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Ask the Experts

Moderator:	MEREDITH A. RATAJCZAK
Panelists:	JACK L. GIBSON
	MICHAEL A. HUGHES
	DANIEL J. MCCARTHY

Summary: This open forum is an opportunity for participants' questions to be addressed by experts in the field. Questions may be raised by the moderator and panelists, as well as by participants from the floor. At the conclusion, participants are better informed about issues affecting specific areas of practice.

MS. MEREDITH RATAJCZAK: I am the moderator. We received probably a total of 13 questions in advance. Thanks to all of you for that. I will read each question as it was submitted. After our experts are done giving their views on a question, if you have additional follow-up questions or if anybody from the audience would like to make a comment or provide some feedback, please feel free. This is an open forum, so we appreciate your participation.

Allow me to introduce our panelists today, our experts. The first is Jack Gibson. He joined Tillinghast-Towers Perrin in February 2002 as the life sector leader for North America. In this role he's responsible for the marketing, sales and client service activities for more than 100 consultants in seven major offices. Jack's areas of expertise include mergers and acquisitions (M&A), demutualization and life company rehabilitation. He also specializes in working with U.S. and non-U.S. companies in strategic planning, enterprise risk management, risk and capital management and product development.

On the far end is Mike Hughes, a partner in the Chicago office of Ernst & Young's Insurance and Actuarial Advisory Services Practice, with more than 17 years of experience. His areas of expertise include financial reporting and performance analysis, M&A, financial planning, valuation process improvement, asset/liability risk management (ALM), capital management and litigation support. Mike currently chairs the American Academy of Actuaries' Committee on Life Insurance Financial Reporting.

Next is Dan McCarthy, a principal with Milliman USA. He co-manages the New York life and health practice. His areas of expertise include M&A, demutualization, strategic and operational review, sales compensation system design and review, appraisals, product development and pricing and the design pricing and review of employee health benefit programs. Dan has served on the governing boards of both the SOA and the American Academy of Actuaries, and he's currently an officer of the Academy. He also served for six years on the Actuarial Standards Board.

With that, I'll start with the first question. As submitted, the question says, "How does actuarial practice develop with regard to questions about interim results and asset-adequacy analysis projections? The early practice notes put out by the Academy concluded that our view 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 Actuarial Opinion and Memorandum Regulation (AOMR) calls for a discussion in the Required Asset Adequacy Issue Summary (RAAIS) report of why interim results may be a significant concern to the appointed actuary. Does the Academy plan any updates to the standard of practice (SOP) concerning interim results?"

MR. DANIEL J. MCCARTHY: I thought I would begin with a historical quote because about 15 years ago I asked Bob Callahan if I should be concerned about interim results in doing asset-adequacy analysis. He said at that time—a liberal position for Bob—that in his view the deal that had been struck in putting together the 1980 amendments and the asset-adequacy analysis was that you would be able to look over the entire horizon, and you wouldn't need to worry about interim results. The question asks how actuarial practice has developed. I think that's a good way to put it because I think, in fact, practice has developed.

Concerning the Academy's practice notes, the first thing I would say—and the Academy's general counsel, Laura Bloom, would say it if she were here—is that practice notes are not authoritative. Practice notes are examples of how to carry out a practice, and they are not intended to be either all-inclusive or authoritative. The SOP has already been changed to include the requirement to look at interim results. The Academy will republish all of the 1995 practice notes within the next year so that by 2004, the 1995 notes, including the ones that discuss how to think about results and so forth, will be out there in new form. But I would stress that those will be examples of how to think about and apply the SOP; they will not be authoritative.

One last thing I would say is that to me, the whole focus of this is partly a wake-up call, if you like, on interim results. But it also partly will call into question the assumptions that are being used to support an asset-adequacy analysis when you have losses in the early years and gains later on. People will say, "Are those for real?" I think we'll pick that up probably with some of the other panelists as we go along here.

MS. RATAJCZAK: For the next part of the question, could the panel speak to the types of interim results that should be commented on in the new RAAIS report?

MR. JACK L. GIBSON: The current SOP and practice notes do provide some guidelines. Partly to the extent that there are interim negatives, our primary look is that that should be dealt with, and it's okay to deal with that out of surplus and not reserves. But the key is to consider the implications of severe negatives. The key is how you define the word "severe." In essence, the key is to look for cases that might cause significant other events, such as cases in which you might have significantly higher lapses that are implied by this and that might be triggered by a ratings downgrade or some event like that. While they are subject to judgment, I think those are the primary things that are being looked for.

MR. MICHAEL A. HUGHES: I think if the results were severe enough that they would potentially cause a downgrade, you would need to anticipate the effect of that on lapse rates, etc. I think that's a good point. I would also make the point that the near-term results tend to be more credible; you can put more weight on the near-term results than you may be able to put on the longer-term results. So I think it's important to scrutinize really appropriately the types of scenarios that are impacting the longer-term scenarios and really how comfortable you feel about those long-term projections.

