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Appointed Actuary Forum

Moderator: JAMES MERWALD

Panelists: STEVE BADER
RANDAL J. FREITAG
J. TIMOTHY GAULE

Summary: A panel of appointed actuaries, along with substantial audience participation, shares its perspectives and practical experience in fulfilling the duties and responsibilities of the appointed actuary. Topics include managing the process, responsibilities of the appointed actuary, reliance on and responsibilities of other actuaries, keeping current on evolving regulation, Sarbanes-Oxley and getting the most out of the work involved.

MR. JAMES MERWALD: I'd like to welcome you all to the Appointed Actuary Forum. As the program indicated, this is an open forum. That format relies heavily on a great deal of audience participation, so we're counting on you to have some good questions and, hopefully, some good answers to the questions that are raised here. We're serving as facilitators. We certainly have our own thoughts and opinions on different things, and we have prepared some questions in advance, but we'd like to hear your questions and thoughts.

I'll start off by introducing our panelists. I'm a consulting actuary with Actuarial Resources in Kansas City. I've served as an appointed actuary since there were appointed actuaries and even before that. I currently serve as appointed actuary for three companies. Steve Bader is an assistant vice president and associate actuary at Kansas City Life, and, among his roles, he serves as appointed actuary for Kansas City Life and also two of its subsidiary companies, Sunset Life and Old American. Randy Freitag is senior vice president at Jefferson Pilot Financial Corporation. One of his roles there is to serve as appointed actuary for three companies. Finally, Tim Gaule is vice president and valuation actuary for Security Benefit Life, and he's its appointed actuary. All of us have many years of experience.

I'd like to ask the other panelists to give a few comments about their companies. You'll get an idea of what environments they're operating in so that you can take that into account as they provide feedback.

MR. STEVE BADER: I've been at Kansas City Life for about 34 years. I'm a first-time panelist, long-time listener, at these meetings, so I'm here to give the "everyman" opinion on what appointed actuaries are doing out there. Kansas City Life primarily writes life insurance and annuities and writes very little health insurance business. Sunset writes similar types of business, so it's not a stretch to give the opinion for Sunset Life. Old American is a final-expense-type writer of insurance, so it's basically one product line; there are not a lot of issues there, with mortality experience being the main one.

MR. RANDAL FREITAG: As Jim mentioned, I'm the appointed actuary for three statutory entities, which are domiciled in three different states: North Carolina, Nebraska and New Jersey. Those companies are an aggregation of nine, 10 or 11 different statutory entities that we've purchased or merged together throughout the years. As a mid-size (about a $7 billion market cap) company, we're a publicly listed company, so we focus first on GAAP reporting, but statutory reporting and how it impacts our statutory capital is obviously very important to us. We are a AAA-rated company, so levels of capital and statutory reporting do have some relevance to our life.

MR. J. TIMOTHY GAULE: As Jim mentioned, I'm the appointed actuary for Security Benefit Life. I'm also the appointed actuary for our new New York company, First Security Benefit. We primarily market variable annuities. My areas involve not only the statutory evaluation, but the GAAP reporting, because even though we're a mutual company, we're owned by a mutual holding company, and for years we've always managed on a GAAP basis. We actually do monthly reporting on a GAAP basis, and this year we're making sure we're in compliance with Sarbanes-Oxley (SOX). We like to manage ourselves like we are a publicly owned company. We definitely have a lot of challenges right now with getting C-3 Phase II implemented. My group does all the work for deferred acquisition cost (DAC) and Standard of Practice (SOP), so there are definitely plenty of things to do.

MR. MERWALD: We sent out a survey to the people who had signed up for this in advance, and we did get some feedback on that. I thank anyone who did give some feedback.

One of the issues that came back from a couple of respondents was the treatment and handling of the regulatory asset adequacy issue summary. I think Donna talked about that this morning in her session. It appears that there are going to be 16 states that will have passed the new Actuarial Opinion and Memorandum Regulation (AOMR) by this year end. There were 10 at the end of 2004 and six more (maybe seven) coming on this year. The 10 for 2004 and prior were: Alabama, Colorado, Florida, Indiana, Iowa, New Mexico, North Carolina, North Dakota, Rhode Island and Virginia. The new states for this year are: Alaska, California, District of Columbia, Kansas, Texas and Wisconsin. There may be Wyoming, apparently.

There are some issues as far as whether or not you have to actually send the asset adequacy issue summary in to all these states, and, if you do, how confidential it is and how you go about doing that. From my personal experience—this probably falls back on having to do similar things for California and Illinois before the new AOMR came out—it was always due on March 15, which gave you two weeks after the annual statement had to be filed. I usually just send them directly to the states. California and Illinois would always say to send it to the actuary and it will be confidential. With some of these other states, I always say that it's a confidential document, and some of them will tell you to whom to send it. Other times, I have to contact my client and find out to whom they send the annual statement, and I'll probably send it to the same individual. I do send it separately so that it's not part of the regular annual statement filing.

The Academy's *Life and Health Valuation Law Manual* is supposed to be out around Christmas. That will probably cover how some of these states want things filed and what they're going to do with them. Apparently, there's some indication that some of the states that have passed it only want the summaries from companies that are domiciled in those states. I haven't taken that approach yet. I don't know what you have done in the past.

