④ THE FINANCIAL REPORTER

NEWSLETTER OF THE LIFE INSURANCE COMPANY FINANCIAL REPORTING SECTION

NUMBER 44 DECEMBER 2000

Letter From The Editor

by Thomas Nace

This issue of the newsletter comes at the heels of the just completed Annual Meeting in Chicago. This event is important for the Financial Reporting Section and its Council in that it marks the end of a term for some council members, while for others it marks the beginning of a new term.

One of the members whose position on the Council has come to an end is Council Chair Mike McLaughlin. The new Chair for the upcoming year is Mike Eckman. It seems that since the last three newsletter editors have had the same first name (Tom), the Section feels that it must keep up this tradition when choosing the new Section Chair.

I would like to personally take this opportunity to thank Mike McLaughlin for the leadership he has provided to our Section over the last year. In particular, he has been a great supporter of the newsletter and has helped me in many ways. I believe he has been a great asset to our Section.

At the same time, I congratulate Mike Eckman in his new role as Section Chair. Mike will be addressing the Section through the newsletter in our next issue.

New members to the Section Council are Ted Kitsos and Clark Manning. In addition, a current member has been re-elected for a new three-year term, John Bevacqua. Congratulations to them as well.

Deborra Poorman will be assuming a newly-created position associated with the Council related to Web site Communications. In the next issue of the newsletter, we plan on having an article from Deborra describing the focus and objectives of this position.

With the ever-growing use of Internet communications as well as communications via the newsletter, it will serve our Section well to coordinate all Section communications and determine a proactive strategy with respect to Web site communications. Good luck to Deborra!

(continued on page 2, column 1)

Determining the Value of Business Acquired

With Some Fair Value of Liabilities Considerations

by Jim B. Milholland

Accountants and actuaries have long known that the purchase of a life insurance company or block of long duration life insurance contracts requires recognition of an intangible asset representing the value of the business acquired (VOBA). VOBA is an intangible asset similar to deferred acquisition cost (DAC) and is amortized by the same methods as DAC. VOBA goes by many names: present value of future profits (PVFP), value of life insurance in force (VIF), cost of insurance purchased (CIP), among others.

In the case of a purchase of a block of business with no accompanying infrastructure or distribution, that is, when it is apparent there is no Goodwill, the VOBA "falls out" of the accounting for the acquired tangible assets (investments) and the assumed liabilities (reserves). VOBA is the deferred cost of the contracts as measured under GAAP accounting, namely, the excess of the fair value of the reserves over the fair value of the investments, bringing into the calculation any related tax accruals.

In the case of a purchase of a company or a transaction involving not only existing contracts but also infrastructure or new business capacity, the purchase price typically reflects some consideration for the infrastructure. In this situation the VOBA is not apparent. It does not "fall out," but must be determined through a purchase price allocation, and there is the possibility of some Goodwill. Goodwill is the excess of the purchase price over the net assets acquired, where the net assets include VOBA.

When there is the possibility of Goodwill, VOBA must be calculated. It should be kept in mind that VOBA is not a financial instrument and that it cannot

(continued on page 3, column 1)

In this Issue

Editor's Notes
by Thomas Nace...1

Determining the Value of Business Acquired With Some Fair Value of Liabilities Consideration
by Jim B. Milholland...1

Financial Reporting Section Meets in Chicago...7

Highlights of the September 2000 NAIC Life and Health Actuarial Task Force Meeting and Other Items
by Raymond T. (Ted) Schlude...8

Implications of Materiality for the Financial Reporting Actuary
by Allan W. Ryan...13

GAAP Textbook Team Meets at the Annual Meeting in Chicago...15

Chairperson's Corner
by Mike McLaughlin...16

The New Health Reserves Guidance Manual
by Rowen B. Bell...17

Treasurer's Report...20

Thanks to the Annual Meeting Speakers!...22

Financial Reporting Section Photos from the Annual Meeting in Chicago...23

Focusing on What Really Matters...24

Editor's Notes
continued from page 1

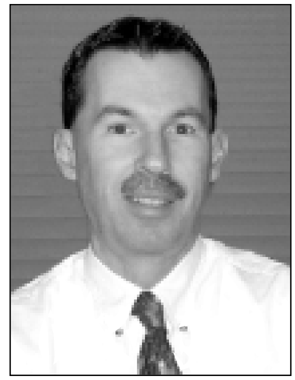
At the Financial Reporting Hot Breakfast Session of the Annual Meeting, we solicited comments and suggestions from the attending members with respect to the newsletter, among other things. I will be reviewing the written comments related to the newsletter and plan on providing a summary in the next issue. The initial review indicates a lot of interest in this topic, as the number of responses was much greater than expected.

Now allow me to describe what we have in store for you in this issue.

Our feature article is by Jim Milholland and covers Purchase GAAP accounting and, in particular, the determination of the Value of Business Acquired Asset (VOBA) and Goodwill. Jim's article incorporates the use of fair value concepts in determining the VOBA, and he uses examples to illustrate potential issues.

Rowen Bell provides an excellent summary of the new Health Reserves Guidance Manual. The new Manual provides guidance regarding the calculation and documentation of health reserves for statutory financial statements.

Ted Schlude has written a very informative summary of the September LHATF meeting. This article is quite comprehensive and provides an update to many actuarial issues currently facing financial reporting actuaries. You won't find a better summary of current financial issues than what Ted has assembled here!



Tom Nace, Editor

Allan Ryan has put together a timely analysis of an issue which faces all financial reporting actuaries across the board. The topic is materiality. Many actuaries may often assume that materiality is defined in terms of the size of a particular number or the size of the difference in numbers. In his development of the concept of materiality, Allan illustrates that this may not be the case.

Mike McLaughlin has written his farewell article as Section Chair. This appears in the Chair's Corner section of the newsletter.

Finally, I have included the Treasurer's Report as of June 30 for the Financial Reporting Section. Many thanks to Lois Chinnock for her help in assembling the report.

This issue is the fourth and final issue for the year 2000. It's hard to believe that we have completed another year in what seems so short a period of time. Wasn't it just yesterday that we were all worried about the impending doom that Y2K would wreak upon us? For all of you who built those underground bunkers and hoarded canned goods and bottled water, it's OK to come out now.

I thank all of the authors for their contributions to this issue, as well as all of the authors who have contributed to the *Financial Reporter* during the past year. I look forward to another year of quality articles from our members.

***Tom Nace, FSA, MAA, is vice president with PolySystems Inc., Pennsauken, N.J. He can be reached at* tnace@polysystems.com.**

THE FINANCIAL REPORTER

Issue Number 44 December 2000

Published quarterly by the Life Insurance Company Financial Reporting Section
of the Society of Actuaries
475 N. Martingale Road, Suite 800
Schaumburg, IL 60173
Phone: 847-706-3500 Fax: 847-706-3599
World Wide Web: *http://www.soa.org*

This newsletter is free to Section members. A subscription is $15.00 for nonmembers. Current-year issues are available from the Communications Department. Back issues of Section newsletters have been placed in the Society library and are on the SOA Web Site. Photocopies of back issues may be requested for a nominal fee.