MS. RATAJCZAK: The next part of the question is: If the present value measures used in typical asset-adequacy evaluation include a favorable adequacy opinion, are there patterns of interim results that under commonly accepted actuarial practice would require additional reserves to be established?

MR. MCCARTHY: I frankly don't think this is a bright line, but I do think—and Jack and Mike have already suggested this—that you really have to be stress testing the assumptions and asking yourself if this is for real when you get these results of significant early negatives and significant positives. I think particularly if you have pushed the assumptions a little bit and find even in a scenario that continues today—a kind of a level scenario—that you still have that and if the turnaround point is way out, while I wouldn't call it commonly accepted actuarial practice, I would say you should think hard about putting up some reserves.

MR. GIBSON: Certainly when you see these kinds of interim results coming out the way they are, one thing that actuaries need to ask is whether there is a problem with the model. Sometimes this is just indicating that there's a larger problem with your model accuracy, and that's really the thing that needs to be addressed.

MS. RATAJCZAK: The next question is: I'd like to hear the panel's comments on what they've seen in the industry in terms of good will impairment testing under Financial Accounting Standard (FAS) 142. In particular, I'm interested in a detailed examination of what you do if you have to go to the second stage of the test.

MR. HUGHES: I'll start with the first stage of the test, just to set the stage here. FAS 141 and FAS 142 indicate that you no longer need to amortize goodwill as you have in the past, but you do need to periodically check it for impairment. To do that impairment check, you basically divide your business into different reporting units and then compare the fair value of the reporting unit to the carrying value of the reporting unit on a GAAP basis. If the fair value is greater than the carrying value, then you don't have any kind of impairment problem, and you can move on. If you do fail that test, though—the fair value is less than the carrying value—that's step one. Then you would need to proceed to step two.

Under step two, if you're trying to assess whether or not goodwill associated with a particular reporting unit is impaired, you would basically treat that reporting unit as if it were acquired and do PGAAP accounting as of the date of the impairment test. You would assume that the fair value of the reporting unit is the purchase price, and then you would go through your FAS 141 sort of PGAAP analysis. So, you'd mark the assets and liabilities to market, and you'd determine the value of the intangible assets and the residual value. The difference between the value of the tangible and intangible assets would be the implied fair value of goodwill. If the implied fair value of goodwill is less than the actual goodwill that you're holding, then you would have goodwill impairment, and you would reduce the goodwill that you're carrying by that excess. So it's a bit of a convoluted test, but those are basically the underlying principles.

MS. RATAJCZAK: The new Derivatives Implementation Group (DIG) rules around embedded derivatives in modified coinsurance (modco) treaties are confusing a number of folks in the industry, I think. I'd be interested in the panelists' guidance and understanding of how this derivative is to be quantified in practice, what thoughts they have about why this requirement has emerged and any other observations on the topic.

MR. HUGHES: B36 is a real quagmire. Again just to set the stage, FAS 133 requires that you bifurcate embedded derivatives from the host contract, namely separate an embedded derivative from the host contract and then carry the embedded derivative at fair value with changes in that fair value flowing through income. But you don't have to do this bifurcation if the embedded derivative is clearly and closely related to the host contract. A lot of modco treaties and coinsurance for funds withheld treaties have the interest rate used in the reserve transfer reflect the return on the underlying assets that are held by the ceding company. This exposes the assuming company to a credit risk associated with the assets held by the ceding company. This is different than the credit risks associated with the ceding company itself.

At first, the thinking was that credit risk on those assets was sort of clearly and closely related to the reinsurance treaty, but they came to the conclusion that it was not. Now you are required to separate out an embedded derivative that relates to the credit exposure that you have on the assets that are held by a ceding company. Then you hold that at fair value—if you can figure out what it is—and reflect changes in that through income.

Now, to do the calculations, you start by figuring out what the host contract is because you need to draw a clear delineation between a host contract and the embedded derivative. You basically have three choices for this. You could say that the modco agreement itself is the host contract, or you could say that you have a floating-rate debt host, or you could say that you have a fixed-rate debt host. Then based on the determination that you make as to the host contract, you could have either a credit-only derivative or a total return swap with a floating leg or a total return swap for the fixed leg. You would use standard corporate finance techniques to value those embedded derivatives. The actual calculation of these is a little bit hairy. Suffice it to say that it is a very complex area. A lot of companies are struggling with it. It's really getting a lot of attention because the requirements are hitting people quickly.

MR. MCCARTHY: It's worth nothing, if you haven't seen it, that the June 2003 issue of the *Financial Reporter* has a very good primer on the subject, which gives you good definitions of terms and basics that Mike alluded to. There is a lot of complexity in valuation beyond that, but it is a good basic primer, and I would encourage you to look at it if that's a matter of interest.

MS. RATAJCZAK: What is the most extreme stochastic modeling that you have seen? How many scenarios on how large a block, on how complex a model, on how many PCs or what type of computer that ran for over how many days?

