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Ask the Experts

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Summary: This open forum was an opportunity for participants' questions to be addressed by experts in the field. Questions were raised by the moderator and panelists, as well as by participants from the floor. In addition, some questions were submitted in advance by prospective attendees, allowing panelists time for more detailed responses. At the conclusion of this session, participants are better informed about issues affecting specific areas of practice.

MS. MEREDITH RATAJCZAK: This is an open forum called "Ask the Experts." Our panel of experts includes Bradley Smith, chairman of Milliman, out of our Dallas office. Next is Larry Gorski. He's a consulting actuary with Claire Thinking, previously with the Illinois Insurance Department. Then we have Jack Gibson, managing principal of the North American life practice for Towers Perrin. I also see other experts in the room, and we hope they put in their two cents where it's necessary. I'll serve as your moderator today.

We are going to start with the questions that we received in advance, and then we'll open the floor to questions from the audience. We hope there are lots of those. Of the questions that we've received in advance, the first one is, "How do you perceive the role of the valuation actuary will change with the impending principle-based valuation methods? How should actuaries serving in this role prepare?" Larry?

MR. LARRY GORSKI: Thank you. I think I could talk for about 45 minutes on this question. I do believe that the role of the valuation actuary will change from his or her role in asset adequacy analysis with a floor to a principle-based reserving or capital approach without a floor. I think there will be much more regulatory attention given to the work of the actuary when dealing with making point estimates. When you're working in an environment where you're testing a reserve that is supported by a formulaic number that is perceived to be conservative, maybe there's not as much review of that as there should be, but when you get to a point estimate, there's going to be a lot of work.

Not only will there be more attention, but I think the reviews are going to be done by different people. I'm going to rely on my Illinois experience here. In Illinois, there were field actuarial examiners and a Springfield office of actuaries. The Springfield office reviewed asset adequacy work, while the field examiners reviewed formulaic reserves. Under a principle-based approach, I think some of the work of reviewing principle-based reserves or capital will be done by field people. Consequently, you're going to have different people without any experience doing this kind of work reviewing the work of the valuation actuary when it comes to principle-based work. That's going to lead to a greater need for documentation on the part of the actuary. And it won't just be reviewed by different people, but it's going to be reviewed more frequently. Right now, asset adequacy analysis work is generally reviewed on an as-needed basis. If you have a large stockholder dividend filing, you may review it in conjunction with a periodic financial exam or you may review asset adequacy analysis when there is a perceived issue with the company. However, under a principle-based reserving approach, the work of the valuation actuary is going to be reviewed annually and, again, by people who might not have the experience in doing that.

This next point may be troublesome to some people. When an actuary is involved in formulaic reserves and you have an issue where the answer is somewhat uncertain, you generally get the opinion of regulators and form some consensus. That opinion should stand up over time over different situations. But when you're dealing with valuation actuary work under a principle-based approach and you get an opinion on a certain situation, that opinion is only going to apply to that situation. Any difference in circumstance—whether it be the significance of the amount of business subject to this question, or maybe regulatory attention, or how peer groups address that particular issue—any change in that over time will tend to cause any opinion or viewpoint that had been expressed in the past not to be applicable to the new situation.

There's at least one more dimension I can think of where the role of the valuation actuary is going to change. Under the principle-based approach, especially when you're talking about variable annuities with guarantees or some of the more complex products, regulators are going to be looking for consistency in what the valuation actuary is doing in the principle-based area, and what the company may be doing with that same risk analysis but for other areas, whether it be internal risk management, for rating agencies or for hedging purposes. So the role of the valuation actuary will also focus on making sure that his or her work is consistent with comparable work for other purposes. There are many changes that are going to come about for valuation actuaries.

MR. JACK GIBSON: I'll just add a couple of points to Larry's comments. One thing that I think will increase significantly is the degree of need for interaction between the pricing and valuation areas. There will be even greater importance on the need for consistency of assumptions or at least consistency in the view of what is best estimate and the basis for those best estimate assumptions. Another thing is that, for the valuation actuary, there's certainly a tremendously increased demand on education and understanding of option pricing and of current developments in this area. The impact on the valuation actuary is going to go through a significant change over the next two-year period. In part, the regulators, the rating agencies and the companies themselves all really need to ascend the learning curve and determine the right way to look at things. I heard David Ingram of Standard & Poor's (S&P) talking about the learning curve that S&P is going through and their interest in talking to companies about their own models and what they're finding. As the rating agencies and as the regulators increase their understanding and further define the peer review process and what that's going to entail, that in turn will cause a secondary impact on defining the role for the valuation actuary going forward.

MR. BRADLEY M. SMITH: I'll take a little different spin on the question. As we talk to executives of life insurance companies, CEOs, CMOs or CFOs, the questions that they ask typically revolve around four topics: growth, efficient use of capital, emergence of earnings, either statutory or GAAP, and the level of profitability. If you think of those questions as the questions that are concerning the people that you report to, the question more appropriately becomes not how does the role of the valuation actuary change, but how does the role of the actuary in general change. Growth clearly has ramifications on the product development function. Efficient use of capital clearly affects both product development and valuation. The concept of more reserves being an effective use of capital is no longer reasonable, given the market-based options that companies have. The emergence of earnings is a critical element. My sense overall is that the valuation actuary function and the pricing actuary function are going to converge. Many companies have already merged these functions. They're going to have to work together and essentially understand what each other does so that there's no disconnect between the initial pricing and the actual emergence of earnings.