Chairperson
Michael V. Eckman, FSA
Vice-Chairperson
Barry L. Shemin, FSA
Treasurer
James P. Greaton, FSA
Secretary
Clark P. Manning, Jr., FSA

Council Members:
John F. Bevacqua, FSA
Theodore J. Kitsos, FSA
S. Michael McLaughlin, FSA
Stephen J. Preston, FSA
David Y. Rogers, FSA

Editor of *Financial Reporter*
Thomas Nace, FSA
PolySystems, Inc.
6981 North Park Drive, West Bldg. - Suite #303
Pennsauken, NJ 08109
Phone: (856) 663-8711
Fax: (856) 663-8712
E-mail: *tnace@polysystems.com*

Staff Liaison, Lois Chinnock
Phone: (847) 706-3524
Email: *lchinnock@soa.org*

DTP Coordinator, Joe Adduci
Phone: (847) 706-3548
Fax: (847) 272-8548
Email: *jadduci@soa.org*

Expressions of opinion stated herein are, unless expressly stated to the contrary, not the opinion or position of the Society of Actuaries, its Sections, its Committees, or the employers of the authors. The Society assumes no responsibility for statements made or opinions expressed in the articles, or criticisms, and discussions contained in this publication.

Copyright © 2000 Society of Actuaries. All rights reserved.
Printed in the United States of America.

Determining the Value of Business Acquired With Some Fair Value of Liabilities Considerations
continued from page 1

be calculated as discounted cash flows. So, how is it calculated?

To answer that question, it is useful to describe a typical transaction. When a company purchases a block of business, the company takes over the obligation of the contracts, namely the future benefits and related expenses. Long duration con-tracts requiring funding and the reserves represent a commitment of certain investments, which in combination with future premiums and investment income will mature the policies.

A transaction for a block of business is usually accomplished by the buyer simply accepting cash or investments needed to fund the obligations and taking over the liabilities. Typically, the value of the reserves ex-ceeds the value of the investments deemed necessary to fund the obligations. Why would an informed buyer accept investments with a total value less than reserves?

The answer lies in the point just made, that the buyer has determined that the policy obligations can be met profitably from the future cash flows. Put another way, the valuation of the liabilities by the prescribed accounting methods is conservative by comparison to the value of the assets actuarially determined to be sufficient to meet the economic requirements.

Viewed this way, the value of the business acquired can be said to represent the buyer's willingness to assume obligations for which the accounting measure of the liabilities exceeds the measure of the supporting investments. Defined as this excess, VOBA is conceptually the same in a reinsurance transaction where there is no Goodwill as in a transaction where there may be Goodwill.

With this perspective, determining VOBA can be seen to depend on valuing the reserves and the investments deemed to be funding them. The insurance contracts are readily identified and valued. The key to the VOBA calculation is determining the value of the investments deemed to support the business.

The identification of the investments in support of the insurance contracts is often accomplished by means of an actuarial appraisal. The appraisal value is the present value of the incremental contribution by the contracts to the distributable earnings of the company, discounting at a rate which represents the buyer's desired internal rate of return. As is well known, the common appraisal value methodology is to discount statutory book profits and reduce this result for the cost of capital. For this purpose, the appraisal value of the block includes the value of the required surplus acquired or contributed. The appraisal value is the price paid for the insurance business and the required surplus. It is usually seen as a component of the total purchase price; that is, the block of business or the company is acquired at a premium or a discount to the actuarial appraisal value. An arm's length transaction for a block of business or an enterprise with infrastructure value would typically be made at a premium to the actuarial appraisal value. It is this purchase premium which gives rise to Goodwill.

With the definition of VOBA as the intangible asset representing the difference between the GAAP measure of the liabilities, and the GAAP measure of the supporting investments, and using an appraisal value to determine the price paid for the insurance business, VOBA can be expressed by the following relationship:

FVIA + VOBA = FVL + DTL + AAV, where

- **FVIA:** fair value of investments funding policy obligations and required surplus
- **FVL:** fair value of liabilities
- **DTL:** deferred tax liability
- **AAV:** actuarial appraisal value of the block of business and the required surplus

FVIA is the GAAP fair value of assets supporting the business. They may be specifically identified, or, as a short cut, when a liability-only model is used for the appraisal, they can be indirectly identified as a portion of the investment portfolio having a value equal to statutory reserves and required surplus, as long as the assumed investment yield in the appraisal is validated. The mark-to-market of the investments is not discussed here because it is a subject covered extensively in accounting literature and because the fair value of investments is generally provided to the actuary. The actuarial "heavy lifting," beyond the appraisal, is the valuation of liabilities and the VOBA determination.

Fair Value of Liabilities

The GAAP accounting literature on purchase accounting requires that the buyer's basis for the assumed obligations and the acquired assets be at fair value. Applying fair value concepts to insurance liabilities can be a challenge.

The common practice for FAS 60 contracts is to recalculate the reserves using current assumptions. This means updating the mortality, lapse, maintenance expense, and interest assumptions, and including provision for adverse deviation. Because FAS 60 reserves are net premium reserves, valuing an existing block of contracts requires finding a starting point, either selecting the beginning reserve or the net premium. For example, it is common to pick a net premium that is a uniform percentage of gross premiums, based on an analysis of typical net-to-gross premium ratios for similar contracts currently being issued.

Probably the most common practice for FAS 97 universal life-type and investment contracts is to hold the account value as the reserve, either on the presumption that account value is the fair value or on the belief that FAS 97 defines a reserve basis which is not changed by purchase accounting guidance. The conclusion that account values are the appropriate liability

(continued on page 4, column 1)

Determining the Value of Business Acquired With Some Fair Value of Liabilities Considerations
continued from page 3

for purchase accounting of UL contracts is not the only one that can be supported, as discussed further below.

There is very limited experience in purchase of blocks of business that are valued under FAS 120, although this is likely to change soon as a result of the recent wave of demutualizations and the possibility of purchase transactions involving demutualized companies with significant blocks of participating policies. One could assert that because the dividend scale is adjustable, FAS 120 reserves are fair value. Alternatively, one might argue that the fair value may be different.

As noted, it is common to revalue FAS 60 reserves, but less common to do so for FAS 97 contracts. The presumption that account values are default fair value can be challenged, however, by an examination of cash flows. Considering a block of universal life contracts, for example, the account values are the accumulated deposits. The liability can also be viewed as the discounted expected distribution from the account, namely cost of insurance charges, funds released on death, expense loads, surrender benefits, surrender charges, and maturities.

The account value is equal to these distributions, discounted at the same crediting rate assumed in the projection of the distributions. The distributions can be seen to be cash flows loaded for profit, risk, and acquisition cost recovery.