MR. GIBSON: One job that we were on involved a client who was running several thousand model points for start, so it was an extremely large model. They wanted to take that extremely large model and run more than 10,000 scenarios, so they were setting up to do this on 50 of the fastest PCs at the time. This was, I believe, roughly December of last year. When we left the project, because we were only providing some of the support on this, they were up to being able to run 5,000 scenarios on 30 PCs, and it was taking two days. There were some significant network interruptions, memory problems and some other things that they were running into.

Other situations that we've seen that involved a lot of complexity had to do with stochastic-on-stochastic modeling. This is definitely a big area that companies are looking to advance to, and there are a few different ways that people are doing that. One is with regard to dynamic hedging. We've been involved in some circumstances in which we felt we needed to look at things on a weekly basis, basically by doing stochastic scenarios and then for each stochastic path, doing a stochastic scenario out at that point. We had a rather simple model, but because it was doing so many calculations, it was still taking roughly two days. For other applications, it depends on what people are using the stochastic-on-stochastic modeling for. They may be looking at longer periods of time, such as quarterly or annually, which can still create quite a bit of complexity but not as much so.

One thing I touched on in a talk I gave yesterday was that I think you do have to question, when you're running stochastic modeling, whether it's possible to slim down your model somewhat or approach your calculations a little differently. The model that you need to use for your annual financial planning may not need to be the exact same model that you need to use for 10,000 random scenarios. Also, you may be able to eliminate certain categories of calculations. You may have categories of calculations that you need for a full-blown income statement and balance sheet, but that you don't need for purposes of the kind of data that you're capturing for sensitivity testing. So there are things that can and should be done to more fully analyze the situation.

Also, to the extent that one of the steps you consider is to make the model smaller, clearly that's somewhat of a dangerous step in the sense that you have to take that very carefully. You have to find ways to test the model robustness—not just at a baseline scenario—but perhaps through a series of deterministic scenarios, for example.

I imagine most of you are aware that just last week there was a jointly sponsored Canadian Institute of Actuaries and Society of Actuaries stochastic modeling symposium. Of the 40 papers submitted, 30 were approved, and those have all been published. I believe you can get them all through the symposium. I know ours are on our Web site. I encourage those of you who are interested in this topic to look into some of these papers because I think some of them are quite good.

MR. HUGHES: We've also used some techniques to avoid a true stochastic-on-stochastic, which is sort of geometrically complicated. There are ways of using duration and convexity and the five Greeks and things like that to sort of approximate the fair values without having to go through a full stochastic-on-stochastic process.

MS. RATAJCZAK: A good question related to your answer, Jack, is, for something that big, how do you know that what's coming out is right?

MR. GIBSON: I think you have two big questions. How do you know it's right? I think you do have to do some detailed analysis around selective scenarios, including at the extremes. Then, how do you deal with all this data? One of the challenges that companies face is that they have all this data, and there are two people in the company that actually can come up with a conclusion from it. But those aren't the people who have to make decisions off of it, and those people are not convinced with what they're hearing. So that's another tremendous challenge.

MS. RATAJCZAK: Is codification retroactive? Does it impact any previous reserving methodologies put in place on policies issued before codification was effective?

MR. GIBSON: We had a debate on how to answer this. Dan thought the answer should be "no, but," and I thought the answer should be "yes, but." We were making the same point; we were just coming at it from different directions because it is a yes-and-no answer. The start of my answer is "yes," but the qualifier to that is that you have to look at what is being implemented so that the rules in place are applicable to everything. But if you're implementing a regulation that is only prospective by its very nature—XXX is an example—then, of course, that will only be prospective.

MR. MCCARTHY: It might be worth taking a couple things out of the codification book to give you a sense of why it isn't yes or no. The book says that it's effective January 1, 2001, but then says, "Specific effective dates and transition or grandfathering go to each statement of principles." Well, if you go to Statement of Standard Accounting Practice (SSAP) 51, which talks about reserves, it says for reserving methodologies, go read the actuarial guidelines. SSAP 51 also says it's effective for years beginning January 1, 2001. "Contracts issued prior to that shall be accounted for based on the laws and regulations of the domiciliary state." Then the question is, for older contracts, to what extent does the domiciliary state subscribe to the actuarial guidelines? The answer is usually they do, but for some states that can be a little different. We have a couple of examples that I will save until a later question to illustrate that the actuarial guidelines are not always crystal clear in and of themselves as to what their effective rules are.

MR. HENRY W. SIEGEL: I was the Academy's representative when they were putting the original codification in. That language was put in specifically to make it not retroactive. Basically it was intended to say that if you were doing something at the time codification came in and your state said it was okay, then you could continue to do it. That's what that language was meant to say.

MR. MCCARTHY: I agree that it was. However, as we'll see in a couple of instances, the guidelines don't always square with that, and that just illustrates the problem. I don't challenge your statement, Henry, but it illustrates the problem. It's why you get answers such as "yes, but" and "no, but." My suggestion was "maybe." We had various takes on it.