MR. GAULE: Donna mentioned today that there has been some confusion as to where to send these. I forget which state (it might have been North Carolina), but a couple of years ago I prepared the summary and then gave it to the individual in charge of our filing. She didn't send it in because it wasn't on the checklist. So a month later, we got a letter asking where it was. It's good to know that there's going to be some direction on where to send that.

As Jim mentioned, I do indicate right in the first paragraph that it's confidential. We also have a footer on each page saying that it's confidential and proprietary. So that's what we've done.

MR. FREITAG: We have in the past operated under the assumption that these documents are confidential, and they always have been treated confidentially. Like Jim, we've always filed separate forms with California and Illinois. We send to the various states that require these items. Occasionally we'll miss some, and we'll hear from them a month later. We'll file them at that time, which usually isn't too much of a problem.

I'm fortunate to have a group of people who focus on keeping up with the various states' requirements. If you're a large enough company, it helps a lot to have somebody who focuses on these issues, depending on the way your company is structured. I, myself, have numerous responsibilities; appointed actuary being one of them. If I were to try to keep up myself with the various states and their requirements, Jefferson Pilot would be in trouble because we would surely miss a few.

MR. BADER: I have an additional comment. I've been remiss in not sending the issue summary to a state. I just didn't know that they required it. In hindsight, I would go to their Web site and try to find what their requirements were as far as filing the summaries. I wasn't very successful in finding it there, so I think that the best source for knowing when and where to file it is probably with the ACLI.

MR. MERWALD: Another question that came in falls under the responsibilities of the appointed actuary. It's kind of a broad, encompassing question. What procedures within our processes do we use to ensure that everything is accounted for? How detailed do you get? In my experience, I'd probably start in the old-style opinion. There were about six or eight numbers we opined on. I'd start to see where those numbers came from, build back through the work papers and get comfortable with the sources on those. It would vary on how the numbers were being generated and a lot of common sense in trying to build up trends and other analytics that you can use to check how the numbers vary from quarter to quarter or year end to year end.

Also, the wording in the opinion has recently changed so that you have to make some comment that the amounts shown in the policy exhibit are consistent with what's in the valuation. That's always a good check to make sure that you have reserves set up for all the business that the company says is in force. I'm sure that there are other things that people have done.

MR. BADER: When I filed my first opinion, I made up my own document. I wrote it the way that I wanted it to be written, in plain English. Several states came back and said that I didn't follow the regulation as far as what the wording should contain, where this comma should be and the semicolon should have been. I changed my practices, made it a very boring but comprehensive document and left it to the person reviewing the document to figure out what the heck I was talking about.

MR. FREITAG: The way that I ensure that everything is accounted for and done is threefold. It's really how I view my main responsibilities at Jefferson Pilot. First, it's hiring good people. Second, it's making sure that those people have the resources that they need and operate in an environment that is controlled in nature. Third, it's making sure that those people provide me with the information that allows me to get comfortable with the numbers.

With a fair amount of experience with Jefferson Pilot, getting comfortable with the numbers usually, for me, involves looking at trends at higher levels. I don't need to go down to the detail level. I have enough experience with the numbers and enough quality people preparing those numbers to understand, if I receive the proper reports, if something material went wrong with the numbers. So, once again, I make sure that I am hiring the appropriate people, making sure that they understand the rules, giving them the resources so that they can understand the regulations, making sure that they operate in an environment that's controlled and documented—I'm probably one of the few people who found some value in SOX 404, which provided me the ability to add a level of controls that actuaries historically weren't very good at—and making sure that they provide me with the information that allows me to do my job, which is to assign opinions, not only at the end of the year, but throughout the year for various items.

MR. GAULE: I agree with a lot of what Randy just said. You can't overemphasize the importance of having good people, and I feel very fortunate that we do have a very good staff. As I mentioned earlier, we're primarily a variable annuity company, so we've been doing cash-flow testing. We're now working with C-3. We do monthly valuations. I have a couple of people that are very good modelers. I have a couple of people that are very good at running the numbers every month.

That's one advantage of doing monthly valuations; we see trends every month. We have a seriatim-based system that we bring into an Access database. There are a lot of queries we have that we run automatically every month, where we're looking at relationships between reserves and cash values with Actuarial Guideline (AG) 34 benefit. We're looking at maybe what that benefit has done in the last month compared to the reserve.

Actually, I see some blessings in SOX, too. Someone mentioned at one of the earlier sessions that actuaries are probably not good documenters. I think that SOX is forcing us to make sure that we do document changes, especially around spreadsheets, where it's easy to make changes. We have controls in place now where only certain people have access to those spreadsheets, and when they make a change, it has to be documented.

I think that one of the real challenges we're going to have going forward, though, is that there are a number of software systems out there—Moses, Prophet and Alpha—that all are open code. We're using one of those systems to do our C-3 work. There are a lot of moving parts in there, and I think that the challenge is going to be making sure that you're comfortable with the results there, because it's easy to make changes.

MR. BADER: One of the things that we talked about this morning was what type of audience this would be and whether it would be mainly small company actuaries or just who would be here. I'm at a $4 billion company, so I consider it a medium size. Are there a lot of small company actuaries out here that maybe don't have the staffs that Jefferson Pilot does or Kansas City Life does that might feel more of a burden to meet all the requirements? That's an issue.

When we first initiated the process 20 years ago, it was new to us, and we were kind of flying blind for a while. We did it before it was even required, so we didn't have a lot of guidance at the time. It's one thing to rely on staff. I have a limited staff, probably smaller than Randy's, but I can only offer sympathy for the people that maybe don't have the staffs that we have.