Absent from that list of four topics—growth, efficient use of capital, emergence of earnings and profitability—is the level of statutory reserves or level of GAAP reserves. Most executives presume that the statutory reserves are adequate, meaning that they make sufficient provision for the liabilities going forward, but also will allow for a smooth emergence of earnings going forward, either GAAP or statutory. It strikes me that our focus needs to be not just on the establishment of the reserve, but also on understanding the ramifications of that reserve. When you think about companies that have gone under or have become statutorily insolvent, there are few companies that have become statutorily insolvent because their statutory reserves were inadequate, allowing dividends to be sent through the holding company and the life insurance company itself to become statutorily insolvent. The problems that typically lead to insolvency are either criminal, asset-based or profitability–based—in other words, the products were priced inappropriately at the time or the assumptions that were used in the pricing of the product didn't emerge. The focus of the valuation actuary has to move from the formulaic approach to the principle-based approach, which in my mind means that there's going to have to be a smooth transition or, from your boss's standpoint, it's going to have to be nearly seamless between the valuation function and the pricing function.

MS. RATAJCZAK: Here is the second question. "As we develop 2001 CSO X factors for business issued in 2005, we're considering changing the basis of our anticipated mortality from the 75/80 mortality table to the 2001 valuation basic table (VBT). Should this new anticipated mortality also be used to show compliance with the X factor requirements for our existing 1980 CSO X factors? There is a possibility that this would cause the 1980 CSO X factors to increase due to the steeper slope of the 2001 VBT." Larry?

MR. GORSKI: The author seems to be hinting that maybe the answer is "no" because of the need to increase X factors. I would approach this question a little bit differently. The real question should be, "Is the 2001 VBT really the anticipated mortality for that 1980 CSO business?" If it is, then the answer is "yes." If it isn't, then the answer is "no." Rather than looking at the effect of moving to a new table, one should be analyzing what the anticipated mortality for the business really is. The author goes on to give a rationale for the increase in X factors, which he or she says is due to the steeper slope of the 2001 VBT. While the 2001 VBT may have a steeper slope than the 1980 CSO or other tables, I've read in at least a few places that there's some question as to whether that steeper slope is real or actually due to the lack of homogeneity in the business that was used to produce the 2001 VBT table. It's possible that the anticipated mortality for the 80 CSO business, and maybe for the business subject to 2001 VBT, should not be the 2001 VBT as a stand-alone table. Maybe there's a need to make some adjustments to that, trying to reconcile the issues with the homogeneity of the business underlying the table and the actual business that you're applying the table to. I think this is a complicated question, not a question that just could be answered with a simple "yes" or "no" based on the result.

MR. GIBSON: When you look at the actuarial standard of practice, it requires the actuary to change the X factor if he or she believes a new table represents relevant emerging experience. My sense is that most companies don't view the 2001 VBT as representing relevant emerging experience, and that the relevant emerging experience had been published before and is the experience that underlies the 2001 VBT. I think that's a reasonable justification for proceeding, whether it's to increase or decrease or maintain your X factors, and to ignore the 2001 VBT if you're so inclined. Changing the X factors is a substantial exercise and shouldn't be undertaken lightly, and my sense is that most companies will not change X factors based upon the 2001 VBT.

MS. RATAJCZAK: Question three is, "Let's say you were at a privately held or a non-stock company that doesn't do GAAP currently. Sales have been very flat or declining over the last several years. There are plans to start growing again. Management has asked for a simple GAAP-like reporting method in order to show the profitability of the new production that statutory accounting may hide. What would be the best way to proceed on this request without having to increase or overtax the small actuarial and accounting staff?" Brad?

MR. SMITH: I'm not sure that there's a simple GAAP-like reporting mechanism that you can implement very easily. But it does seem to me that the underlying question that this management is asking is how to reflect the value added of this year's production. It seems to me that the use of cash-flow testing, typically done on a profits-retained basis, could be easily turned into a profits-released type of analysis where you can, quite frankly, easily create an actuarial appraisal or a value-added type of analysis from year to year leveraging work that you've already performed. My first recommendation would be to say let's look at the cash-flow testing. Let's make sure the cash-flow testing is realistic, realizing that we might need to change some assumptions, because some assumptions in cash-flow testing were overly conservative. Let's do that and try to create a value-added type of reporting mechanism to see if that satisfies management and give management the insight they desire.

UNIDENTIFIED SPEAKER: I have a couple of different responses to this question. First of all, the question part is talking about how to get management to focus on the value added by new business. One potential approach, rather than go with a GAAP-like method, would be to take more of an embedded-value approach and look at the value of new business, not unlike how a European insurer would look at it. But with regard to GAAP, the concept of GAAP "lite," if you will, has recently been brought up more and more, at least among companies that are not GAAP-compliant. It does depend on the type of business. For Financial Accounting Standard (FAS) 60 business, one option is to generate unit factors, which would be a fairly small up-front investment, and then have a database to produce GAAP reserves and deferred acquisition cost (DAC). We're certainly aware of a number of companies that use an approach like this, which would work fine as long as there's not a loss recognition event. For FAS 97 business, it's much more complicated, but you could project the existing business every period and have a spreadsheet for DAC and the unearned revenue liability with fairly simple factor assumptions. That's not going to work well for anything that has a FAS 133 or an SOP 03-01 reserve effect, but if the company is not trying to actually represent the results as GAAP, but just show "GAAP-like," which is how the question is worded, I still think that's an option.

The largest areas of change when you compare statutory to GAAP are related to the timing of the profits, and the types and nature of the new products are going to have an impact on that. One important issue is the deferrable acquisition cost deferral. You can come up with factors that are comparable to what other companies have used by talking to people that have worked with other companies. Estimated deferability percentages for DAC and other factors along those lines can be used. It's certainly very important to anybody that takes this kind of approach to try to drive home with management to do GAAP on a more complete basis. It's much more thorough and certainly could yield a materially different answer.