MS. RATAJCZAK: The next question: Should mortality only or yearly renewal term (YRT) reinsurance in Financial Accounting Standard (FAS) 97 line deferred-acquisition cost (DAC) models be handled as a variable expense in the margins used to amortize the DAC, or should the reinsurance be DAC separately on an FAS

60 basis, with reinsurance gains or losses hitting the bottom line as mortality variations would on an FAS 60 line?

MR. HUGHES: Well, maybe we can take a little vote here. How many think that you should reflect the reinsurance effects in your DAC amortization? Let's see a show of hands. How many think that it should be handled separately on an FAS 60 sort of a basis? I'll give you two answers—the technical answer and what happens in practice. The technical answer is that you should really follow 113—take the reinsurance costs and spread them over the life of the policy in proportion to the gross profits, if you will, on a direct basis and that the FAS 97 DAC amortization would be unaffected by that. But then you would also true up the spreading of the reinsurance costs in the same manner that you would sort of true up your DAC balance to reflect emerging experience.

As you know, not everyone really follows that in practice. I think 113 is very confusing. It was really intended more to deal with some property and casualty situations, and in practice companies have tended to more often reflect the reinsurance effects in their estimated gross profits (EGPs) and just do their FAS 97 DAC amortization on a net basis. But I think a literal reading of the guidance would have you go down a different path.

MS. RATAJCZAK: I guess the NAIC rejected the state-of-domicile opinion as an acceptable method of alleviating the burden in asset-adequacy analysis, of handling state variations and historical implementation of various valuation bases in methodology.

MR. MCCARTHY: The 10th amendment to the U.S. Constitution says that states can do whatever they please, and I don't think the NAIC really had any choice. They probably got as close as they could with the new changes, in which they point out that, in effect, any state can agree to accept a state-of-domicile opinion and not require any change. I don't think, as a practical matter, that they could have gone any further than that because any state could say, "Hey, you can't tell me." So, given the situation, I think the NAIC did the best it could, which was in effect to encourage the states to take state-of-domicile opinions, but they could not require them.

MS. RATAJCZAK: Next question: What are your individual views on whether the federal government should provide a backstop to group or individual life insurance to handle terrorism catastrophes?

MR. GIBSON: I'll take an initial shot. This is really a broader question, but from an actuarial point of view, what's the likely need of this from an industry standpoint? Let's think of that at first as, say, an epidemic. The 1918 flu epidemic had mortality of seven to 10 deaths per 1,000. The figure of five deaths per 1,000 corresponds to 1.5 million deaths, which is obviously a fair amount. I think the issue here is that it can be obviously much more of a regional and a concentration issue, which presents a bigger problem with certain companies or certain economic categories, depending on the markets companies are in. I thought it was interesting that the reinsurers have pulled together and come out with a $300 billion lawsuit against various parties, including Osama bin Laden and Iran and several different countries. I guess that suit is an alternative to a federal backstop for these kinds of things. But we'll watch to see how that plays out.

MR. MCCARTHY: I should disclose at the outset that my colleagues and I have been consultants to a group of about 14 group life insurance writers who were seeking to get the federal provision related to group life enabled. But I will provide some background. This week's *Best's Review* on property/casualty has an item that says, "Terrorism insurance"—meaning with respect to buildings—"may not yet be a popular product, but the fact that it's available at all is a sign that the Terrorism Risk Insurance Act of 2002 has been successful, industry experts said." It goes on to point out that, of course, it expires in 2005, and that's a problem.

I think that issue, which Jack alluded to, is really a market issue. The bill provided, in effect, that commercial/property casualty risks would be subject to the terrorism backstop that the federal government set up. Essentially it did so because it said that the market had been extremely disrupted, and Congress found that the market wasn't likely to be undisrupted unless there was some kind of federal backstop. Interestingly, it did not apply to personal property/casualty lines—homeowners and so forth—and I'll come back to that in a minute.

The bill also recognized that there was some possibility that group life insurance would present concentration risks—many people for one employer, one billing and that kind of thing. It basically directed the Treasury to conduct a study and determine whether: a) reinsurance for catastrophe risks was less available after 9/11 than before; and b) whether the market for group life was, or was likely to be, affected. On the first point, there was a very good survey done by LIMRA International, which the Treasury accepted, that said indeed, catastrophe reinsurance has essentially gone away but for very small amounts at very high prices. On point B, however, only minor disruptions were found in the market so far, and notwithstanding the fact that it might have had room to act on the basis of the evidence before it, the Treasury has recently announced that it will not provide at this point a backstop with respect to group life.

The American Council of Life Insurers (ACLI) and the group life writers have concluded at this juncture that the most likely thing to work toward is that if the federal legislation is to be renewed in 2005, there may be a stronger effort to get group life included. I frankly think it is highly unlikely that individual life will be included for the same reason that personal property and casualty lines were not included. While it certainly is a risk, the concentration risk is not there. I've always tended to assume that if there were a really megascale terrorism act or something like that, none of this matters, and the federal government will have to deal with the issue on a broad industry basis. I think all of us are hoping that we never live to see that day.