MR. MERWALD: Here's an interesting question. What advice would you give a first-year appointed actuary? There are several things that come to mind with that. There are some obvious procedural things. Make sure that your company tells the states or writes the states, so that when they get your opinions, they know that you're the appointed actuary. I think that you're supposed to formally accept the appointment in writing.

I'd encourage you to talk to the previous appointed actuary, depending on the situation. That could be quite helpful and informative. If it's your first year, you probably are able to ask a lot more questions the first time through than you can the second or third time through. So I'd encourage you to ask a lot of questions and not be afraid.

Again, the Academy practice notes serve as a good source. There are different practice notes that come into play here. There's one on cash-flow testing practices, and there's another one just on being the appointed actuary. Those give you good ideas on how to handle situations.

MR. FREITAG: I, myself, would encourage that individual to make the effort to reach out to other areas and to other actuaries in his own company to find out about the company with which he's working. Actuaries, I find, tend to be a little insular and much more comfortable working at their computer and digging through paperwork. I generally find that that's an inferior way to find out about something. I encourage my people to get out, communicate with others and find out what they can about the companies. Of course, it's important to understand the rules. So if you're in your first year, you need to do a thorough review of the appropriate guidance and regulations that exist around what we do. I think that would get you off to a good start.

MR. GAULE: I agree with what Jim and Randy were saying. When I became appointed actuary at Security Benefit, I was hired in for the position. The previous year end, they had used an outside consultant to do the opinion, so that was kind of good because I could call him independently. I got real comfortable that there wasn't anything that had been hidden somewhere.

I also agree that it's important to try to talk to as many people as you can. Donna, I think that there was a presentation in Kansas City a few years ago by the NAIC. I remember that you had given out a sample memorandum, and I actually used that. I used a combination of yours and the one that was done by the consultant. That's the one I basically have used for years. So I agree—reach out and learn as much as you can.

MS. DONNA R. CLAIRE: As far as the seminar that I was talking about this morning, if you're a brand-new FSA, you may be closer to having to take it. It's probably my favorite seminar. This one is three days, plus an exam if you want to do that. That's the audience; you're a relatively new or brand-new appointed actuary. What do you do? What do you look at? Basically, it's a lot of information packed into a three-day seminar on what you do if you've become the appointed actuary of a company. This year it's given around November 11. It's on the www.actuary.org Web site.

MR. JERRY F. ENOCH: I'm getting a little more specific about Randy's comment about reaching out to people. Specifically, I'd encourage people to become friends with people in the investments department. You probably know the liabilities inside and out, and sometimes things don't make sense. In just casual conversation with those people, if you're on good terms with them and they trust you and they're free to talk, it can really make things easier for you in the analysis.

MR. MERWALD: Thank you, Donna and Gerry. There is another area that goes along with the responsibilities of the appointed actuaries or reliance on other actuaries. There are a couple of questions as far as what responsibilities you think you can delegate to other actuaries to do for you if you're the appointed actuary. If you do do that, or if you have to rely on them, what kinds of things can you do to evaluate the work that's performed by another actuary on whom you're going to have to rely as you form your opinion?

MR. BADER: I'm maybe closer to the process than most people, but the people I rely on are, first, our IT department to provide the correct inventory (the policies we have in force). I rely on our investment accounting people to provide the proper accounting of our investments. On the actuarial side, we have one actuary who's responsible for asset modeling. I rely on him because he's the expert and has more expertise in that area than I do. In specific instances, I might rely on a few of our actuaries who model certain product lines. Again, they're the experts. I'm pretty close to the process, so I maybe don't rely on others as much as other people do. I perform a fairly extensive review of the results and actually write the memorandum myself in addition to the opinions.

MR. GAULE: All the valuations are done in my area and all the cash flow testing is done in my area, so it gets back to another comment Randy made about having good people. I'm relying on those people because I'm not actually the one running the models or running the valuation system. But again, it gets back to the fact that we do the monthly reporting, so we're seeing results monthly. When we do do the cash flow testing, there are a number of things we look at as far as validating the model. We make sure that the starting balances match up to our valuation file. I always like to look at the first few years of the projection and look at things like projected surrenders and spreads. Do they make sense? Is there some relationship to what we've seen the last few years? We're probably a smaller company in a way—we're about $10 billion of assets—but it comes down to having good people and staying close to what's going on.

MR. FREITAG: First off, I think it's important to remember that the fact that you rely on people does not change the fact that it's your name at the bottom of the page. So, first and foremost, you need to remember that it's your name. In terms of what I specifically do inside my opinions, I largely request and receive reliance opinions from areas over which I don't have control. For instance, I'm not responsible for the investment area. I work with them on a regular basis in setting an investment policy for our businesses, but I'm not directly responsible for it. I will request a reliance opinion from them and receive it. Likewise, I will rely on the IT folks and the administrative services folks for the listing of policies that we receive, which forms the basis for our cash-flow testing.

MR. MERWALD: To kind of echo what other folks have said, you have to have some confidence in the person preparing the numbers on which you're going to rely that the person knows what he or she is doing and can do a good job. Then, in addition, you can build checks. I have situations where the companies I'm opining on may have blocks of A&H business, and they rely on other actuaries to prepare the claim reserves.