MS. RATAJCZAK: This is question four. "Consider cash-flow testing for my existing business. Due to the nature of my products, I have tax book losses for all later years. Can I use this negative income tax as an increase to my surplus?" Larry?

MR. GORSKI: I'm going to put on my former regulator hat and, recognizing I'm not an expert in taxes by any means, I'm going to offer a tentative answer, which is "no." But I'm couching this as a tentative answer, one that maybe with some discussion and better understanding of the issue, I could be persuaded to change to "yes." The issues I would discuss with a company who comes to me as a former regulator would be surrounding what drives the realization of the tax losses in the future. Is it business that is being aggregated with a business that's generating the tax losses for purposes of cash-flow testing? If it is and everything's being modeled in a consistent manner, then maybe I can be persuaded to change my "no" to a "yes." If it is business that's being produced in the future, then my answer would stay "no." I'd want to understand more thoroughly what the driver for realization of the tax losses is.

Secondly, and again this is really out of my realm, I know there's been some changes to statutory accounting and now there is a deferred tax asset. If somehow you're going to bring into your cash-flow testing realization of tax losses, it would seem like you would have to allocate a portion of that deferred tax asset to your block of business being tested, which would mean you would have to eliminate other assets from what's being allocated to that block of business. So I would want to understand and explore that issue also. Since I know I'm out of my realm when I talk about taxes, maybe I haven't made any sense at all. A simple argument could convince me that my "no" should be changed to a "yes," so I'm willing to hear other viewpoints on this one.

MR. SMITH: I generally agree, but I'm not sure I would start with a "no." I would start with "it depends." It depends on, as Larry pointed out, whether you have any reasonable expectation of utilizing the tax losses. When we're doing cash-flow testing and generating positive tax, our analysis assumes that positive tax is being paid, even though, for instance, we might have a large new business function that's generating tax losses. If you automatically would answer this question "no," that you can't use the losses generated, it seems to me that you would expect to be able to use the losses generated from new business loss at the existing business. The real question that it comes down to is whether you have a reasonable expectation of getting a refund from the IRS. In other words, are you going to be able to utilize these tax losses? There's lots of source for that. There are profits down the line from other business, there are profits from new business that's going to be generated, there is interest income on capital and surplus, there is the release of the DAC tax asset and so forth. It requires a substantial amount of analysis. If you go in with the idea that the answer is "no," very few company managements are going to just throw away a tax loss carry-forward or tax losses. It's a valuable asset, and you have to be very careful to not come across as overly conservative here, but realistic, and address if there is a realistic opportunity to utilize those tax losses.

MR. GIBSON: I'll just make one minor supplement to what has been said, which is that, in addition to all the things Brad mentioned to get a more complete view of the taxes across the enterprise, very few companies actually cash-flow test all of their existing liabilities. For the businesses that you are not cash-flow testing, you need to look at whether those create income or further losses. The complex thing about this is that you need to realistically look at the taxes on an enterprise-wide basis.

MR. GORSKI: I have a follow-up. Part of the reason I said "no" is that asset adequacy analysis is defined to be testing of certain blocks of business, no new production. It's a very limited test, as opposed to a more comprehensive test of a company's in-force business and new business in its entirety. I liken this discussion to some of the discussions that have taken place with respect to recognition of revenue sharing income in C3 Phase II. It's very clear in the guidance for revenue for C3 Phase II risk-based capital (RBC), at least, and for reserves that you're attempting to model not only the cash flows of the product and the cash flows of supporting assets, but a much more comprehensive view of the business. What's being suggested here is a much more comprehensive modeling of the business, which I don't believe was the purpose or intention of asset adequacy analysis. That differentiation between modeling the business in its entirety versus asset adequacy analysis testing of reserves was sort of the driver of my tentative "no."

MS. RATAJCZAK: Question five: "We introduced P-GAAP a few years ago. We've been using rough models and approximations. There are about 20 blocks of business. Recently, we received the resources to build the exact models. This would be a 15-month project. Must I get beat up every quarter by running through the changes on the blocks we completed? Or can I wait until the end when all 20 blocks are done and just run through one change number?" Jack?

MR. GIBSON: This question quite frankly raises a lot of questions in my mind. The answer is "it depends," and I'll explain why. The first and most important issue is to clearly understand the nature of the prior models and assumptions and what the basis is for the view that those models are inadequate. It's important not to over-model, as many of the power blocks may no longer be that significant. So you certainly have to look at the significance. The level of change, of course, is going to depend on the level of approximations used in the past and the size of the block. Clearly, if a material difference in results is indicated, either in level of equity, the period of earnings, goodwill, etc., that needs to be reflected as soon as you can determine that that's the case.

What I would recommend here is first try to determine on an approximate basis the likely degree of the problem. If possible, separate these 20 blocks into at least two categories and try to identify the blocks that could likely have a material impact and deal with those together and try to do those as quickly as you can. To the extent that this is somebody who isn't just doing GAAP for internal purposes, but is publicly reporting, of course the market does need to be informed quickly if a profit change is going to be material. You really can't be in a position to say that you're going to go ahead and wait until the end of the 15 months and aggregate all these together if you're able to determine more quickly that you do have some material issues. That's partly why I was saying that if somebody could try to do the two or three largest ones together, and try to do those in the same quarter, you have a little more flexibility about how you deal with that new information.

MR. GIBSON: I think it depends on whether the business is FAS 60 business or FAS 97 business. If it's FAS 60 business, which is subject to lock-in constrained only by loss recognition, you're going to have a very difficult time explaining any severe discontinuities or pre-conversion versus post-conversion, so you should keep that in mind. FAS 97 business clearly is continuously unlocking retrospectively and prospectively. Quite frankly, the one piece of advice I would have with respect to this situation is that you need to have a serious conversation ahead of time with your auditors to make sure that they understand the situation and the limits to your ability to convert instantaneously. You should help them understand the detail, and you should understand what they're comfortable with before you proceed on a track that may or may not create problems with them.