MS. RATAJCZAK: When is it appropriate to bring future reinvestment at current yields into estimates of future margins in FAS 97 unlocking exercises? Is there any problem with realizing that the portfolio yield will walk toward future reinvestment and that the DAC amortization impacts of such will occur as the earned yield changes and as the DAC is unlocked to reflect those changes in future periods, as opposed to in the current unlocking exercise?

MR. HUGHES: I guess I would say that there is sort of a conceptual problem with what's being recommended. I think the guidance in FAS 97 says that you should be using your current realistic best-estimate assumptions, and that doesn't give you a default option that you can just assume that reinvestment yields will be the current reinvestment yields or to just let those bleed into the EGPs as the reinvestment occurs. I think you're required to make all kinds of assumptions. One of the assumptions that you need to make is about reinvestment yields, and then that will impact the earned rates in the portfolio and potentially credit new rates, etc. So from a conceptual standpoint, I think you need to take your best shot at realistic best-estimate assumptions and then reflect that. Of course, from a pragmatic standpoint, there is some subjectivity in terms of where you put those realistic best estimates.

One thing that I will say is that, as interest rates have come down to historic lows—at least prior to the last couple months when they've spiked back up—it's been causing a lot of strain on reserve adequacy for different types of products or the recoverability of DAC and things like that and even in cash-flow testing results, again with the reserve-adequacy-type issues. We've seen more and more companies trying to build in significant ramp-up in interest rates as the baseline assumption. While I think maybe a moderate degree of rising rates may be appropriate, depending on the steepness of the yield curve and a variety of other theoretical considerations, I'd be very cautious assuming as a baseline assumption that rates will really ramp up significantly over a multiyear period.

MS. RATAJCZAK: Question 12 is a long one. The IRS recently said that Actuarial Guideline (AG) 33 cannot be used for tax reserves on policies issued prior to the NAIC's adoption of AG 33. Is the IRS's decision regarding AG 33 correct? From the explanation given, based not on the specifics of AG 33 but simply on committee report language, do you agree that it is likely that the IRS would rule similarly on other AGs? What about AG 32, which in substance requires companies to hold continuous reserves for life policies? The IRS, in Revenue Ruling 9474, said that if a company changes to continuous in its NAIC reserves on inforce policies, the company must also change from curtate to continuous in its tax reserves. This seems to say that AG 32 is applicable to inforce policies for tax reserves.

MR. MCCARTHY: We were really happy that a question involving a 9-year-old revenue ruling came in ahead of time, as opposed to being asked from the floor, because it gave us a chance to go look at it. AG 32 said essentially that you need to go to immediate payment of claims in your reserve basis for new policies, and for inforce policies, you need to do that also on a phased-in basis, unless you can demonstrate that you have other reserve margins. Interestingly, what the IRS said in the old revenue ruling that was referred to—for which they did a very careful reading of section 807 of the tax law, which is the reserve section—was, "Gee, 807 doesn't really say anything about what to assume about the timing of a payment of claims. On the other hand, it does say that when you don't have any other guidance, you use statutory methods." So they therefore said, "It looks like a company that goes to statutory reserve calculations on an immediate payment of claims basis is required to do that for tax purposes because 807 says that if you do one, you do the other, unless there's some other guidance."

This got me thinking about this question of effective dates of actuarial guidelines. AG 32 does, in fact, say that it's applicable to old policies on a phased-in basis, unless you have margins, and that it's applicable to new policies. That brings us then to the more recent question that was raised on AG 33. The IRS, in a technical advice memorandum, said not only don't you get the step-up in reserve right away—by the way, on 32 they said you get it through reserve strengthening—it also said you don't ever get it for contracts issued prior to the effective date of the guideline. That led me to wonder what the guideline itself said about its effective date. It says that it is effective in 1998 for all contracts issued on or after January 1, 1981. So in effect, it is retroactive for a long way.

MR. HUGHES: Which version? There are multiple versions.

MR. MCCARTHY: That is true. I'm using the one in the codification book. The IRS does not seem to have followed here the dictum that reserving methods are what the NAIC, through actuarial guidelines, say they are. I think we need to recognize that, in effect, there are two kinds of actuarial guidelines, as I think about them very broadly. One is the kind that says, "This is purely interpretative. We're telling you what the law means, and it's what it always meant." The others are more developmental. "This is a new issue, and here's what we're saying about how to handle this new issue, which really wasn't probably contemplated in the law." The IRS is not very clear as to whether or not they're relying on that in the technical advice memorandum, and frankly, I think that they may have a tough time sustaining that position. But their position essentially is that since the guideline was not in effect with respect to those prior contracts, their version of it is that you don't ever get the reserve deduction. Mike, I think you said you believe some folks will be contesting that.

MR. HUGHES: Well, it could very well end up in tax court, because it's a ruling that has people perplexed.

MR. MCCARTHY: And by the way it has implications beyond this guideline. There are other circumstances in which it can apply.