Over the years, I've built up confidence in the person doing the work. That can be through a combination of seeing how the experience runs out and getting a feel for the quality of work the person does. I might have somebody in our firm who has more experience and expertise in the A&H area to do a double-check, look at the numbers and get comfortable with them, too. There are a number of things you can do, but, as Randy said, at the end of the day, that is your name on the opinion, and you can't rely on any other actuaries in your opinion, even though you can mention them in your memorandum. You have to get comfortable with their work.

MR. GAULE: I might add, Jim, that Randy had a good point. I do, in my opinion, have reliance statements on the investment department, and I also get one from the IT area. As I think Jerry mentioned, I do agree that it's important to have a good relationship with the investment department. We do, and we meet with them. In fact, we just met with them a few weeks ago to set the assumptions that we want to use for cash-flow testing this time around, in terms of reinvestment and default rates. I think we have a good relationship with the administration area. We have a little bit of an advantage because, again, with that seriatim valuation, we can see things that maybe they don't always see. So we have pushed back a few times when we've seen some things that look unusual. Recently we had a few policies where there was a very large death benefit on the variable annuity contract relative to the account value. That just didn't make sense to me. Ultimately, it is your name that goes on the paper, and I don't think you ever want to forget that.

MR. MERWALD: One of the new potential responsibilities for the appointed actuary is the C-3 Phase II sign-off. I'd like to take a survey of the crowd. How many people here work for companies that write variable annuities? We have a pretty good share. In those companies, how many of you are going to have the appointed actuary be the person who signs off on the C-3 Phase II? Has that been decided yet? It looks like, I'd say, almost less than half the people. Are there a lot of companies that don't know yet? From the appointed actuary standpoint, maybe that could be good or bad if someone else is doing it, but it would probably lead into another question. If you are in a variable annuity writing company, then how are your models that you use for your C-3 Phase II going to compare with what you used for your regular cash flow testing on the variable annuities? Are you going to set up two separate sets of models? Does anyone have any thoughts on that?

MR. GAULE: In our case, it's a tough answer in a way. We've been working with C-3 Phase II for a year and a half, at least. The model we started with was the cash-flow testing model and, obviously, we've put a lot of revisions into that model for C-3 Phase II. Now we've turned around and put a lot of that back into cash-flow testing. We like to think that those are basically the same model, although when you run it, you're looking at different things. If we can, we want to have very similar models for the two processes. To me, it's hard if you have two different models, because there can be different answers in how you reconcile that. But basically, we started with cash-flow testing to develop C-3, but it has kind of, like I said, revolved back around.

MR. MERWALD: Let's do a survey. How many people in the audience serve as appointed actuaries? Out of this group, how many have any peer review done on their opinion work? So maybe 10 percent of the folks are doing peer review. I think that's one of the things that's going to become more of a responsibility for us as we get into more principle-based work. I don't know if anybody has given any consideration to that, or maybe there are some people currently doing it.

I know that consulting firms tend to do that more often or have that as part of their standard of practice. As far as some of the folks out there who have had peer review done, I don't know if it's done by someone else in the company or if you have friends at other insurance companies where you're sharing the peer review process with each other or if you're hiring an outside consultant maybe to come in and do it.

MR. BADER: We share our work with our external auditors, so that's one of the peer reviews we go through. They're very accommodating, and I welcome their opinion. In the state of domicile, which is Missouri for us, we've used the opinion and generally had some good comments on it, which I welcome, because sometimes you feel like you're working in a vacuum. You like to know that the work you're doing is meaningful. But our external auditors have been a help there.

MR. FREITAG: As of right now, the external auditors and others are the primary external peer review. But in many ways, the way I've structured my particular department, in my role, I'm almost the peer review level. Other people do the bulk of the work, and I spend the majority of my time peer reviewing their work and getting comfortable with it.

MR. GAULE: In our case, too, the external auditors are reviewing our cash-flow testing every year. In fact, they're coming in next week. We're going to talk about anything that's going to be changed for this year, although I think most of the meeting is going to be devoted to C-3 Phase II. In fact, in that regard, in a couple of weeks, we're actually going to sit down with the actuary in our state of domicile and review with him where we are in C-3 Phase II. I'd rather be proactive there. We have some living benefits that are pretty new, and we have some assumptions in the model, but it's going to be important to make sure that those assumptions are our prudent best estimate. It's a little difficult to come up with that right now when there's not a lot of experience. That's one more reason why I want to talk with the state and make sure that what we're doing is something with which they're comfortable. I don't want to find that out next February when we'll really be under the gun to get something completed.

MR. LEW H. NATHAN: With respect to peer review, does it have to be done by an independent party, or could it be done by someone on the appointed actuary staff if that person is qualified in his or her own right (by education, training, et cetera) to be able to sign the opinion? My question is really one of independence and whether there has to be independence or whether it could be on a person's staff.

MR. MERWALD: Currently, that would be a good practice. I suppose, as required peer review becomes part of the regulation, then something like that may not fly. I think that they're trying to define who can do the peer review and that type of thing. Currently, it makes sense that somebody on your staff would be a good person to do that.

MR. FREITAG: I always value Donna's opinion. Do you have one on this, in particular?

MS. CLAIRE: Basically, I do agree. Right now, it's probably even better, in effect, to have somebody who's familiar with your business to review the business and do a peer review. It's important to make sure that the person doesn't feel intimidated by whomever they're going to give the advice to. It could even be, for example, the pricing actuary, who may have been a valuation actuary five years ago. That may be a good person to peer review the work. There is no current requirement to have somebody from the outside do it. Again, the external auditors, in a number of cases, will at least look over the work.