MR. SMITH: Of course, none of us are currently with accounting firms. I was once with an accounting firm. The other thing that wasn't asked, but is an important subcategory, is that the determination will need to be made as to whether the changes that are being reflected here are corrections of an error or whether they're refinements or improvements in your estimates. You deal with those differently. In addition to just looking at materiality, you are going to need to make an assessment. It's certainly possible when you go in and replace a highly approximate technique with a more refined technique that you may, in fact, find things that are just blatant errors that you didn't catch because you were using such an approximate technique. To the extent that that's true, that is going to need to be dealt with in a different way.

FROM THE FLOOR: I agree with everything that was said by all three panelists, but I think there are some other things that need to be considered. It would depend on just how rough the old model was. Even on FAS 60 business, many companies adjust for the difference between expected premium in force that was used to determine the value of business in force and actual premium in force now. There are some companies who may have had a static schedule. Certainly that adjustment needs to be taken into account and looked at that way. If you talk about a few years ago, that initial balance of value business in force is locked in. It's the assumptions on how you amortize that that need to be looked at. Again, if you had a static amortization schedule, a dynamic amortization schedule, or made some adjustments, all those are relevant. The other thing I wanted to bring up was FAS 141 and 142. That would need to be looked at in terms of whether, after all these adjustments, goodwill is recoverable.

MS. RATAJCZAK: Question six: "I'm doing loss recognition on a block of business. Has there been any evolution of consideration for what constitutes a block of business? Can I look at just one block alone? Alternatively, must I consider other blocks with it?" Jack?

MR. GORSKI: I'm not aware of any changes in the level of loss recognition testing. Some of the buzzwords are "Your grouping needs to be in a manner consistent with the acquiring, servicing and measuring the profitability." The short answer is that one can't consider other blocks if it's clear that the business is managed together, for example, if you're adding whole life and term that are sold on the same distribution channel. It's very much aligned with how management looks at profitability and looks at its own analysis. Therefore, the company may select a single block of business, but there must be some basis for the decision—if it's a single block or something that distinguishes it—and a reasonably consistent approach across the company.

MR. GIBSON: I agree with that. There's a large variation in the implementation of the definition of what a block is with respect to loss recognition. I've seen the definition of life insurance, annuity and health as being one line. Essentially, it's separating new business for that particular year and subjecting that to a recoverability analysis, versus all the existing business being a block of business as an extreme for life insurance or annuity or individual accident and health (A&H). Typically, in FAS 60 business, a lot of people would separate old GAAP eras, if you will, and say that that represented a block of business. Essentially, the definition of GAAP era assumptions represented what, in effect, was a block of business subject to loss recognition analysis. I've seen that definition extrapolated for FAS 97 business, where essentially because the amortization interest rate or the credited rate typically stays the same for a year, in fact FAS 97 business issued in any given calendar year is considered a block of business subject to loss recognition because it is considered a separate GAAP era. I think you have a lot of leeway. My sense is you'll get push-back if in fact you clearly have something that could fall under the definition and is clearly generating GAAP losses continuously, that is, would be unrecoverable in such an analysis if you tried to lump it in with a larger block of business. I think you'll get push-back from your auditors. Quite frankly, my sense is that you're much better off addressing such benign problems earlier rather than later, because benign problems grow and become less benign as time goes on and are more difficult to address. I would encourage you to not aggressively try to hide loss recognition issues within larger blocks of business, but go ahead and address them as you identify them.

MR. SMITH: I think we're entering a new era, the post Eliot Spitzer era maybe, where there is more transparency of the result and you have to have a very strong justification for doing what you're doing. The underlying environment in which I think we will operate for the rest of our careers needs to dictate our approach to a lot of these questions.

MS. RATAJCZAK: Question seven is, "On my P-GAAP balance sheet, as another intangible asset, we hold the present value of 10 years of profits on future business written by existing agents and are comfortable with that. But we also hold the value of state licenses at $50,000 a state. If I already have the present value of profits on future issues as an asset, isn't this double counting?" Brad?

MR. SMITH: It's an interesting question from a number of standpoints. Clearly, you need the state license to generate the business, so the fact that you're looking at the value of the business as supporting your goodwill asset, it would imply that in fact you are double counting that value. But, quite frankly, I'm not sure I understand the question, because essentially you established a purchase GAAP balance sheet at the time of the acquisition, and goodwill was the balancing item that made the balance sheet balance. A couple years ago, FAS 141 and 142 were adopted by the Financial Accounting Standards Board. It requires an analysis, as Bud had said earlier, of the recoverability of goodwill. So the concept of holding an asset equal to $50,000 per state plus the 10 years of new business doesn't ring as relevant to me. The reality is you have an asset on your balance sheet, and each year you need to perform a loss recognition test on that asset. It either passes the loss recognition test, at which point you don't write it down, or it doesn't pass the loss recognition test, at which point you do write it down. I'm not sure that my definition of passing the loss recognition test would be $50,000 per state plus the value of 10 years of new business—it's probably beyond the scope of the question as to what you would define it as—but it strikes me that you would define it as some measure of the present value of profits to be generated in future business, whether that's five, 10, 15 or 20 or even more. That would define either loss recognition or not with respect to the asset that you establish at the time of the acquisition.

MR. GIBSON: I agree that you could argue that perhaps the licensed value should be deducted from the value of new business. But one issue there is that the value of the state licenses has an indefinite life, and for the new business you're looking at 10 years of new sales. One potential way to think of this is that the value of the state licenses is in part dealing with the ongoing value that goes beyond the 10-year period and also would exist even if you were not selling any new business currently.