MR. CHARLES D. FRIEDSTAT: That's a pretty broad discussion of questions. I've been involved with a lot of this over the last several months, including the company that was involved with the technical advice memorandum. Some of the things Dan said are logical. You also have to look at some of the things in the technical advice memorandum. I start with 32 and go forward, because I think there's a little difference in 32 than what the changes in method are for 33 and 34. Going all the way back to the legislative history of the 1984 act—and there's an example in the Blue Book that specifically talks about continuous and curtate functions—basically there are five prescribed things that you have to do, according to the law. Everything else generally is consistent with statutory. A specific example is the immediate payment of claims, so I think that there is little doubt that when companies switched, if they were on curtate to immediate payment of claims, that it was, for cash purposes, a 10-year spreadable event. There were other questions, which I won't get into, in terms of how to implement that, but that one wasn't too controversial.

The issue on this AG 33 has been brewing for a while. Let me give you the quote for the technical advice memorandum for those of you who want to look it up. It's the 2003-28006. It's one of the shortest technical advice memorandums that I've ever seen. It doesn't give the facts, and if you knew the facts, you might not reach the same conclusion, which I think they purposely tried to reach to keep it short. The history of this is that the IRS has stated in a public forum that their position is to be a prospect of application of actuarial guidelines. That is to be their general rule.

I think a lot of tax practitioners believe that you have to look at the actual facts and circumstances of the situation. I don't know who wrote that question, but they obviously had some insights to this, and I'll try to tie some of what they're saying together. One of the changes that took place in that ruling had to do with a change in interest rates. Revenue Ruling 9474, whether you agree with it or not, clearly specifies that a change in interest rates is a change in method and is a 10-year spreadable event. Did AG 33 cause that change in interest rate to come about, or were they clarifying what the law really was in 1981? That's the question that should be asked. The other thing is that the tax law says that you're supposed to use for a method in this case, the interpretation of Commissioners Reserve Valuation Method (CARVM) that's in place at the date the contract was issued.

There's also a technical advice memorandum from 2001—it's 2001-08002—that, not on this particular point, but in general would say that where there's not a prescribed method, there's a hierarchy used: the NAIC method; if not, use certain state rules, etc. It implied in that ruling, which was on a completely different topic, that if something were a permissible method at the time, it might be acceptable. I think that you'll see the IRS stick with this decision. I think it'll be litigated in the case of the company that's involved with the technical advice memorandum.

Let me say a couple of other things. For the vast majority of companies, for AG 33, this is a favorable answer. Now, why would you think that? Take a normal decline surrender charge contract for which the surrender charge declines over seven years. You'll reach the account value within the next seven years on an existing contract, whereas the change in reserve method period is over 10 years. So the vast majority of the companies will not be adversely affected by this. I actually know of a company that took the position that it should apply retroactively, and then the IRS came in and gladly accepted their results, that it only applies prospectively. There are companies though, generally, that have very long surrender charge periods, certain unique types of annuity contracts, such as two-tier annuities, for which that does not give you the best answer. But I think that the verdict is out on that, and there probably will be further developments.

The IRS' initial position on AG 34—although not publicly stated, it will be seen in a few audits—is that they'll also apply it prospectively, and that raises questions of what we were doing before AG 34 came into play, the same questions that I mentioned about AG 33. What was appropriate, and how should you have handled minimum death guaranteed benefits before AG 34 came into play? How were you doing it? It gets into all sorts of situations about the sort of settlement you might or might not have had with the IRS on this issue. It can get very complicated, but the thing that I strive to emphasize is, at least in my opinion, I think you have to look at the specific facts and circumstances. The IRS tends to be starting out with, "It's black or white, and this is how you do it. It's prospectively." How they deviate from that standard in specific cases will be very interesting.

MS. RATAJCZAK: Also, is AG 39 applicable to tax reserves? It seems to increase reserves primarily via two requirements to do asset-adequacy analysis. In addition, it is by its terms only temporary. Is there any way to get a tax deduction for reserves that are based on an asset-adequacy analysis? Is AG 39 a continuing step in the movement of NAIC reserves away from a simple, basic present value of future benefits minus present value of future premiums—using specified table, interest rate and method—and toward the recognition of assets that back those liabilities? If so, should the industry begin to discuss with the government the need to revise section 807 of the Internal Revenue Code to reflect this change in reserve philosophy?

MR. MCCARTHY: I'll start with the last part. Everybody is very nervous about opening discussions with Treasury on potential law changes because for every change you want, there are changes they want. There are people in Treasury who say, for example, that the cash value floor is crazy and should be done away with. So there is a whole lot of nervousness about opening up any industry-wide discussions on section 807. That suggests to me that what really will ultimately drive that is whether reserves that are determined by methods not spelled out or specifically sanctioned, as Bud was talking about in the tax code, are big dollars or small dollars.

If they're small dollars, I think people will do what they have to do and set up what they have to set up, and there will be a lot of reluctance to open up section 807. If, on the other hand, this turns out to be step one in a long-term development away from formulaic reserves, then there will be no alternative but to have that kind of conversation because it will be saying the industry will be going in a completely different way. Just as in Canada, for example, when the statutory reserve method or regimen changed, they had to have a tax discussion. We'd be at that point here. I don't believe we're at that point yet. The question pointed out that AG 39 is temporary. It's temporary partly because people in the NAIC are nervous about the whole prospect—it's moving more away from formulaic reserves—but also, frankly, because with the development of products, nobody can quite figure out what the alternatives are right now.