Crediting rates generally lag changes in new money investment rates in a declining interest-rate environment. For example, crediting rates on existing contracts are often a "bargain" to the policyholder in comparison to rates available in the market for new deposits. A buyer of a portfolio of such contracts, with crediting rates not supported by market rates, could well conclude that the liability, when viewed as the discounted distributions, should be discounted not at the anticipated crediting rates, but at market crediting rates. This valuation is illustrated by the example below. Loaded cash flows, or distributions, and premiums are projected. The credited rate corresponding to new money rates is 5.35%. Because there is lag in moving rates down, actual crediting rates currently are 6.35%. If new money rates remain level, crediting rates will be moved down to 5.35% as market place pressures allow, assumed to be at the end of five years in the example.

	Distributions/Premiums "Loaded" Cash Flows				BOY Discounted	BOY Account
Year	Surrenders [(1)]	Deaths [(2)]	Express Loads	Premium	Value	Value
1	$8,126	$6,188	$713	$15,770	$105,151	$100,000
2	$8,661	$6,188	$660	$14,612	$112,265	$107,915
3	$9,048	$6,293	$612	$13,534	$118,001	$114,632
4	$9,380	$5,916	$566	$12,528	$122,437	$120,159
5	$9,635	$5,766	$524	$11,588	$125,654	$124,566
6	:	:	:	:	$127,735	$127,937

1) Surrender benefits plus surrender charges

2) COI charges plus amounts released on death

When distributions are discounted at 5.35%, the discount value is $105,151, a liability that is greater than the $100,000 account value. This result is expected when interest crediting is at bargain rates. Note that after five years, when investment yields and crediting rates return to a normal relationship, the discounted distributions and the account values are basically the same.

(Differences in the sixth year beginning values are due to slight timing differences in the calculations.)

Purchase accounting requires fair value at the purchase date, which then becomes the basis for future valuations. The difference between the fair value of the policies and the account value, the "fair-value adjustment," should be amortized over the period of time for which the difference between the market and actual crediting rate is expected to exist under the projection scenario. The amortization becomes a component of expected gross profits.

The result is to amortize the adjustment in a fashion that "normalizes" the expected gross profits, which will provide the revenue stream for VOBA amortization. In this scenario, then, the reserves after the fifth year will be account values. The amortization of the fair value adjustment can be made dynamic with respect to emerging experience — accelerated, for example, if the policy persistency is worse than expected.

A similar case can be made for a fair value adjustment to FAS 120 reserves.

Determining VOBA

The use of the relationship described above for determining VOBA is best explained by means of an example. Consider the case of the purchase of a company for which the statutory balance sheet is as follows.

VOBA Example: Background
Acquired Company – Statutory Balance Sheet

	Assets		Liabilities and Surplus
Investments	$92,920	Reserves	$88,000
		Surplus	$4,920
Total Assets	**$92,920**	Total L&S	**$92,920**

Note: Inforce business is universal life
Investments are amortized cost, classified as Held-to-Maturity for GAAP
Reserves are CRVM
Surplus equals required surplus

This example starts with statutory figures because the appraisal value is calculated on statutory-based financials. The discount rate in the actuarial appraisal is 12%, and the surplus is exactly the required surplus. For simplicity, it is assumed that the investments are held to maturity, although this is seldom the case.

The purchase price is the actuarial appraisal value plus an amount for infrastructure as shown below:

	Purchase Price
Value of in force	$7,439
Required surplus	$4,920
Appraisal value (AAV)	$12,359
Purchase premium	$1,000
Total purchase price	$13,359

The next step is to determine the fair value of assets and liabilities. This is shown on the next chart.

(continued on page 6, column 1)

Determining the Value of Business Acquired With Some Fair Value of Liabilities Considerations

continued from page 5

Value of Assets and Liabilities

	Statutory	Sellers GAAP	Fair Value	Fair Value Adjustments
Investments	$92,920	$92,920	$96,833	$3,913
Reserves	$88,000	100,00	$102,138	$2,138

Note:The Investment difference is amortized by the effective rate method
The Reserve difference is amortized to normalize expected margins

It is necessary to show values on three bases. The appraisal is statutory-based, but the accounting adjustments are from H-GAAP to P-GAAP. Note that the fair value of liabilities is not the account value. Rather, because the acquisition was made in a time of declining interest rates, for reasons discussed above, the fair value exceeds the account value.

With these numbers, one can calculate VOBA as the excess of the price paid for the block plus the obligations, including the deferred tax, over the assets acquired at their fair value.

VOBA and Goodwill Calculations

	VOBA		Goodwill	
Purchase Price	$12,359	*	$13,359	**
Plus obligations at fair value	102,138		102,138	
Deferred Taxes	<257>		<257>	
Investments Acquired	96,833		96,833	
VOBA	$17,407		17,407	
Goodwill			$1,000	

* amounts relate to acquired contracts and required surplus
** amounts relate to total acquired company

The resulting $17,407 of VOBA is brought over to calculate goodwill as the excess of the purchase price for the enterprise over the net assets acquired, including VOBA. The answer is $1,000, a natural result of the approach chosen. It is also an intuitively correct result, since the purchase premium was $1,000.

The entire balance sheet has this appearance.

GAAP Balance Sheet

	Assets		Liabilities and Surplus
Investments	$96,833	Reserves	$102,138
VOBA	$17,407	Deferred Tax	<257>
Goodwill	$1,000	Equity	$13,359
Totals	**$115,240**		**$115,240**

The deferred tax is actually a deferred tax asset, which is not unusual. Since VOBA is a function of deferred taxes and is at the same time a timing difference in the calculation of deferred taxes, the deferred tax liability and the VOBA calculation require solving simultaneous equations. This is illustrated in an appendix.

Earnings Emergence

The VOBA asset is amortized into income in the same manner as DAC, based on the appropriate revenue stream — namely, premiums for FAS 60 policies and expected gross profits for FAS 97 policies. With these methods, the earnings attributable to the acquired policies will average a 12% ROE in the above example. This is a natural result of the fact that the appraisal value was made using a 12% discount rate.

Conclusion

The actuarial appraisal method for determining VOBA can be seen to link the pricing of transactions to GAAP accounting. This is most apparent from the fact that Goodwill in GAAP is the same as the amount seen to be the purchase premium. It also results in an expected earnings emergence, which is consistent with the buyer's expectations from the pricing process. It can be applied with or without the fair value concepts for reserves as described above.

***James B. Milholland, FSA, MAAA, is a partner at Ernst & Young LLP in Atlanta, GA. He can be reached at* james.milholland@ey.com.**

APPENDIX

Supporting Calculations for VOBA

VOBA is determined by the relationship
FVIA + VOBA = FVL + DTL + AAV

Under GAAP accounting for taxes, VOBA represents a timing difference similar to DAC. So while it can be seen that VOBA depends on knowing DTL, the DTL also depends on VOBA.