MS. RATAJCZAK: Question eight: "I have a large block of term business. It was level term converting to increasing premium whole life. There's huge lapse assumption: 80 percent at the end of the level period. A lot more people are staying around, and for those that did lapse, it takes a quarter to get them off the administrative system. My reserves, benefit, maintenance and DAC are skyrocketing at this point. How are other companies dealing with this?" Jack?

MR. GIBSON: We have seen a fair number of cases where companies will hold GAAP reserves equal to statutory after the level term period. It obviously is very difficult to accurately estimate the percentage that convert. We've seen people who look to amortize the DAC over the original level term period. But that being said, I found the question to be a little bit surprising. I think you have to get at an understanding of why the reserve change is large. If there's a large change in premium, that arguably should pick up the change in the reserves, so it does call into question to perhaps reconsider the GAAP valuation assumptions and premiums to have a better understanding of why the reserve is so large. Unfortunately, that implies that because of this the loss could impact the entire block, not just the conversions. It could be cause for a reassessment of the entire block, but I think you have to get deeper into what's causing that.

MR. GORSKI: I think this is a very interesting question, because it goes to what I talked about before regarding converging the pricing function and the valuation function. This is going to be a real problem. For instance, if you take a 20-year level term product and turn to annual renewable term (ART), very expensive ART after the 20-year level term, which is essentially the product I think this individual is talking about, we're finding that a lot of this business is being held by trusts, and the trusts are not going to lapse it. Even though it was reasonable at the time and at the pricing function to assume that it's going to lapse, it's not lapsing. That's probably good news from a pricing standpoint, because if a lot of the business doesn't lapse, you don't have nearly the antiselection you assumed at pricing, and it's probably quite profitable business for you from that point on.

From a technical standpoint, it seems to me that DAC is a separate issue. If you have a big increase in DAC you're going to have to deal with it. If it's a totally a function of the mechanics of DAC factors, you're going to have a hard time justifying that. In reality, as far as the benefit and maintenance expense reserve goes, if in fact you have a lot of people staying and they are on your administration system, it strikes me that you have an offsetting due premium on your balance sheet and you have the reserve. As long as you have the offsetting due premium and the reserve, the balance sheet impact might be quite volatile, but the income statement and the surplus impact will not be nearly as volatile. So you have to make sure that you have consistent handling with respect to these lapses. If in fact you're holding the reserve, but you're not holding the due premium, the result is going to be very volatile.

MR. GIBSON: I do appreciate the theoretical aspect of this. However, in a former life, we found that there was actually a bug in the administrative system that was causing this kind of a problem, so I'd encourage whoever asked this question to make sure that the program is doing what you think it's doing.

MS. RATAJCZAK: Here is question nine. "I'm curious what the conventional wisdom is these days regarding differences in claim reserves between statutory and GAAP." Jack?

MR. GIBSON: I don't have a strong view on this. We aren't quite sure what category of claim reserves is being discussed here, but from my experience I often do see GAAP and statutory being the same on a claim reserve, at least for certain types of business.

MR. GORSKI: The question becomes relevant when you're talking about long-tail-type business, such as long-term care and disability income (DI). For the most part, companies that are deep in DI or long-term care are typically using internally generated tables for both statutory and GAAP, so that the morbidity assumption between the two is quite often very consistent. The difference comes in primarily with respect to the interest rate. The interest rate for statutory is going to be defined as a maximum interest rate, and the interest rate for GAAP should be reflective of what would be a reasonable FAS 60 type assumption at the time of issue.

FROM THE FLOOR: I'll give my perspective on this from the point of view that the question is referring to medical health insurance and shorter term business, because I think that's where I see this question arising. Let me first refer you to an excellent paper on this at the Academy Web site, which will give you more specific wording on statutory, GAAP and best estimate assumptions, much more than I could do in just a minute or so. The issue here is that statutory has to be adequate under moderately adverse circumstances. GAAP theoretically has to be best estimate. There also has been, on the GAAP side, an increased emphasis on the balance sheet. For example, a number of years ago it might have been okay if you had a substantial margin at the end of the prior year and also had an overly substantial margin at the end of the current year. You were consistent between years; it didn't affect income. There's much more emphasis now on looking at the balance sheet liability.

I hate to make generalizations, but I think that it is true that most public accounting firms are looking at the margin in your reserves a bit more closely. I've heard anecdotally that some have reduced the level of the acceptable margin that they will sign off on for GAAP. My own personal point of view is that I feel much better when I see the statutory and the GAAP number the same. I am a bit concerned when the margin gets to be completely unrealistic in relation to the risk of being overstated or understated. I will say that I've heard very little attempt to come up with a difference between statutory and GAAP reserves, especially in recent years. In prior years, certain companies rarely would try to make a difference in terms of whether certain claim settlement expenses were or were not required on one basis or another.

MR. GIBSON: Those are excellent points and relate to the environment that we're working in, this kind of post Eliot Spitzer era. I think some companies use, in particular, short-term-type claim reserves as an earnings management tool, deferring earnings until later or accelerating earnings. I don't think that type of earnings management is acceptable. Consistency of methodology and transparency of results with respect to setting the claim reserves and all of reserves is going to be of paramount importance going forward.