Having said all that, going to the principle-based method, my guess is that you're going to wind up with an external reviewer just to give regulators more comfort. But currently, as I said, I think it's almost better sometimes to have the internal. Sometimes it's nice every five years or so to have somebody from the outside look at it, just to make sure that you haven't gotten into a certain mindset and to see if there's something that you're missing. But otherwise, it's probably more important to understand your business.

MR. GAULE: I agree with a lot of what was said. In fact, as I mentioned earlier, it's important to have a good staff. One of the keys on that good staff is to be training people to take your place or someone else's place, because you do have turnover.

We do a couple of other things that are not necessarily peer review. I mentioned that we met about a month ago with our investment department. That was all leading up to a meeting we had with our risk management committee, which is members of senior management, including the chief financial officer (CFO) and other key people. We spent about 45 minutes going over our key assumptions on cash-flow testing and where we were going to change them this year. The pricing actuaries came in and did the same thing.

At the end of the year when we're done with cash-flow testing, we do share those results with senior management. We've gone all the way to the board a couple of times, but we don't always do that. How many people actually share the results all the way to their board? Just a handful. Actually, quite a few over here.

MR. MERWALD: Are most of you making a presentation to the board, or do you know if they just get some summary of the results in their regular board book? Does anybody have any comments on how the information is shared with the board?

MR. FREITAG: I'll talk a little. I don't mean to offend anybody when I say these things. The cash-flow testing report, in and of itself, in terms of how we manage our company, is of little value as it is currently formatted, other than that it serves as a springboard for all of the more substantive asset/liability modeling (ALM) work we do on a continuous basis. The report itself, without surplus and other things, really isn't of value to my management team, other than proving out our reserves, which is something they assume when they sign the opinion. It serves as a springboard for the much deeper and more important ALM work that we do on a regular basis.

MR. BADER: Our results are made available to the board, but they've never really looked at them per se. Prior to SOX, I don't think that they would have cared. But under SOX, they feel they probably have some fiduciary interest in understanding things like cash flow testing, DAC unlocking or whatever affects the financial statements. In fact, it might garner more board interest in the future.

MR. GAULE: I agree with Randy. I don't think cash flow testing by itself has that much value as a management tool. I am optimistic that the principle-based approach is going to have a lot of value. Recently we shared our preliminary C-3 results with management. I think that it was very interesting to them to see the tail scenarios and what happens to some of the guarantees.

More importantly, we have a couple of products that can, by themselves, develop a lot of capital requirement. They're learning a lot from that, and I think that that's going to have some impact on decisions in the future as to what kind of guarantees we offer and how we price them. I do think that there's a lot of potential for where we're headed with the principle-based approach.

MR. MERWALD: Randy, do you use the same basic model then for cash-flow testing and ALM work and maybe later in new business and other things? One of the questions is: How can you leverage some of this cash-flow testing work to get some additional, more useful benefits for the company?

MR. FREITAG: Yes, and the process goes both ways. It definitely does serve as a springboard, like I said. It depends on the purpose for which we're using the model, whether the model that we use for an ALM purpose is going to be more granular. If we're focused more on individual line results, it's possible that we take that cash flow testing model and make it much more granular in nature, so the results that it puts out are more specific to that particular line of business.

The way our models get fed, as I mentioned, goes both ways. As we work through, for instance, our pricing process over the course of the year and products we may develop over the course of the year, our product development team is going to work hand in hand with the team that does the cash-flow testing or the ALM work. The work that they do for the product development team on a stochastic basis is going to feed into that year's cash-flow testing. We feed this work into our models throughout the year, and those models then serve, depending on the purpose, as a springboard for other items.

MR. MERWALD: I don't know if we have any more comments from the panel or people in the audience, as far as trying to get comfortable with these models that we're starting, that we've been using in the past and continue to use and will probably use even more, as far as trying to get comfortable with saying that we have good models, the assumptions are not only reasonable but they're in our models correctly, and modifications we might have made to reflect our product features are being accurately modeled.

I don't know if anybody out there has any ideas on how they would handle that or how they have handled it in the past. From a personal standpoint, it seems like you kind of start with a single-cell model as you're putting in new features and get comfortable with that, and then build from that. As you add more cells to your model, you try to make sure that the summing and grouping and aggregation of the results don't introduce any more errors in that.

Another issue in managing the whole process is: What steps have people taken to try to get things done in a timely manner? I know just from observing and being part of the process that it's good if you can streamline your production of the numbers so that they don't occupy all your time. The production of the information is almost secondary, and it provides you information and data that you can analyze and then provide meaningful feedback to management about trends and that type of thing.

MR. BADER: Ours is streamlined only from the standpoint that we've done it for a number of years. So we're testing as of September 30, but the work, obviously, isn't starting until mid-October because we're doing third-quarter valuation work. There will be a flurry of activity in mid-November until the end of the year, and then we're doing year end. The test work is done so that we can satisfy our auditors, for instance, that we don't have any issues regarding cash-flow testing. Then after the year-end work is done, we prepare the memorandums and get the filings and so on. It has evolved over a number of years; I can't say that we've made a conscious effort to streamline it. Luckily, we haven't had a lot of turnover in staff. Everybody seems to know what to do.