DTL is the statutory rate applied to the timing differences and then summed. In this example, we assume that the investments have a basis equal to amortized cost (or H-GAAP) and the other timing differences relate to reserves and to proxy DAC. If the statutory rate is 35%, then

DTL = .35
{Tax Reserve minus P-GAAP Reserves

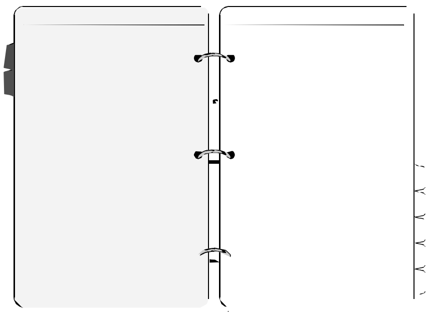
+ P-GAAP FVIA minus Tax Assets
+ VOBA minus Proxy DAC}

Tax reserves	=	88,000
Tax assets	=	92,920
Proxy DAC	=	7,917

Solving the simultaneous equations results in VOBA = 17,407.

Financial Reporting Section Meets in Chicago

Editor Tom Herget, basking in the glow of a major project completed in only 14 months.



I attended the NAIC Fall meeting held in September, 2000. Summarized below is what took place at the Life and Health Actuarial Task Force (LHATF) and selected other meetings.

LHATF Special Topics Meeting

At the special topics meeting, the following projects were discussed:

XXX Implementation Issues:
Major issues being addressed by regulators are described in minutes to an August 4, 2000 conference call. They include:

A. UL With Secondary Guarantees –
Development of an Actuarial Guideline to Address Shadow Account Products: Three documents have been proposed — the first two include a May 9, 2000 Guideline and subsequent August 30, 2000 Guideline written by Bob Potter of North Carolina. The original version would require level premium treatment for shadow account products while the more recent version allows an ART type reserve consistent with wording in XXX regarding minimum premiums.

ReliaStar presented a third proposal that is a modification of the original Potter guideline that they argue is designed to handle reserves consistently with the real expected premium pattern for the product.

B. Other Product Designs:
Regulators continue to be concerned with new product designs that they perceive as abusive. At least two designs have been identified besides shadow account products. The first guarantees the level premium unless an interest rate index (tied to Treasuries) falls below a certain level (3%) perceived by the regulators as highly unlikely. Here, the regulators argue that premiums, from a practical standpoint, are guaranteed and, from a literal standpoint, are not.

The second product is a UL product where, if the AV goes to zero under the specified premium level, the policyholder can convert the policy to a traditional whole life product where the premium under the whole life contract is the UL product's specified premium based on the original issue age of the insured.

respect to clarification of XXX. The legal opinion appears to be pre-codification based, where examiners used actuarial guidelines for guidance, and some states explicitly embraced some or all of them. With codification, it appears that the actuarial guidelines will have more force because of the disclosure requirements in codification.

At the Life and Health Actuarial Task Force meeting, the group decided that they would have a conference call to discuss:

1. E-mail or Lotus Notes-Maintained Hot Product List

2. Whether a guideline is needed at all

3. The Potter Guideline versus ReliaStar Guideline

4. How the ASB and/or ABCD might be able to assist in the area of abusive product design

Finally, the regulators clarified that the select factors described in XXX are not available to be used in Variable Life and Variable Universal Life product designs because these products were specifically exempted from XXX.

Proposed Changes to the AOMR:
LHATF voted to expose the current draft AOMR (with minor editing) for comment. The Academy has also informally distributed a draft of the corresponding ASOP revisions. The draft AOMR eliminates the Section 7 formula reserve opinion and leaves it up to the opining actuary to develop criteria and rationale for the type of adequacy testing/review that would be required for each line/category of business. It also provides the potential for some relief to the opining actuary with respect to the "this state" opinion. Actuarial Standards of Practice would provide guidance to the actuary in the area of adequacy rather than regulatory baselines, which have been completely eliminated from the AOMR draft.

A couple of minor changes to the draft may be made to include due, unpaid, and deferred premium assets in the opinion schedule and to clarify exactly what is to be opined upon with respect to the separate account (currently p. 3, line 27 includes all liabilities in the separate account including some that are non-actuarial and also does not consider the CARVM allowance booked as a negative liability in the general account).

Several interested parties raised concern that this version of the AOMR would not receive wide state adoption because of the elimination of the small company exemption. This is an area where the industry is split and the regulators are adamant that some adequacy analysis must be performed regardless of company size.

VAGLB Working Group Report:
The VAGLB working group presented its report, which includes a draft Actuarial Guideline MMMM on VAGLB reserving. Outstanding items include fund transfer issues (in particular, whether the ability to transfer funds should somehow be reflected in reserves), developing guidance with respect to guaranteed payout annuity floors, and development of a Life Practice Note. The intent was to leave the guideline flexible enough to be able to handle any new product designs that might appear, by defining a set of principles related to: integrated CARVM, the impact of VAGLBs, scenarios to be used, level of reserves, and recognition of the impact of reinsurance.

Currently, the document specifies an 83-1/3 percentile for reserve adequacy. This is an area where regulators will ultimately have to decide what the confidence level for reserve adequacy should be. The opining actuary would be responsible for deciding that the representative scenarios are appropriate and for monitoring emerging experience to confirm their conclusions.

The effective date is recommended to be December 31, 2001 and will include the standard three-year phase-in language common in other recently adopted actuarial guidelines.

Finally, several concerns related to VAGLB reserving were raised. One criticism was the 83-1/3 percentile benchmark, given the significance of the tail for these products. Another criticism was that the five funds, defined in the GMDB Reserve Guideline 34 and used here, did not contain very high volatility and therefore, generate low reserves for VAGLBs. The Academy members stated that part of the reason that the methodology generated relatively low reserves in an integrated framework was because CARVM by definition creates a very conservative starting point from which to perform the integrated reserve calculations.

One interested party indicated that several large reinsurers of VAGLBs would have significant reserve releases if they were to move to valuation according to the Guideline. The higher reserves that they hold result from: assigning a higher confidence level than 83-1/3, use of higher volatility factors than contained in the draft, and recognition of more fund classes (more volatile funds) than specified by AG 34.

Presently, most companies continue to use an accumulation of charges approach pending final guidance on reserves. Regulators' concerns with respect to accumulating charges for the VAGLB benefit relate to the possibility that the benefit could be mispriced and therefore, the reserves would be inadequate.

The Academy still plans to work on immediate annuities, to refine language in the guideline and will begin to outline/develop a practice note. The Academy will also update its survey on current reserving practices employed by companies for VAGLBs. LHATF voted to expose the AAA report for comment and will have a conference call to discuss the outstanding issues.