MR. GORSKI: I want to bring together a comment Jack made on the first question and the comment you made just now by Bud. When Jack was addressing the first question, he pointed out the need for the valuation actuary to be more knowledgeable about what's being done in other elements of the company. Further, there appears to be a difference in the basic rules for computing GAAP claim reserves or statutory claim reserves, an element of conservatism, and Bud was suggesting that you feel more comfortable when they're both the same. Again, I'll put on a regulatory hat. I think regulators are starting to look beyond simply statutory accounting requirements and reserving requirements to gain comfort with the numbers that appear in a statutory statement. Putting all that together, let's just say that the recommendation coming for you would be for the same values for GAAP versus statutory. If I were a regulator, I would say maybe the statutory numbers are under-reserved, because there should be an element of conservatism there. So I think there may be a danger in providing numbers that are the same when the basis for the two numbers are at least conceptually different, because I think regulators are going to start looking at that to gain comfort on the regulatory side.

MR. SMITH: There's also the element of communication. I felt, when doing a certification last year, that the margin was so substantial and I was a valuation actuary on a statutory basis, I had no problem if the reserves were good and sufficient. But the margin was so overly substantial in my opinion that I felt I had to make a statement, and that was consistent with my role as a valuation actuary for statutory. I also suggested to the company that this was very likely to come under increased scrutiny if they used the same number for GAAP. If I could find the reserves good and sufficient, but have a comment that there was substantial margin, it was going to come under increased scrutiny on a GAAP order.

MR. GIBSON: I'd like to make one other point, because I think this is an excellent discussion. You have to recognize that over the last 10 years there have been a lot more requirements placed on companies with respect to their certifications and projections. In fact, if you go into a company you'll typically find a FAS 97 projection system, essentially a FAS 97 accounting system, that's supposed to represent retrospective actual and prospective best estimate. You'll have a projection of the existing in force for your cash-flow testing or valuation actuary opinion. You may have a loss recognition analysis. You have an illustration actuary projection done by the illustration actuary, passing the illustration actuary test, the lapse support and the self support tests. You'll typically have pricing projections. You may have an actuarial appraisal done. You may have done embedded value.

So you have all of these analyses. A lot of times when we're brought in we ask them to do a projection. The discontinuity between the assumption used in each is palpable. You have five different projections projecting the same blocks of business all using best estimate assumptions that are different. I think that's going to be a problem for companies going forward. Again, it goes to the merging in my mind of all of the actuarial functions, as opposed to strictly thinking of ourselves as valuation actuaries or pricing actuaries or illustration actuaries or corporate actuaries. I don't know where that discontinuity is going to rear its ugly head. I've seen a couple instances where it has, but I think it has the potential in this litigious and highly scrutinized regulatory environment to be problematic for the actuary and for the company.

MR. GORSKI: After 15 years, Brad and I finally agree on something. I think it is a problem and I'm glad that you took that perspective. From a regulatory perspective, it's only now with the advent of C3 Phase II and maybe X factor analysis that regulators are looking outside the regulatory books and records and looking at analyses done of a similar task in different methodologies for different purposes and beginning to recognize that there are differences and trying to understand the rationale, if any, for those differences and use those differences to maybe argue for increased regulatory statutory reserves.

MS. RATAJCZAK: Question 10: "In calculating the amount of the investment earnings portion of gross margins on an indexed annuity for the purpose of DAC amortization, is it best to apply an earned rate to the total account value or the value of the whole contract?" Brad?

MR. SMITH: It's hard to say until you understand the exact circumstance. This is clearly an extrapolation of the concepts of FAS 97 and an interpretation on my part, but it strikes me that the FAS 97 is expecting you to show as an income item the difference between interest on the entire reserve and interest credited on the entire reserve.

MS. RATAJCZAK: Those were the 10 questions submitted in advance. I'm going to open the floor for further questions.

FROM THE FLOOR: I want to make some additional observations on question number two regarding the X factors under the 1980 CSO and the 2001 CSO. Some of you may remember I had a slight responsibility for the X factor. There are sizable differences, and I think you really have two issues here. When we developed the 1980 CSO 19-year select table, the regulators at that time were very concerned about the older age. There's actually a serious discontinuity at age 70 in this table. That serious discontinuity does not exist when you write business on the 2001 CSO, because it's basically applied directly to the select table under the 2001 CSO. That being said, there will be advantages at higher age factors. Remember when we set the X factor, there was a requirement that it cannot go down by duration, so you still have to do the present value.

A separate issue relating to this is the actuary, on each anniversary, has to re-establish his X factors. There's no concept in either the 1980 CSO business or the 2001 CSO business. You can set an X factor at issue and walk away from it and not validate it against your actual then-current view of your pricing mortality for that block. Now, why am I raising this? The 75/80 mortality table has two distinct differences from the 2001 VBT. It's my personal belief that as people study these two tables, maybe neither one is totally appropriate, but the 2001 VBT at the higher ages appears to be a more appropriate pricing basis for gradation of your actual experience in the 75/80. The 75/80 really was only priced and designed to age 72 and had an artificial extension after that. The other issue is that the 75/80 extension, even though it's artificial, ends at age 100. If you then basically study your pricing mortality and change your basis and look at your higher age mortality, you then have a pricing basis that you have to look at. Regardless of what that is, at each anniversary, if you've changed your opinion about later duration mortality, you're obligated to go back to the calculation of the X factor on each block of business, look that it passes the test on the first five durations, and look that it passes the test on the present value basis. If, because you changed your view of what experience mortality is, that results in a change in your X factors on all blocks, you have to make it. It really is not a question of the 2001 CSO; it's a question that you've changed your view on future mortality. Because there's the discontinuity in the 1980 CSO, in general after age 70 there's unusual conservatism, which will moderate any effect that occurs because you've changed your view. But it's the view change of what your pricing mortality or experience mortality is that should be governing your X factor on the 1980 CSO, and not simply that there's the 2001 CSO coming along.