MR. FREITAG: First and foremost, to the extent you have deadlines and dates you need to meet, it's important that you communicate to the people doing the work exactly when things are due. I always make sure that people know when I need things and that we operate to that schedule. You often find that actuaries, once again, tend to work in a little less structured fashion, which can create problems at the end of a long, complicated process, such as cash-flow testing for a large company.

It's also important to make sure that your people are armed with the tools they need to manage an ever-increasing process from a complication standpoint, whether that's bigger-and-better computers or the latest technology, which allows us to think about our business in different ways. I think it's important that if your folks need that, that you assess that and buy it if it seems to add value to the process. We do that on a regular basis.

MR. GAULE: Again, I agree a lot with what Randy had to say. With something like cash-flow testing or C-3, it's important to have a schedule where people know the deadlines. In our case, with cash-flow testing, we run that as of September 30, and, typically, our auditors are in in early December, and we have the numbers. We don't have the memorandum put together, but we review that with them and, hopefully, make sure that they're comfortable with everything. Then early in the year we actually put the memorandum together.

I also think it helps that we do the monthly valuation. We're meeting as a group every month, going over those results and looking for anything that doesn't look correct. Then we have a little more time. Even though you're doing it monthly, you have some time to try to figure out what's going on there.

My area also does all the DAC calculations. To avoid a crunch right at year end, we typically do those calculations as of November 30, although that can be a challenge when you have a lot of variable business because you can get a big move in the market. So there have been some times where we might adjust amortization for what has happened in that last month; it seems like more times than not we're making an adjustment there.

MR. ENOCH: This may sound like it's not addressing the streamlining issue, but my question is, are any of you working from things other than the standard printout from your software package in looking at the results? I think that this relates to the streamlining issue, because just looking at aggregate results of the company makes it a little harder for me to know if there's anything wrong. But if I'm looking at lines of business, at individual scenarios, it's much easier for me to spot if there's something wrong. I like to be able to get that done before I'm finalizing the opinion, and I like to do anything that can be done in order to make it easier to analyze specific scenarios and specific lines of business. Of course, once you're looking at that many things, there are a lot of things to look at. That helps streamline the whole process and even helps get us to where we can confidently sign an opinion. Does anyone have sets of graphs or something that they create that enable them to quickly analyze a scenario, or multiple scenarios, for a line of business?

MR. FREITAG: Whenever I have to analyze things, I want to make it as easy as possible for myself. In fact, I met with my folks not too long ago. It's important for me that what they provide me is in a format with which I'm comfortable and familiar. I work with them to make sure that what they deliver is not something they're used to, but is something that I'm used to seeing on a regular basis. For me, that happens to be our company's internal format for reporting financial results. That's how I want to see, for instance, the dynamic validations of my cash-flow-testing models. It's important to me to get the information in a format that is consistent and with which I'm comfortable. That makes the process much easier for me.

MR. BADER: At my company, we do our cash-flow testing by product line, and the memorandum is organized in that fashion. We have, for instance, nine product lines, and then we'll aggregate results at the end. From a consistency standpoint, what I attempt to do is a reconciliation from one year end to the next, by product line, of the way the results are looking and if that's the way I'd expect them to look, based on changes in interest rates.

MR. GAULE: At our company, we report by line of business, but we basically sell variable annuities, and our lines of business tend to be different products. One of the things that we're looking at right away is how those results compared by product, and that ties right back to our financials. We've designed a lot of reports ourselves. We spill our valuation system into an Access database, and there are certain queries that I'm used to seeing every month, so we're not relying on something coming out of a vendor system. It's something that we've created. It's the same with cash-flow testing. We have certain ways we want to put those results together, and we've been doing that for years. I think that helps. We've designed reports that make sense to us and relate to our financials.

MR. MERWALD: One other area, as far as managing the process, that ties in with this is SOX, which seems to be mentioned at every session I go to, along with principle-based reserves, which are two totally conflicting things, I think. As far as SOX, I'd like to know people's opinion. I know that giving birth to it has been quite painful for everybody, but once you get through the process, do you feel like it's actually helped you long term? I think that I've heard comments to that effect already. One question that we received ahead of time is: What do we do to keep all our spreadsheets and databases that are used in the valuation process in compliance with Sarbanes? I would appreciate any comments from the audience on that.

MR. BADER: What I found is that it's expensive, first and foremost. It's expensive to implement and even expensive to maintain. It is painful from the standpoint that it forces actuaries to do some things that they're not really comfortable in doing, such as documentation, and that turns out to be one of the benefits. It forces actuaries to do documentation, so it probably enhances your abilities.

As far as spreadsheets, somebody had asked, what are the issues regarding SOX on spreadsheets and worksheets and stuff like that? One of the best things I heard—I'll credit Bob Holliday with this idea— was that if you have a spreadsheet that's very complex and thus has maybe a high degree of risk in developing a material misstatement, what you might want to do is separate the assumptions, because one of the risks is having assumptions embedded in your spreadsheets or your calculations. You don't really know where they're at; they're just in there some place. But anyway, segregate your assumptions in a separate spreadsheet and make somebody responsible for those assumptions, then segregate the calculations in another spreadsheet and make somebody else responsible for those calculations, and then possibly even make the results a separate spreadsheet and make somebody else responsible for that. That was probably one of the more practical things I heard at the session.