Actuarial Guideline XYZ – Nonforfeiture for UL Products with Secondary Guarantees:
The regulators discussed the current version of XYZ as well as an ACLI proposal. Frank Dino discussed his version of Actuarial Guideline XYZ and stated that based on his testing, nonforfeiture values might arise for products with secondary guarantees in the 30-40 year range. He further described his

(continued on page 10, column 1)

Highlights of the September 2000 NAIC Life and Health Actuarial Task Force Meeting and Other Items
continued from page 9

methodology as application of existing regulation and the guideline provides some historical background.

Next, the working group received an ACLI proposal that appears to have general industry support, although some of the details need to be fleshed out based on some of the regulators' questions. The approach, simply stated, is designed to address one major problem area for the industry as it pertains to XYZ – non-forfeiture net premiums which are based on valuation mortality, rather than expected. This results in low premium products having to provide the same dollar amount of NF value as high premium products. The ACLI proposal would address this by calculating a ratio equal essentially to the present value of adjusted pricing net premiums divided by the present value of valuation mortality.

Pricing net premiums would be equal to the gross premium less provision for first year expense allowance (125% of gross premium). The second calculation would determine the present value of 80 CSO mortality. This ratio would create a set of pricing qx's, which are multiples of 80 CSO mortality. Cash values would then be calculated using a retrospective Fackler-type accumulation. The ACLI idea as proposed would simply deal with secondary guarantees and is not contemplated for non-forfeiture generally.

A group of regulators and interested industry representatives will work to reach consensus on XYZ and the ACLI proposal.

LHATF – Task Force Meeting

The following projects were discussed at the Task Force Meeting:

General Non-forfeiture Project:
Documents discussed include a non-forfeiture law prepared by LHATF (Frank Dino) and an alternative NF proposal from the ACLI.

The LHATF version introduces the concept of a plan and annual certification and also provides for a minimum set of cash values. The ACLI version appears to not provide an absolute floor but one that is defined in the policy and therefore would be controlled by market competition rather than regulated.

Both approaches require a retrospective determination of values. LHATF plans to discuss NF in detail at the December NAIC meeting. The Dino draft NF law was officially endorsed and subsequently exposed by LHATF for comment.

Unified Valuation System (UVS) – Sample Illustration:
Tom Herget and David Sandberg, representing the Academy, presented numerical examples and discussed the impact of covariance on results for a total company. Lines of business illustrated to date include term, par whole life, universal life, long-term care, and a corporate account.

Regulators asked what tools were being developed at the Society to assist the actuary in this analysis. An SOA seminar in November will introduce this topic to Society members, and shortly thereafter, research will begin.

Update of 1980 CSO Valuation Table:
A brief presentation related to the update of the 1980 CSO Mortality Table was provided by Tom Foley.

Direction to date includes:

1) use of a 25-year select period, which is supported by recent company experience;

2) refreshing the experience from the 1990-1995 experience period to year 2002 or 2003 when the table will be released, as well as consideration of a method to keep the table current in years beyond 2002 or 2003;

3) considering a formulaic approach for reflecting NS/SM, gender, underwriting status, etc.;

4) marrying other older age experience (VA, Bragg) with insurance data;

5) consideration of what the appropriate margins in the table should be, given that underwriting varies significantly; and

6) whether an X-factor type valuation adjustment to reflect individual company experience will be recognized.

The new mortality table will be discussed in detail at the December NAIC meeting.

Actuarial Guideline IX-C:
Revisions to Actuarial Guideline IX-A to Allow Substandard Mortality for Immediate Annuity Valuation: LHATF voted to expose this AG for comment, which was originally developed by the industry and subsequently modified by LHATF. Recent additions to the guideline require the appointed actuary to comment on the appropriateness of the substandard mortality and to report any material deviations in experience in the actuarial memorandum that supports the annual actuarial opinion.

Actuarial Guideline VL-GMDB:
In moving forward with a guideline, two possible versions of VL GMDB were introduced. Rather than selecting one, the regulators decided to expose VL GMDB for comment with both versions. The effective date of this guideline will most likely be December 31, 2001 rather than December 31, 2000. The regulators also clarified that the 19-year select factors and X-Factors introduced by XXX are not available to variable life and variable

universal life products because they were specifically excluded from XXX.

SERFF/Essentium Presentation:
LHATF also received a presentation from NAIC SERFF and Essentium related to electronic form filing at the NAIC. This is designed to create a paperless filing system that would be accessible by each state (for forms filed in that state) and by each company (for forms that the company filed with a particular state). How freedom of information laws would be handled was discussed, as well.

Accident and Health Working Group:
Several projects of note include development of a draft LTC Guidance Manual for the recently adopted LTC Model Regulation on Rate Stability and Adequacy and development of an acceptable credit disability mortality table to be used as a valuation standard. The working group also made a recommendation related to which cost containment expenses should be classed as losses and which should be classed as expenses at the request of the Statutory Accounting Practices Working Group.

Other Events

Life Liquidity Risk Working Group:
This working group discussed a draft report prepared by the AAA on Liquidity Risk. The group also discussed the status of the New York circular letter, which is to be used by New York to gather liquidity risk data for companies licensed in New York at 2000 year-end.

The Academy report discusses three types of liquidity:

1) day-to-day cash management;

2) ongoing/intermediate term cash flow management; and

3) stress liquidity.

The emphasis of the working group project is on stress liquidity.

The Academy report also identified several products of particular interest, which include:

1) funding agreements with put options;

2) GICs with rating agency bailouts;

3) COLI/BOLI with rating agency bailouts in the form of side agreements; and

4) reinsurance agreements that contain bailout options if the reinsurer receives a downgrade.

The report also discusses various regulatory actions which include requiring liquidity plans, adding liquidity interrogatories to the statutory statement, requiring pre-approval of certain contract provisions and/or outright disapproval of certain contract provisions.

The largest objection to these types of provisions relates to the fact that they would be invoked precisely at the time of company difficulty and that they create a fairness issue between different classes of policyholders.

One regulator stated that there has been a noticeable change in the market attitude of companies in the sense that recent contracts are more commonly 60-90 day puts and that the number of 7-14 day puts has decreased dramatically.

This working group will have two interim conference calls in order to have an interim report available for the Life (A) Committee to review at the NAIC December, 2000 meeting.

Life Disclosure Working Group:
The working group adopted the new GRET table to be effective January 1, 2001. The new GRET table is available on the NAIC web site. Next, the revised UL Model Regulation was adopted, which excludes the disclosure aspects of the old UL Model Regulation since disclosure is covered by the Sales Illustration Model.

Suitability Working Group:
The working group discussed two draft models: Suitability of Sales of Life Insurance and Annuities Model Regulation and the Unfair Trade Practices Act. Issues discussed include:

1) how/if the model might recognize IMSA efforts;

2) that there not be duplication of effort with respect to variable products already regulated by the SEC (provide for a safe harbor); and

3) certain products need exemption such as credit insurance, direct response business, group annuities and other institutional business (although working group members do not necessarily agree with the interested parties).

