdictions that do. I don't think there's any way around it. If you want to do one statement, I don't see why you're in a position that you have to hold those reserves.

Now, if you think the state of domicile is more important in terms of being able to show good RBC and other things like that, and you think you can demonstrate better RBC without the XXX, then you might have different statements. You have to be solvent in every case.

MR. MARCO: Logistically it could be a nightmare to do a number of statements. I would think that a state would expect its requirements to be reflected in the Blue Book.

MS. RATAJCZAK: I guess it's pretty common. I've seen separate New York filings. That's probably more common in different Blue Books elsewhere. I guess I've actually seen it in at least one other state besides New York.

MR. RICCI: I think probably if it's something you feel comfortable with and the state doesn't have any objections, why not do it that way. I know that in several cases I've been involved with, you basically had to burn it into the statement. In your example it's not necessary, as long as you provided for it adequately.

MS. RATAJCZAK: The next question is, Do you use higher levels of materiality when determining disclosure issues? In particular, codification implies that any reserve held above the minimum required reserve must be disclosed separately. What are the considerations for materiality in this situation?

MR. MARCO: Would it depend on the reason why you're holding the higher reserve? In most of our Blue Books, we hold a reserve, which in some cases is redundant. Do we really have to disclose that, under codification?

MS. RATAJCZAK: Yes.

MR. MARCO: We all disclose that?

MS. RATAJCZAK: Yes, you're suppose to.

MR. RICCI: Is the difference between that and continuous material? I would argue that it is. Then what do you consider not to be material?

MS. RATAJCZAK: Materiality is materiality. I don't think having a different standard of materiality for disclosure than some other reason why you need to talk about materiality matters. We've talked throughout this session today about determining materiality. It depends: it depends on your level of surplus and how big the block of business is. I wouldn't necessarily change my definition of materiality for disclosure purposes.

FROM THE FLOOR: I tend to agree with what you're saying. Having done a little bit of research about what the word "material" means from an actuarial context, and also seeking out guidance on what materiality means in an accounting context, you won't find exactly the same words. It boils down to what you said before; there's some judgment involved. You've got to be able to estimate and give numbers and be able to present your case to somebody. As long as you can say, I don't think it's material, because here I think this, it comes with a range. If your idea of materiality is different than that of the auditor or someone else, at least you can resolve that. Part of it is quantification, just as the panel has said, in relation to earnings, in relation to surplus, etc. Ultimately it comes down to the adjustment call.

MR. MARCO: The accountants have a formula of sorts that they use for materiality. I'm not sure I understand how it's determined, but it's usually expressed as a percentage of assets, liabilities or net income.

MR. RICCI: I think that's part of the answer. You have to work with your auditors and your accountants, and it comes down to a meeting of the minds. If you can't come to a meeting of the minds, then you have to be able to support your position. Many times we don't do that. We'll just assume, and that's probably where the work can be done.

MR. MARCO: I think part of it boils down to our standards being written to give us a lot of leeway in terms of what we do. They are not formulaic. Very often it would be a lot easier for us if we had a formula to follow. It's not intended to be that way. I think the trend will be to continue to move away from cookbook-type approaches.

MS. RATAJCZAK: The next question is, What are your thoughts on the move toward the use of stochastic testing for setting reserves, and at what point does it make sense to not use stochastic testing and rely on some other methodology because of a small-size block, such that the additional expenses of complying might be greater than the additional reserve set up?

MR. RICCI: There's stochastic testing, and there's stochastic testing. You can run a fairly decent stochastic method by using a homegrown approach, which can get you where you need to go with a small block of reserves. It doesn't mean that you have the resources to do that in certain situations. I think this goes back to the issue about gross premium reserves. At some point you have to determine exactly what the trend is. Eventually you get to the point where you can say, I'm going to wall off these reserves, and then on a going-forward basis, I'm going to use some kind of gross premium approach on them. On a going-forward basis, I'm going to do stochastic testing, some way of improving your standard.

MS. RATAJCZAK: I think in terms of the first part of the question asking for thoughts on a move toward the use of stochastic testing for setting reserves, it makes a lot more sense in the case of variable annuity then using a quasi–fixed-annuity approach for the base policy reserves and then a couple of other methods for doing it on the auxiliary reserves. I think it would be hard for it not to be an improvement over the way we cobble together how we deal with the products today.