MR. DANIEL J. McCARTHY: I want to offer a comment on question one that was prompted by something Larry said. I started thinking about regular total review of asset adequacy testing. Right now, even though I've been the appointed actuary for a company in a state that is known for stringent regulatory review, in the end, for companies that have substantial blocks of in force business, it really hasn't mattered very much because, as Larry pointed out, you have a floor. Mostly, the discussion has been how much margin you have above the floor. It doesn't change the fact that the reserves are the reserves on your books. When you go to principle-based with no floor, the question of differences of opinion between the valuation actuary and the regulatory reviewer are going to matter a lot more. There are going to be questions of materiality that we really haven't begun to think about until now. It's going to raise the question for the profession, the people who are appointed actuaries or regulatory reviewers, as to exactly how big a difference will matter in terms of requirements, for example, that a company restate its reserves because the regulator doesn't like the view of the reserve setting. So it's going to take what up until now it has been largely a theoretical discussion and make it a very practical discussion where we don't have a lot of experience.

FROM THE FLOOR: This is sort of an extension of Dan's question, and it also relates to question number one. Up until now, the wording of the opinion has been essentially prescribed by regulators. There are many, including myself, who believe that is an inappropriate approach, because it is the opinion of the actuary and the actuary should have significant ability to revise the wording of the opinion that fits the circumstances, although I can see the purpose of a prescription. But going forward under a principle-based system, how do you envision the opinion wording should change? Where should it change? Maybe you can extend your discussion a little bit on the memorandum itself.

MR. GORSKI: Just like with the opinion language for asset adequacy analysis, I suspect the American Academy of Actuaries will have a lot of input with regulators as to what an opinion should look like under a principle-based approach. I don't think new language is going to pop out of a hat somewhere without the Academy probably owning that hat and helping what comes popping out of it. I think there will be language changes and, with the memorandum, I suspect the same thing's going to happen. When you look at the C3 Phase II report, there's an extensive discussion of required discussion of the memorandum, but there's an underlying principle that the actuary really has to disclose anything and everything either in the memorandum or in support of the memorandum. The exact wording is still something that's going to be worked out, since we don't really know exactly the structure of principle-based approach. It's premature to talk about specific language, but nonetheless, the language will change.

MR. GIBSON: There's an underlying theme to the last two comments from the floor. Right now, our opinion is to make good the reserves in light of the assets, and make good and sufficient provision. Under a principle-based approach—and many of you may disagree with me—I'm not sure that it should be an actuarial judgment as to what level within that probability distribution of results the reserve should be, and also as a supplementary question, what the surplus should be. Certainly actuaries have a lot to say and can add a lot of insight as to where that number should be set, but personally I think that that's a societal question. It's a question with respect to at what level society wants its financial institutions reserved and at what level it wants them capitalized. With 80 people in a room, I don't think we should make 80 separate judgments with respect to what is, in fact, a societal question. We need as a profession to demand that that level is whatever level on the probability distribution is defined by society through regulation. Then the opinion degenerates into an opinion with respect to the reserves meeting that level.

MR. SMITH: It does make sense and there probably will be certain portions of the opinion that will be prescribed, at least in terms of what it takes to constitute a clean opinion and what's being asked of the valuation actuary to put forth that opinion. But it seems clear to me that there's going to need to be quite a bit of disclosure around the distribution of results. There's so much focus on looking at the stochastic results and what percentile and what's the likelihood. But maybe more importantly, this opinion should have a clear discussion or disclosure about those areas that were subject to actuarial judgment and about where the degree of uncertainty is, and have some degree of stress testing around those items that are subject to judgment, so that the reader, whether it be the regulator or others, can develop their own view on that kind of sensitivity and the conclusions to those items.

MR. GORSKI: Brad makes a very good comment. I'm glad he brought that up about a benchmark, the benchmark not being an SOA-determined benchmark or an Academy-determined benchmark, but a societal or regulatory benchmark. That's exactly what took place with C3 Phase II. The Academy never recommended that be it at 90 conditional tail expectation (CTE) or at a 95th percentile or what have you. The Academy recommendation was that whatever is chosen should be consistent with what the regulators had already chosen for the risk-based capital target, which had been about 90 or 95th percentile. Going to CTE was a big switch, but 90 CTE and 95th percentile maybe are roughly equivalent based on the distribution of results. I think your point is that's not a professional judgment, but a regulatory judgment speaking for society.

FROM THE FLOOR: This is sort of a follow-up to the comment that Dan McCarthy made, having to do with materiality. When we examine a company, we normally set our materiality level at 5 percent surplus, and from that then follows what we call a "tolerable error" at 2.5 percent. If we're looking at any particular line item on examination, intolerable error level is going to be 2.5 percent of surplus, and that then governs how deeply we get into examining that line item. I recently had occasion to examine a company and, as part of the examination, I reviewed the Actuarial Opinion and Memorandum (AOM). There was a segment of their reserves that basically comprised less than 4 percent of their total reserve liability; it was probably about 3.5 percent. It was labeled "immaterial," and it was not subjected to cash-flow testing. They also didn't address it in terms of immunity or covered by margins. The only thing that they had on the grid of liabilities was IMM. Even though it was only about 3 to 3.5 percent of reserves, it turned out to be in excess of 100 percent of their capital and surplus, and so I slapped their wrists. I'd like to ask what you guys think should be an appropriate level of materiality?