The working group plans to have a longer working session at the December, 2000 NAIC meeting and feels it is still on track to have models completed by the June, 2001 NAIC meeting.

4. International Accounting Standards Working Group: A presentation was provided by Ian Hague of Deloitte and Touche, Toronto related to work being done by the "Joint Working Group" on the IASC's Financial Instruments Project. The JWG plans to turn its work product over to the standards setters in each country for their adoption (or rejection). A final paper of the JWG will be available in a couple of months. Major issues discussed by Ian Hague include:

– Insurance Contracts: are outside the scope of this project.

– Fair Value: most relevant measure of value, eliminates historical cost methods where differences in identical items could arise between two companies.

– "Market Exit Price" Focus: would define a hierarchy for obtaining market prices with focus first on identical instruments, then to similar instruments, and finally valuation techniques would be the last resort.

(continued on page 12, column 1)

Highlights of the September 2000 NAIC Life and Health Actuarial Task Force Meeting and Other Items
continued from page 11

- Credit Risk: the corporation's own credit risk would be reflected in the valuation process.

- Timing: It is anticipated that this guidance will become a requirement three or four years from now.

It was noted by interested parties that such an accounting system will result in earnings volatility and will result in many difficulties with respect to management performance evaluation. The IPs are developing a work plan to comment on the JWG paper once it is released.

Life Risk Based Capital Working Group:
Various reports were heard from the American Academy of Actuaries and are briefly discussed below.

- **Common Stock Covariance:** The Academy originally looked at the relationship of the S&P 500 Index compared to bonds when they made the C-1 common stock independence proposal two years ago and is now in the process of analyzing the covariance of individual common stocks with bonds.

- **DI, LTC and Stop Loss Factors:** The Academy is still collecting and analyzing data with respect to revising the C-2 risk factors for these categories of health business.

- **Workers' Compensation Carve Out:** The Academy issued its final report which illustrates significantly lower RBC for excess coverage in the life blank compared to the P&C formula. The working group received the report and next will consider alternatives for dealing with the differences created between the life and P&C RBC formulas.

- **Codification:** Treatment of C-1 Real Estate: The Academy presented a report on a proposal to change the C-1 treatment for real estate. This was necessitated as a result of the reclassification of real estate to a GAAP basis under Codification, which results in a loss of the risk characteristics that had formerly been included in the annual statement. The new approach would focus on a "cash on book" aggregate return, which would determine whether a lower or higher C-1 factor should be used.

Cash on Book Return	RBC C-1 Factor
6% or less	20%
6% - 9.65%	Grade Factor Linearly
9.65% or Higher	3%

This approach would provide on an overall basis, the same amount of C-1 related to real estate but would differentiate newer (more risky) properties based on the cash on book return.

- **Codification: Deferred Taxes:** With codification, deferred tax liabilities and deferred tax assets (subject to limitations) will be reflected in the blank and therefore need to be reflected in RBC and AVR/IMR. Initial recommendations include use of pre-tax factors and then conversion to an after-tax basis. That way, if tax rates ever change in the future, the basic factors will not have to be changed. The report also provides a summary of the implicit tax rates incorporated into the current C-1 factors.

6. Health Organization RBC Working Group: Many of the HORBC topics overlap with the Life RBC Working Group as discussed below.

- **C-1 Common Stock Covariance:** It was noted that the health RBC approach is closer to P&C (15%) than the life factor approach (30%), so it is unlikely that HORBC would consider the current life covariance project, unless it was in the context of the RBC Task Force as a whole.

- **Growth Calculation Factor:** The HORBC working group will consider whether they need a growth factor and/or trend test similar to that used in the life formula.

- **Annual Statement Changes to Move Primarily Health Companies to the HORBC Formula:** The AIC staff prepared a list of Life Companies and P&C Companies that would fall into a health blank as a result of the 95% test (health premium/total premium) proposal.

- Finally, the group discussed results of the 1999 Year-End Database survey and the fact that 28% of HMO's are at or below Company Action Level, and that there is still a significant number of cross-check failures as well.

* * *

The next NAIC meeting will be held in Boston in December, 2000.

Raymond T. Schlude, FSA, MAAA, is a consulting actuary at Milliman & Robertson, Inc. in Chicago. He can be reached at **ted.schlude@milliman.com.**

Implications of Materiality for the Financial Reporting Actuary

by Allan W. Ryan

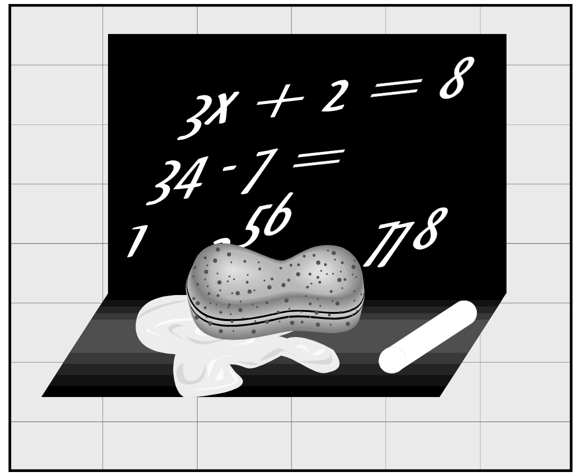
Background

The concept of materiality as it relates to financial statements is subjective, and its assessment requires significant judgment. The basic and somewhat limited guidance in actuarial literature substantially defers to the accounting profession. The Securities and Exchange Commission (SEC) has recently focused on materiality with respect to registrants' financial statements, most notably in the release in August 1999 of *Staff Accounting Bulletin 99* (SAB 99).

Within this framework, the focus of this article will be on the implications of materiality for the financial reporting actuary, or, more precisely, any actuary involved in the preparation, review, or audit of life insurance company financial statements.

It is assumed that the reader is familiar with SAB 99; accordingly this article provides only a brief summary of its contents. Interested readers may view or download the entire document on the SEC's Web site: *(www.sec.gov/rules/acctreps/sab99.htm)*.

It is important to emphasize that SAB 99 does not change current law or accounting guidance, and it does not constitute rules or interpretations of the SEC; rather it is intended to clarify current guidance. Perhaps the most important message is that "misstatements are not immaterial simply because they fall beneath a numerical threshold," and that exclusive reliance on a numerical threshold has no basis in either law or the accounting literature. Also, intentional misstatements, regardless of materiality, are not appropriate, and may be illegal.



Accounting and Actuarial Literature

Under American Institute of Certified Public Accountants (AICPA) Auditing Standards, pronouncements of the Financial Accounting Standards Board (FASB), SEC rules, and court decisions, the concept of materiality is well established. The term comes close to being defined in FASB Statement of Accounting Concepts No. 2, which states

"the omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."