So I think we are at a time of transition. We really don't know fully transitioned to what. But number one, although I'm sure people will claim it, I think it will be difficult to get a tax deduction for an AG 39 reserve not supported by a specific formula in an actuarial guideline, and number two, I think there will be a whole lot of nervousness about going into 807.

MR. FRIEDSTAT: This question came up at our tax discussion, and it's really two questions. It's really what you do in a specific situation and going forward. I absolutely agree with the direction that you're talking about as far as the future. AG 39 is the first type of reserve getting away from, if you think about it, a formulaic approach. The whole guidance and all the legal history behind reserves, even prior to the current actuarial practice, talk about a net premium valuation basis, and that was a very significant element in the legislative history of this and all the court cases. This is the additional reserves due to stand-alone capital testing. It would be hard to describe if that falls into that situation, and the move towards more stochastic approaches will clearly make it some time in the future. I agree with you. Now isn't the time, but as we go more and more away and give more and more flexibility away from formula reserves and net premium valuation basis, that will be the case.

As far as AG 39, that's a tough one. Let me just say that the Academy does have a committee that is working with the tax implications not only of the short-term solution, but also of the longer-term solution. I think they're dealing with all of these issues and some more specific issues that have come about. But the question really boils down to looking at the tax law, and it says you're supposed to use the interpretation of CARVM that's in place at the date the contract was issued. Prior to this, there were reserves being set up for AG-39-type products. They could arguably—most of them, and there were variations—be net premium valuations. In some way they were deductible. You might have to revalue using interest rates.

Here, what's really causing a lot of questions is whether this additional reserve on stand-alone cash-flow testing fits in with a greatest present value of future benefits

CARVM. Is it CARVM? I know that when I chaired the AG 35 task force that dealt with taxes, there were two overriding principles that we said had to be in the actuarial guidelines to be effective for tax purposes. One, because there was a choice of methods, we had to be able to show that there wasn't a bias in terms of using one method over the other. The second one was absolutely that the method had to be consistent with CARVM principals. I believe it's very easy to argue that AG 35 is consistent with CARVM principals. I've seen it come up under audit. They're not challenging that particular aspect. But on AG 39, this is really the first time that you're coming up with a non-formula reserve. I think people are looking at this differently than a company-wide asset-adequacy test reserve, which clearly is not deductible, and that's why the question is coming up at all—because it's a reserve in relation to a specific product.

MR. MCCARTHY: Yes, but AG 39 made an attempt to say that it's CARVM.

MR FRIEDSTAT: Yes, very much so, and that's really what the heart of the issue boils down to. I think there's a great deal of uncertainty about it.

MS. RATAJCZAK: That was our last submitted question, so we want to open the floor to the group here for any follow-up questions, additional questions, questions related to materials, things that you've heard throughout the course of the meeting.

MR. SCOTT FRANK: I know Mike was saying that we can speak to him later, but I hope other people are interested. The B36 modco agreement does have some significance to some companies. It does have a short time frame. I have a goal to try to learn as much as I can about it at this meeting; I'd appreciate it if other people are as interested. If you could spend a few minutes going through it in a little more detail than what you did earlier today, which was helpful as well, I would appreciate it

MR. HUGHES: I would prefer to defer to our subject matter experts on that. It is very technical, and that just hasn't been my real focus. I'd prefer to deflect that to our people.

MR. GIBSON: I won't add anything specific to that, but let me just say that if you were trying to learn as much as possible about that and since it is considered public knowledge that the one company has had to deal with this last year is Annuity and Life Re, you might look at certain financial statements if they're publicly available on that. Again, I'm not sure that the approach that they took would necessarily be the one that every company will follow. As Mike said, there are a lot of questions on this. It won't be a quick answer. I'm not knowledgeable on this, but if you talk to 10 knowledgeable actuaries who would tell you how they would approach this, you'd probably have 10 somewhat different answers. So there's a lot of judgment, and again I could put you in touch with somebody who has dealt with this issue also and more specifically, but that's not me.

MR. HUGHES: Let me open it up a little bit. Is anybody in the group comfortable speaking to the details of how you would actually do the calculations? In general, I would say once you get to the clear definition of what the embedded derivative is, in terms of what type of a credit derivative or total return swap or whatever, if it can be put into a closed-form solution, you could potentially do it that way. I suspect that in most cases you'd be using a simulation-type technique and doing the discounted cash-flow valuation based on simulation modeling with appropriate risk premiums and that sort of thing. It is a little scary, though, when the guidance isn't clear. I mean FAS 133 is sort of this way, and 113 is sort of this way. Now we have B36, and there are probably five people in the country who understand how to do it. The GAAP requirements, in some respects, get really quite technical.