MR. SMITH: It's an excellent question, because we've seen a number of companies over the last 10 years experience substantial setbacks because of what they would consider minor lines of business. It may be workers' comp reinsurance that leaked into their balance sheet. On the casualty side, we're seeing a number of companies that have done finite reinsurance, which has been a small part of their business but has now turned into a massive headache. It represents a challenge for anybody looking at a company. We do a lot of work with stock analysts. Clearly, their focus is on the major lines of business, but they all want to know if there are any black holes in the company. I think your question is whether a small balance sheet item could represent a large black hole for the company. None of us could give you a numeric recipe for how you identify those. It's strictly diving into the operations of the company on a very detailed basis that allows you to identify them. The auditing firms are struggling with this. Five years ago, there was tremendous pressure on fees and, therefore, pressure to do less and pressure to focus on only the big things. In this day and age, we have very complicated balance sheets and minor lines of business that can cause large problems. So I don't think there's any easy answer to the question of materiality or how we're going to avoid these black holes. My sense is that CEOs across America are recognizing this and divesting minor lines of business that have no potential at all to add substantially to the bottom line, but could in their worst fears create a black hole negative. But I'm afraid that there's no easy answer.

MR. GIBSON: I don't have anything absolute either. Clearly, you can't just have a materiality that looks at surplus, because the surplus can vary quite a bit company to company. Some companies are fairly light on surplus; some would be very surplus rich, and I don't think the definition of materiality should be unduly focused on that. But I was intrigued by the terminology and the reference to a "tolerable error." Like Brad, the place where I have the biggest concern is if the balance sheet item itself is used to determine whether it meets a materiality threshold or not. It's a preferred method to challenge the company to identify the plausible swing in value. Obviously, in certain cases it could be multiples of the current balance sheet reserve entry. We can even take recent examples where, in the early stages of variable annuities, people are taking certain risks and just accumulating fees and holding that as a reserve that obviously in a number of cases proved to be many multiples of error; the actual reserve was multiple times what was being held. You can also look at long-term care, where some of the assumptions prove to be really quite off in terms of how some people originally approach things and how they now see things. I think that you do need to go beyond just looking at the balances themselves and do stress testing or some other technique to come up with the degree of potential volatility or potential error around the existing calculation.

MR. GORSKI: There's probably very little I can add except to agree with both presenters. As a former regulator, it's very difficult for me to say that anything is immaterial. Whenever I jump into a situation, unless it's a product that has a long, long track history and you know in your gut that it really is immaterial, to me everything is material. I can spend a lot of time looking at mapping of accounts to indices to make sure that a mapping function for C3 Phase II purposes makes sense, because I think it is important. It may be more important tomorrow than it is today, but at some point in time it's going to be important. I don't work under the belief that something is immaterial just because it's small today. I have to really have a much more in-depth understanding of the item to be able to say that it really is immaterial and I won't spend any time looking at it.

FROM THE FLOOR: As we move from formulaic reserve methodology to principle-based, do you see us moving away from asset adequacy analysis to some other form of analysis of the reserves? Or are asset adequacy analysis and cash flow testing still going to be part of our function?

MR. GORSKI: I suspect that whatever comes out of a principle-based approach will, in some sense, bring in the asset adequacy analysis cash flow testing mechanism. But rather than being a test of adequacy, it's going to be the setting of those reserves. It's going to be the instrument for making that point estimate, so it's going to take on more importance within a different structure.

MR. ROBERT J. HONKOMP: I have a question totally off of any of the subjects we've been dealing with so far. It's a practical question. Our company is trying to do some asset/liability management (ALM) work in the area of duration matching between assets and liabilities. I would like to get some insight into what companies are doing for some practical considerations of calculating duration of liabilities. We've looked at it from two standpoints, and we get quite different answers. One is present value of cash flows. If that's what companies are using, I'd be interested in what's in those cash flows, what discount rate is being used, things like that. We've also looked at it from the direction of gross premium valuations, considering the market value of our liabilities and what's needed to mature the block in the future. We've shifted the yield rate up and down 1 percent and calculated a gross premium valuation accordingly. We've looked at it from the standpoint of reserves minus the present value of distributable earnings to get our gross premium valuation. We get quite different answers, so I'm looking for some insight on what companies are doing.

MR. GIBSON: I think that people do tend to look for effective duration. My experience is that generally market value liability would be a present value of the benefit cash flows based on best estimate assumptions and including assumptions for future premiums, withdrawals, etc. It there is a question about whether you use cash outflows with future premiums excluded or not, our experience is that for products where that is a strong anticipation that would be included, but for other products they may well be excluded. So it really depends on the product involved.

MR. SMITH: I agree. I think you should focus, when you're doing these calculations, on the cash flows as opposed to anything that would involve book profits or interest on book profits. There was a question submitted that talked about looking at duration by making 100 basis point changes in the interest rate curve. You have to be very careful, depending on the line of business, with respect to the convexity that 100 basis point shifts could essentially result in a change in duration. So I tend to think that when you're doing these calculations you should probably look at 5 or 10 basis point shifts in either direction in order to minimize that aspect of your analysis.

MR. GORSKI: The question seems to be stemming simply from an analysis of the liability side of ALM. It seems to me the question should not be viewed in a vacuum, but viewed in conjunction as to the methodology being used for determining duration measures of the asset side. It probably should be addressed within the context of your investment strategy for supporting a particular product. The investment people, the liability people and any ALM committee should agree as to what the best measures are for both the asset side and liability side, and then become the tool for managing that business and then retrospectively looking at whether that business really is being managed in that fashion. Maybe the question is putting the cart before the horse or getting things out of sequence. To me, it's a more fundamental question that only can be answered from both sides of the issue.

MR. SMITH: Part of the question had to do with the choice of discount rate. There's a wide range of practice with regard to discount rates, but I think there's a move toward using a risk-free curve plus a corporate spread. The spread could be something like a spread of a company's debt, but slightly lower since this is insurance company liability, not debt.

MS. RATAJCZAK: We've just about run out of time. I want to thank our three experts for preparing and enlightening us.