MR. MARCO: It's safe to say too that a good number of the older software packages are very limited as to what you can do with stochastic testing. Most of them will allow you to do interest rate scenario shifts. If you want to do something along the lines of mortality and morbidity, you're pretty much out of luck. Now, if you have a large block of term insurance, you really don't need to worry about interest rates. However, where does that leave you? The standard seems to imply that you should do stochastic testing. The way I see it, if the standard implies the need to do something, you're almost forced to consider seriously doing it. Again, if something goes wrong, someone will ask you why you didn't do it.

MR. RICCI: It means you might resort to something other than pushing a button to do it.

MR. MARCO: Right. This, of course, would come at year-end.

MR. RICCI: When all you're looking for is buttons.

MS. RATAJCZAK: The next question is, My impression is that many companies base their asset adequacy testing on the New York Seven scenarios. How adequate are they considered as scenarios by the regulatory community?

MR. MARCO: I can't speak for the regulatory community, but as a practicing actuary I can tell you they are meant to break something. Other than that, they might give you some continuity from year to year. However, if you're trying to develop some sort of statistical measure that you can use to determine whether reserves are adequate or not, I think it falls short significantly. Some of those scenarios now don't make too much sense, considering the interest rate environment we're in.

MS. RATAJCZAK: They never made sense for anything based off of that for variable business.

MR. MARCO: Right. A three-point dropdown scenario in today's market doesn't do much for you.

MR. RICCI: We modified those already, right?

MR. MARCO: Well, yes.

MR. RICCI: To one-half or whatever.

MR. MARCO: So what is it telling you?

MR. RICCI: That's exactly right. If you're going to water it down to let it fit into what could be a semirealistic situation, what good is it?

MR. MARCO: Well, I wouldn't be surprised if eventually the New York Seven was replaced with something a little bit more dynamic. I hate to see what that would be offhand, but it's probably going to be here eventually.

MS. RATAJCZAK: Yes, but who would have thought our current interest environment was that plausible for any period of time?

MR. MARCO: That's true, but very often the regulations are written around the available technology. Down the pike you'll probably be able to run a thousand scenarios over an evening. We're not there yet, but you can see that coming. Requirements are going to evolve accordingly.

MR. RICCI: I think the problem is in the capacity of the company to deal with this situation, or the capacity of their regulators to handle it. A case in point is this whole Quad M situation. Going from Guideline 33/34 to a Quad M approach is tremendously complex. I'm not talking the method where they used calibration points and fund amounts, and you made sure that your scenarios fell within a certain level and that kind of thing. The regulators looked at it eventually and said, My God, we can't handle this. Then they came up with Guideline 39, which said, basically, You do it. I think everything is going to fit eventually. You're going to have to be able to justify your results and communicate them to the regulators in a way that they can understand. However, I don't think there will be less and less of this fixed formulation going on.

MS. RATAJCZAK: That leads into the next question. Asset adequacy testing generates reams of reports and tables. Is the regulatory community realistically able to analyze the data they receive, or do they simply focus on companies that they may be concerned about? Are there any changes contemplated to make the review process more manageable for the regulators?

MR. MARCO: One of those would be the executive summary.

MS. RATAJCZAK: That's definitely true. I think we all know that some of the insurance departments probably can handle the information they get, and others can't. I think that some have adjusted the way in which they look at your filing as maybe the New York approach, taking a more overall risk-management view of what you're doing. I also have to say that, in some cases, I don't think we give the regulators enough information to determine whether what they are looking at is reasonable or not. Some of the issue is on our back, providing them with the information they request, so that they can do their work.

FROM THE FLOOR: I think a lot of the regulators are going to be a lot less concerned with process and more with results. I don't mean to be glib with that. Basically they're going to say, Let the auditors handle the process, but as far as they're concerned, they want to know the impact of an executive summary or something like that. They'll be specifying exactly what ought to be included in that and the results orientation, which is something they can understand, as long as it's put in a method that they appreciate.

MR. MARCO: At some point it will evolve. You would assume that eventually you might get a required metric like the probability of reserves not being adequate is roughly X percent based upon scenario testing of Y runs, or something like that.

MR. RICCI: Yes, but then you're really talking about top level. You're really talking about results, aren't you?

MR. MARCO: That's what they want to know.

MR. RICCI: You're not talking about process at all.

MR. MARCO: Right, there's no process there, but that's the result they're looking for. How comfortable are we with the reserve result?