MR. WILLIAM H. MOYER: I have a follow-up on the AG 39 tax reserves. Would you consider the accumulated charges on the inforce to be tax-deductible or only going forward for like new issues? In another session, they said that if you look at it on a present value of benefits minus present value of premiums—the prospective approach—you'd say that the entire inforce would be. But we're using a kind of retrospective method and they are equal, so you should be able to get the whole thing deductible.

MR. MCCARTHY: I think, in many respects, you're back to the point Bud was making before. It's uncharted ground because the IRS is, in one sense, taking a hard position but, in another sense, feeling its way too. It would be hard to argue in this case that AG 39 is something we all knew about anyway and all they did was clarify it. That argument frankly doesn't pass the straight-face test, and if it doesn't pass the straight-face test, I think the IRS will be tougher on saying that it only applies to contracts after they're effective. I'm afraid that's where you come out because the argument that we all knew this in our minds and they just wrote it down really doesn't work here.

MR. HUGHES: But I would make the point that you can't really promulgate new law through the actuarial guideline process. So, the only way the actuarial guidelines can be effective and authoritative is if they're characterized as interpretations of the law.

MR. MCCARTHY: I agree with that. They are interpretations, but there are interpretations and interpretations. If you look back to the early actuarial guidelines, I'd say they wrote down kind of what everybody had really thought or many people had thought all along. This was obviously a development to respond to an issue that was festering. While it's an interpretation, it's not the same kind of interpretation.

FROM THE FLOOR: I just want to make a couple of comments. The technical advice memorandum came up at the ACLI, an industry group, and when you have conflict, basically it brings it to a stop. The issue was that that particular technical advice memorandum is unusually favorable to some companies, and, therefore, they're saying that they're getting a benefit that they never have to pay back. Now, that's an interesting position. Well, why fight this? You have to take a bigger position, though. Is that setting a precedent? Of course, that unique situation that created that benefit will not happen in future events. To not protest this—because I think it sets up a bad precedent—is a problem because you have to ask the question—not in this situation but going forward—is that the position you could tolerate with the IRS? The ACLI is saying, "Well, what do I do now that I have a member company that's saying, 'I don't want this reversed because I get a big tax bonus out of this?'" I think several companies got a tax bonus out of this.

MR. MCCARTHY: So, like Mike said, you wait until somebody goes to court.

FROM THE FLOOR: The other comment I have is on the question of interim values. New York State is trying to understand what that means. We've had several meetings with Bill Carmello. They started out saying, "Don't you have to reserve for the negative scenario under every test you did?" We said, "Bill, that's not what it says." We seem to have them considering that at least you have to look at the level scenario. If you have negatives in the level scenario, you really have to react to it. We sort of got them off of the position that if any scenarios fail, you have to put up extra reserves. But I think we'll get them more material to go through. What does the Academy mean by the statements they made in 7 and 22? We have to get into the meat of it. We left it with, "You have to write a letter, and if you have negatives, you have to explain them." So, he seems to be at that position. But if you have negatives in your level, I think he really thinks you will have to put up reserves for them. Maybe you do, but that's where he is right now. So if you're dealing in New York State, that's out there right now.

MS. RATAJCZAK: I can just tell from the number of questions that we had in the appointed actuary forum yesterday that this whole area of looking at interim results and determining when additional reserves are required is a real question area for most practitioners today. I have a question I'd like to ask the group. It's a question that came up yesterday. I'm interested in what your thoughts are on the move toward stochastic methods for setting reserves.

MR. GIBSON: I think it depends on the product and the coverage. I do think that stochastic methods are necessary to set an appropriate reserve level for significant embedded options and guarantees. I think the more complicated issue, in addition to putting your finger on exactly how many of those situations you have, is whether that should be applied broadly, across kind of all product lines *carte blanche*. I guess at this point my answer to that would be "no." But conceivably in the future, to the extent that there are further advances in technology and so forth, maybe we'll get there at some point. I don't feel that's where we should be now.

MR. MCCARTHY: I'm also a walk-before-you-run person here. We have a system, to be sure, that is breaking down in certain areas because of product changes and investment changes, but it is not in ashes on the floor. I'm not sure any of us would have the confidence to say that we could do a complete stochastic analysis and arrive at an appropriate statutory reserve level for a company on all of its risks. To me one of the pluses of AG 39 is that it helps us figure out where we're going and how to do this stuff and where it works and where it doesn't. I think we have large volumes of business for which formulaic reserves supplemented by adequacy testing are an acceptable answer today. I agree that we'll work our way forward, but let's not all jump off the edge of the boat.

MR. HUGHES: I would agree with both of those comments. I would also say that I don't think it's likely that statutory requirements will get in front of GAAP or international-type requirements in this respect. If under international accounting or U.S. GAAP, fair-value-type approaches come into vogue and prove effective and usable, then I think you'll find greater receptivity to that on a statutory basis.

MR. MCCARTHY: Do you think that will happen?

MR. HUGHES: Well, it's slated to happen with international accounting standards (IAS) but not without debate. Obviously the Financial Accounting Standards Board (FASB) has stated their intent to move in the direction of fair value.