MR. FREITAG: Documenting your work and the thoughts you used to get to your work is important. To that extent, SOX is an important addition to the financial reporting world. The key is to extract value from what is a time-intensive process. I do that in a number of ways. For instance, as a public company, on a quarterly basis I am signing attestations for our CEO about the numbers we report. One of the ways I get comfortable making that attestation is through a review of the SOX 404 process papers.

I have an individual who reviews those papers for me. We meet. It's one of the tools I use to make those attestations. As with any time you're signing anything, you need to have support for why you're able to sign that document, and that's one of the ways I do it. I encourage people to try to extract the value from the SOX process where you can. It is going to cost you some money and some actuaries, but, nonetheless, I think it is important.

MR. GAULE: Specifically on spreadsheets, what we've done is limited access to who can get to those spreadsheets. Historically, they've all been out in the network, and, theoretically, any of the actuaries, including the pricing actuaries, had access to them. If it's a spreadsheet dealing with our deferred annuities, there are only a couple of people that work with that. We've limited access, so they're the only people that can get to those spreadsheets. There are also controls around the spreadsheets. If there are any changes to them, we have to document why those are changed.

It seems to me, from a personal viewpoint, that if you can eliminate most of those spreadsheets, ultimately you're probably better off. If you have an extract file feeding into your valuation system and most of the reserves are run through a valuation system (especially one that you've purchased from a vendor), it seems like there are fewer concerns about the quality of the numbers coming out of that. You still have to review them and make sure that they're right, but what I was picking up from SOX was that there are a lot of concerns around spreadsheets that are easily changed. The way we handled that was to limit who could get into those spreadsheets and also require that any changes had to be approved, signed off and documented.

MR. MERWALD: As a matter of a survey, how many people here have gone through the SOX 404 compliance? I would say that we probably have about half, or one-third, maybe. I don't know if any of you went to the earlier session, but the NAIC is in the process of trying to come up with a regulation similar to this, and one of the questions we received in advance was to try to check the status of it. I haven't followed it closely, but I did check with one of the NAIC staff people who were involved in the process, and she was hopeful that they would come up with the framework for it by the end of 2005 or the end of the first quarter 2006.
It sounds like the large sticking point right now is having an outside audit firm do an attestation of the management's assessment of their controls. They did have an exemption level in the draft, which was going to be to exempt companies with $25 million or less of premium. An interested group of industry companies came back and suggested that they think that exemption level should be for companies with $500 million or less of premium. So there's a range that still needs to be negotiated out. We'll see where we end up on that, but it could be affecting us all here in the next year and a half to two years, if they get it worked out.

One of the issues is: What do we do to try keep current on evolving regulation? Coming to a meeting like this is one way to do that. There are other ways. The Life and Health Actuarial Task Force (LHATF) puts out a monthly mailing, an information packet, to which you can subscribe through the NAIC. It gives you an idea of what topics they're talking about. It can be anywhere from 100 to 300 or 400 pages of stuff. It does give you pretty current information on drafts of regulations and reports.

The one challenge that I have in looking at that stuff is when to really start paying attention to this to see if this certain change or regulation has legs. As Donna alluded to earlier in her presentation this morning, we've been working on revising the life nonforfeiture law for 20 years, and so I keep wondering when I need to start getting interested in that.

There are other issues. Big reserve issues tend to get a lot more attention, so I'd encourage you to witness what's going on with AXXX and other issues where the industry gets behind it and things start to move a little better.

MR. GAULE: Obviously C-3 and VA Commissioner's Annuity Reserve Valuation Method (CARVM) has a big impact on us, and very early on we got involved. There are working group calls, and I have to give a lot of credit to the people involved. I don't know where they find the time to put in as much as work as they do. I have a hard time just listening to some of the calls at times. We tried to be involved in that process very early on. I volunteered to be on the practice note group, and I've learned a lot from that. I would encourage people to volunteer, because that's one way you get closer. A lot of the people involved in the process are learning, too. It helps you better understand the background that you don't always see from reading the document.

MR. MERWALD: I have a question for the audience. Given that you have to send your annual statement to the printer by about the middle of February, when do you think you have to have your cash-flow testing done to be able to sign off on your reserves and give management time, if you do have to make a change to reserves, to digest that and get through it? If you're finishing up your cash-flow testing on January 31 and you come in and say that you have to bump reserves, that increase in reserves isn't going to be met with a lot of enthusiasm, but from a timing standpoint, maybe the real question is: How many people do their cash-flow testing using September 30 data as opposed to year-end data? Are there many that use December 31? For the folks that are using the December 31 data, do you do preliminary testing then to get comfortable with it? It's nice to be able to say you did it as of December 31, but do you have a pretty good idea going in that you know that it's going to be okay?

MR. GAULE: Until just a couple of years ago, we were doing it as of December 31, but our external auditors want to sign off by about January 31. It was just squeezing me too tight to run it as of December 31 because by the time we got the runs, we didn't have a lot of time for sensitivity analysis. New York always wants extra analysis. A couple of years ago, we moved to September 30 so that we could get that work done early. That way, if there is an issue, we can talk about it very early in the new year.

MR. THOMAS A. BICKERSTAFF: I'd like some help, either from the panel or the audience, in terms of defining "materiality." I don't see anybody in the audience from a company that I just recently examined. They had about 3.5 percent of their reserves that got handwaved based on immateriality. But that 3.5 percent of reserves turned out to be close to 150 percent of capital and surplus. I kind of slapped their wrist and said that they needed to include that in their asset/liability analysis and at least get the level of reserves that were handwaved below 100 percent of capital and surplus. Does anybody have any opinions on this?