It is interesting to note that the Transmittal Memorandum to Actuarial Standard of Practice (ASOP) No. 23, "Data Quality" (recognizing that this standard does not specifically address financial statements, but is much broader in application), states, in discussing the concept of material bias due to imperfect data:

"a formal definition of materiality was not included in this standard, as this term is common to many standards and should be treated globally. The task force noted that while the accounting profession does not define materiality, it does offer guidance on considerations for evaluating materiality. Development of such guidance is under consideration by the ASB."

This brings us to a more specific reference to materiality, namely "Financial Reporting Recommendation 9: Materiality"(FRR 9). Adopted in 1978 and revised in 1983, it is one of the few remaining standards of practice predating the Actuarial Standards Board.

It is important for the financial reporting actuary to be familiar with FRR 9 and its Interpretations 9-A, 9-B, and 9-C. Paragraph 3 states

"determining whether an item is material or not is a difficult professional judgment. In making that judgment the actuary should consider the decision-making framework of the typical user of the actuary's work, and his probable

(continued on page 14, column 1)

Implications of Materiality for the Financial Reporting Actuary
continued from page 13

response. The judgment involves quantitative and qualitative consideration. Although Interpretations of this Recommendation attempt to provide guidance to the actuary in making decisions as to each of these elements of the materiality judgment, they do not constitute a precise definition of materiality."

This is not inconsistent with the SFAS concept quoted above. Interpretation 9-A of FRR 9 discusses the importance of recognizing the user of the actuary's work; Interpretations 9-B and 9-C deal respectively with quantitative and qualitative aspects of materiality. This concept of qualitative and quantitative also underlies the accounting and auditing literature and is discussed in depth in SAB 99.

Paragraph 4 of FRR 9 discusses the accounting profession's "similar concept of materiality." It notes the need for both actuary and auditor to use judgment. The coordination of the actuary and auditor's activities is further discussed in ASOP No. 22, "The Actuary's Responsibility to the Auditor," which, while not explicitly addressing materiality, delineates the responsibilities of any actuary involved in the preparation, review, or audit of financial statements.

Specific reference to materiality is made in ASOP No. 10, "Methods and Assumptions for Use in Life Insurance Company Financial Statements Prepared in Accordance with GAAP," revised edition. Section 3.8 discusses the use of simplified methods for determining reserves and deferred acquisition cost assets (DAC). In general, it is noted that such approximations and simplifications are appropriate only when the results are determined not to differ materially from the results that would have been obtained from more precise calculations. This is consistent with the standard FASB guidance in each of its statements, which reads: "The provisions of this Statement need not be applied to immaterial items." The final sentence of ASOP No. 10, section 3.8 then says; "The actuary may seek guidance from accounting professionals on the issue of materiality."

SEC SAB 99 addresses registrants' financial statements, and thus, US GAAP reporting. Although statutory financial statements are no longer considered GAAP for mutual life insurers, presumably the provisions of SAB 99 would apply to statutory financial statements filed with the SEC in those cases where such filings are still accepted. In addition, the NAIC has taken steps that are anticipated to lead to the adoption of the concepts in SAB 99 as part of Statutory Codification.

Implications for the Actuary

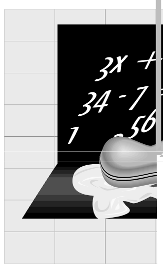
It is clear from SAB 99 and other recent communications from the SEC that there is concern that what may be quantitatively immaterial misstatements are qualitatively material in that they may be used to mask earnings trends or, as an obvious example, to reach a specific threshold such as per share earnings estimates. Referring back to the FASB standard language that provisions of its statements "need not be applied to immaterial items," SAB 99 makes it clear that the SEC does not interpret this to mean "that the registrant is free intentionally to set forth immaterial items in financial statements in a manner that plainly would be contrary to GAAP if the misstatement were material," and that auditors "should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to 'manage' earnings, are immaterial." Therefore, it is important for the actuary to discuss with the preparing accountants or auditors such issues and to be in agreement with respect to materiality.

> ***"It is important for the actuary to both understand the accounting perspective and to use professional judgment. The most critical area may not be data quality so much as the selection of assumptions."***

It does appear somewhat that the actuarial profession is deferring to the accounting profession with respect to materiality, at least in the area of financial statements. But this is in a sense necessary because accountants have the primary responsibility for financial statement preparation and audit. On the other hand, actuaries possess the skills needed to evaluate qualitative and quantitative measures of materiality, and may be designated by senior management as responsible for such evaluations.

It is important for the actuary to both understand the accounting perspective and to use professional judgment. The most critical area may not be data quality so much as the selection of assumptions.

Of course, lack of data may contribute to the difficulty of choosing an assumption. Slight changes in assumptions, such as interest or lapse can have a significant affect on DAC and other actuarial items. While assumptions may be challenged and revisited, it is important that the actuary use judgment and consistency in applying assumptions and methodology. It is one thing for management to come back to the actuary and discuss assumptions. It is another for management to propose changing the interest rate assumption by 50 basis points in order to exceed earnings per share expectations by 1 cent, noting that it only effects earnings by 1%.



Referring back to ASOP No. 10, it may well be inappropriate to go from one approximate method to another, or back to an exact method, where the change was motivated by the need to reach a certain earnings threshold, even where such changes might be deemed quantitatively

Academy of Actuaries Committee on ... al Rep... nor ackn... s to this artic... LIFR members... chair), John W. Mo... el A. Hughes, and Joh... lner, author of the chapte... materiality of the GAAP textb... edited by R. Thomas Herget.

Looking back at the past year, our Section has been pretty active. Here is a brief recap of our main achievements.

First, congratulations to Tom Herget and the team of authors who completed the new textbook, *US GAAP for Life Insurers*. This team, together with the efforts of the POG (Project Oversight Group) and with support from the SOA, has put in over 4,000 hours of effort in a remarkably short time frame (just about 1 year). The speed of this achievement can be put in context by noting that merely updating a typical textbook may require 24 months or more! Not only was this fast work, but also every chapter was examined by several reviewers, which ensures top quality content. Both high level commentary and many detailed examples are included throughout. Expenses of production incurred by the Section were 20 percent higher than budgeted, but we expect those up front expenses to be fully recouped from textbook sales. I predict that this 500-page tome will appeal to a wide audience and have a long lifetime.

Second, the Section sponsored six seminars in calendar 2000, including Basic and Advanced GAAP, XXX Certification, Reinsurance, Embedded Value and Non-traditional Product Financial Reporting. All of those that are complete as of this writing have been very successful, with high ratings on content from participants, plus a modest financial gain to the Section. These seminars make a significant contribution to the professional development of actuaries in light of the changing Society of Actuaries syllabus, which, as you know, is no longer country-specific. We anticipate even more seminars in the future, some of which will be co-sponsored with other Sections.