MS. RATAJCZAK: We have to admit we received one question that stumped us all. I'm going to throw it out, and if somebody in the audience can address it, that would be wonderful. Here's the question: If a Canadian branch operation of a U.S.-based company issued a level cost of insurance universal life policy in Canada, the type common in the Canadian environment, how should the reserve for that policy be set up in the U.S. statutory annual statement? Using the NAIC (universal life) valuation model regulation would seem to imply that the guaranteed maturity fund would always be zero and the guaranteed minimum pension would be less than the net level premium, so that a reserve larger than a whole life reserve would emerge. Does this sound correct? Would regulation XXX apply?

FROM THE FLOOR: I don't think there is an answer to that. Actually we thought about that before because we have international subsidiaries at a branch with some U.S. companies. In fact, some of the coverages that they can write, for example, in

Taiwan, are not even legal in the United States. There is absolutely no way you could value it other than do something reasonable.

MS. RATAJCZAK: Thank you very much. Any other questions?

FROM THE FLOOR: I'm struggling with this higher reliance standard that New York seems to be requesting now in this holiday letter. I can't speak for everybody in the audience, but in my company we have a very complex product line. There are dozens of people who examine the data, who make sure that the calculations are correct; and as the appointed actuary for the company, I rely very heavily on those experts to ensure that the data are accurate and the calculations are accurate, etc. For me to personally review all the records and all the calculations is impossible. I'm trying to understand what is really expected of me now under this higher standard. Currently I rely very heavily and get statements, and I quiz, and I prove, and I really make sure that the people who are doing the work are doing it right. What am I suppose to do beyond that? If there are others in the audience who can help shed light on that, I'd certainly appreciate it.

MR. RICCI: I think part of the answer is that this is a draft.

MS. RATAJCZAK: They're looking for comments.

MR. RICCI: You ought to enter into a dialogue with Mark Greene and tell them the particular circumstances. You won't be alone. There are a lot of people in your particular situation who have done their best to comply with the regulations in a very forthright manner. I think, like most regulators, what they are trying to do is to somehow catch all the evildoers that are out there. In so doing they're making it particularly onerous for all the people who have been compliant in the first place.

FROM THE FLOOR: I did not submit that question, although I can think of a few of our actuaries who probably could have. This is something totally different, a little bureaucratic. I always look at the actuarial opinion as covering Exhibits 5, 6, 7 and 8 of the Blue Book, also some separate accounts, but let's just stay with the Blue Book. A certain unnamed statement has strongly suggested that we need to also opine on the reinsurance and unauthorized reinsurer's liability that's set up on page 3 of the statement. We've resisted through a number of cycles of correspondence. Could you folks address that specific question if you can, and more generally back to the question of literally the opinion. I'm not talking about opinion in general; I'm talking about the actuarial opinion: I opine, etc. Does that need to cover anything other than Exhibits 5, 6, 7 and 8?

MR. RICCI: Isn't that specified in the particular laws and regulations of the given statement? There's usually a model that most of us would follow, in terms of the form of the opinion.

MS. RATAJCZAK: They have those at the tables.

MR. MARCO: The question is, does the state have a right to go above and beyond that if they choose to?

MS. RATAJCZAK: I've seen some companies put pretty much all of the liabilities on that attachment.

MR. MARCO: You could, but as an actuary would you want to opine on anything you didn't have to?

MS. RATAJCZAK: No. I guess an argument could be made that if there is a liability on the book dealing with the reinsurance that is covering the business that you are working with, should you consider it?

MR. MARCO: I think it's reasonable to consider reinsurance, to the extent that it affects your liabilities. The real question is, Do they have a statutory authority to require it? Doesn't that vary from state to state? Some states give the insurance departments the authority to go above and beyond, and in other states it's very specifically designated.

MS. RATAJCZAK: I think the insurance departments always seem to have the ability to go above and beyond.

MR. MARCO: Some states want to. However, I'm not sure they have the statutory to do so, though.

MR. RICCI: I think it's reasonable to expect that somebody in the insurance organization should be taking a look at amounts recoverable from unauthorized reinsurance. Whether that's the actuary or not, I don't know. To me in a way it is, because there's a reserve amount involved. The liability speaks to the reserve. In a way it isn't, because it's more or less a determination of the ability of that reinsurer's letter of credit to carry through and be able to pay the claims. That's more legal than anything else. As far as the rest of it is concerned, the appointed actuary *should* know everything, but in reality he or she should probably try to carve their world into what really should be theirs. Obviously any kind of state requirement has to be considered. I think there's enough to do with Exhibits 5, 6, 7 and 8 than having to go beyond them.