MR. FREITAG: I think you did the right thing in taking your situation in context. You had a thinly capitalized company, so you felt it was important to include 100 percent of the reserves. I think that's what anybody should do. Everything is contextual. Three-and-a-half percent of reserves for some companies may not be much of an issue. It sounds like you might have made the appropriate decision in the situation you faced. I encourage anybody to think about the surrounding situation whenever you look at something like this.

MR. MERWALD: It would also depend on the type of reserves. If they were whole life, 1958 CSO 3 percent, I'd have a harder time slapping them on the wrist than if they were deferred annuities that were sold last year. As Randy said, take it into context and look at it that way. It depends on what form of handwaving they did, whether it was, "We're not worrying about them because it's only 3.5 percent," or, "We're not worrying about them because we feel they're conservative and because of that they're not interest-sensitive. There are mortality margins, and we have margins in the valuation rate."

MR. BICKERSTAFFF: I can't honestly recall what the reserves were, but it was recently issued business that hadn't been thoroughly structured so that they could be modeled easily. But there wasn't any discussion whatsoever in their presentation of the liabilities, in terms of whether they were cash flow tested or it was a gross premium valuation or conservative or based on margins or whatever.

MR. BADER: We do test everything, but it may not be cash-flow testing. I'm getting back to Jim's point. If you have a small block of old whole life business, you don't have to do cash-flow testing, but still do some type of analysis that gets you comfortable that the numbers make sense. That's probably how I would look at it. I think you should still try to test everything.

FROM THE FLOOR: I was wondering how companies deal with things like bulk reinsurance and retrocession agreements when they have limited access to the underlying data.

MR. MERWALD: You're talking from the reinsurer side?

FROM THE FLOOR: Yes.

MR. FREITAG: I'm on the reinsurance side, so I can speak to that. We try to have a model for everything we do now. It may not be fresh; it may need refreshening from time to time. It is a difficult situation, but there should be at least some kind of underpinning behind it, whether it's a pricing model that's updated or something. It is a difficult situation. That's the best I can tell you. I try to limit the amount of it, that's for sure.

MR. MERWALD: I don't have a lot of experience, but I've seen reinsurers who kind of have to create in-force. They have treaties. They know they have some risk in business. You just do the best you can to try to create some reasonable in-force and then go from there.

MR. DAVID M. RUIZ: Many times with reinsurance or agents like that, we try to work closely with the client, the ceding company, and, in some cases, review their cash flow testing work if they've produced something on that block by itself. Even on bulk reinsurance, we still try to get underlying policy data from the clients. The reinsurance world has moved toward bulk reinsurance, but it seems to have moved away from bulk reinsurance. It's still called "bulk," but we're getting all the data also, and I think that that's the best way to deal with it.

MR. BADER: It's a matter of what you would expect if you were on the other side of the fence. We have a block of business that's reinsured, and we provide the reinsurer with a seriatim listing of all the policies every quarter so that they can do their own modeling.

FROM THE FLOOR: The NAIC was supposed to meet in New Orleans a week or two ago. Has it been rescheduled? What's the issue on C-3 Phase 2? Any updates on that?

MR. FREITAG: I don't think that they're going to meet formally. They're going to try to have a fair number of phone calls, if you're talking about LHATF and other items. I've heard recently that they may have an interim meeting, but it would not be a meeting that would be meant to be attended by outside parties. I think that I heard October, maybe, or November.

MS. CLAIRE: There was a call today specifically about the risk-based capital (RBC). They are really trying to have either the interim meeting or a conference call for, in effect, the Executive/Plenary to pass it, because they do understand that people would like to know sometime before December 31, 2005 what they have to do for December 31, 2005.

Considering it got past the Executive Committee, the strong indication is that you're going to wind up doing it this year. I haven't seen anything, so everyone could be surprised, but at this point I'm 95 percent sure that you're going to wind up doing something this year.

You want to do what is required as well as possible. New York is working on their letter right now. This may be covered in their letter also.

MR. GAULE: I'm curious. I mentioned that we're a variable annuity writer, and we're assuming C-3 is going to be in effect, so we're geared up for it. What's everyone else doing? Is that everyone's assumption? I'd probably recommend it, because it's a lot of work. We have a session tomorrow morning on C-3, and Jim Lamson is going to talk about the standard scenario. A few months ago, I thought that the standard scenario was simply one more scenario. It's not. There's a lot of work there. If you haven't gotten started, you better get nervous.

FROM THE FLOOR: I have a question about variable annuities and C-3 Phase II. We're a direct company, but we have a small block of business that's variable annuities that we reinsured. The question is: Can we take the direct company's calculation as our reserve and C-3 Phase II RBC requirement?

MR. MERWALD: So you assumed a block of variable annuities from another company, and you want to know if you can use the direct writer's C-3 Phase II calculations in your RBC calculations. Is that the question?

FROM THE FLOOR: Yes.

MR. GAULE: I'm not sure. I'm probably guilty of not having read that part, because it doesn't apply to me.

MR. MERWALD: It would be a matter of seeing if the underlying assumptions are reasonable for your situation, I suppose.
MR. GAULE: I think so.
MR. MERWALD: Most of the policyholder behavior and that type of thing should be applicable. I don't know if there are any big expense assumption issues.

MR. GAULE: I'd be happy to take your card and try to track down an answer for you.

FROM THE FLOOR: Thank you.