Third, our Section will partially fund a significant research project on UVS (Unified Valuation System). Led by Dave Sandberg, a task force is building a database comprising monthly asset and liability cash flows for a hypothetical company with several lines of business under multiple scenarios at 3 different dates. The project is intended to allow actuaries to evaluate new requirements such as capital adequacy standards and fair value accounting. The Council approved up to $25,000 in funding, with the expectation that Section members will benefit from this research project.

Fourth, we published newsletters in October 1999, February 2000, June 2000, and September 2000. Congratulations go to Tom Nace, Editor, and the authors and contributors. Each newsletter seems to be an improvement over previous ones. In September, we had 28 pages including a variety of articles, letters, updates, a textbook order form, and even the RFP form inviting research proposals. The Council continues to look for ways to improve and

The New Health Reserves Guidance Manual

by Rowen B. Bell

The determination of actuarial reserves for health coverages is often described as being more art than science, more judgment than prescription. At every stage the actuary must rely on professional experience to make a series of choices as to methodology, degree of reliance on the raw data, and integration of qualitative considerations. The range of output from generally accepted actuarial practices in health valuation affords sufficient latitude that two equally qualified actuaries might arrive at noticeably different reserve estimates given the same starting point.

In such an environment, where there is no ready algorithm or checklist, it may be difficult for an actuary, particularly one with less health valuation experience, to be confident that all of the relevant considerations have been taken into account in his or her work product. Similarly, the regulator charged with assessing the appropriateness of a company's health reserves faces a daunting task. In short, there is a need for guidance.

To fill this void, the NAIC's Accident & Health Working Group (an offshoot of the Life & Health Actuarial Task Force) has spent considerable time developing a Health Reserves Guidance Manual (HRGM). This document was initially drafted by an American Academy of Actuaries workgroup but has been thoroughly reviewed and modified over the past year by members of the regulatory community, with continued industry input.

The purpose of the HRGM, as stated in its introduction, is "to provide guidance regarding the calculation and documentation of health reserves for statutory financial statements … This guidance is intended for actuaries and other parties who estimate reserves for health coverages and examiners who review the statutory financial statements on behalf of regulatory agencies." The definition of "health coverages" is broadly drawn, explicitly including disability income and long-term care in addition to medical and dental.

"Guidance" is later construed in the introduction as meaning "a general statement of reserving principles and not specific, detailed instructions." The HRGM is not a cookbook, nor does it have any legal or regulatory standing; rather, it is neither more nor less than a reference source of actuarial practice and relevant considerations regarding statutory health reserving. In this manner, it is reminiscent of the series of Practice Notes issued by AAA in the mid-1990s on cash flow testing.

As of this writing, the final draft version of the HRGM, dated August 29, 2000, is still freely available on the NAIC Web site (*www.naic.org*) and has been exposed for formal public comment. The current intent is for the Accident & Health Working Group to officially adopt the HRGM during the December 2000 NAIC meeting. If this occurs, then after the March 2001 NAIC meeting, the official version of the HRGM will, as is the case for other official NAIC documents, only be available from the NAIC for a fee.

After the introduction, the HRGM is organized into the following sections:

- General Considerations Claim Reserves
- Contract Reserves
- Provider Liabilities
- Premium Deficiency Reserves

In the remainder of this article, I will touch on selected topics from each section. Please note that the material below is based on the final draft version of the HRGM.

General Considerations

Among this section's contents are discussions of the interrelated topics of conservatism and follow-up studies. Highlights of the manual's guidance on these subjects include the following:

- Follow-up studies should be performed, not just in aggregate, but at the level at which the reserves were computed in order to assess the appropriateness of each reserve methodology in use.
- Even where tabular methods are prescribed for the reserves, follow-up studies should still be performed in order to determine whether explicit

(continued on page 18, column 1)

The New Health Reserves Guidance Manual
continued from page 17

conservatism needs to be added on top of the tabular reserves.

- With conservatism, the whole is usually less than the sum of the pieces: the health reserves of an entity, considered in aggregate, should require a lesser degree of conservatism than if the reserves for each constituent block of business were considered on a stand-alone basis.

- The level of conservatism required decreases as the sophistication of the reserving process increases.

Claim Reserves

Despite the name, this section encompasses both the accrued and unaccrued portions of an entity's obligations (often called "claim liabilities" and "claim reserves" respectively). The section also covers an expense liability item, the reserves for loss adjustment expenses (LAE), which are now explicitly required under codification Statement of Statutory Accounting Principles (SSAP) No. 55.

Much of this section is devoted to foundational descriptions of incurral dating methods and claim reserving methodologies, but there are a number of items of particular interest, including the following:

- Unpaid capitations to providers are properly included in claim reserves and need to be calculated via a direct enumeration method rather than an approximation.

- The manual acknowledges that there is wide contractual variation in incurral dating practice for stop-loss coverages, thereby affecting the level of reserves and hence the emergence of earnings.

- In calculating the reserve for medical insurance extension of benefit provisions, although it is to be assumed that all policies terminate on the valuation date, it is acceptable to reduce the reserve based on an assessment of the likelihood that eligible claims will be not be submitted.

- The LAE reserve is typically established as a percentage of the claim reserves, with that percentage determined by an analysis of one's own claims processing expenses. (Implicit in this method is an acknowledgement that the liability for adjudicating the claim attaches to the insurer at the same time as the liability for the claim itself.) However, if the insurer has subcontracted claims processing to a third party who is compensated on (for instance) a percent-of-premium basis, then the insurer does not need to establish an LAE reserve.

- Disability claim reserves should reflect offsets for Social Security and similar governmental benefits, and the assumptions made with regard to such offsets cannot be based solely on historical experience but must reflect known changes in benefit approval practice for such programs.

Contract Reserves

This section is relatively brief, due largely to the fact that the NAIC Health Insurance Reserves Model Regulation discusses many of the relevant issues. Nevertheless, it contains some salient points:

- While the minimum standards allow for one-year or two-year preliminary term methods, it would be appropriate to establish a nonzero first year contract reserve if premiums in the first year are sufficient to cover claims and acquisition expenses.

- Contract reserves are not necessary in situations where there is a timing imbalance of premiums versus claim costs (e.g., seasonality) within a single policy year.

"Disability claim reserves should reflect offsets for Social Security and similar governmental benefits, and the assumptions made with regard to such offsets cannot be based solely on historical experience...."

- Contract reserves can arise even in group medical insurance: Whenever an insurer has issued a guarantee that premiums will remain level over multiple years despite the fact that claim costs are expected to rise during that time, contract reserves are necessary (with no preliminary term provision).

- For coverages without a prescribed regulatory morbidity basis (e.g., long-term care, medical), it is acceptable to use the pricing morbidity assumptions, possibly with an explicit margin added, so long as the resulting contract reserve is conservative in light of anticipated experience.

Provider Liabilities

In the context of the HRGM, "provider liabilities" are contingent obligations to providers under risk-sharing arrangements where financial or operational objectives must be achieved before payments are made. Such obligations are claim liabilities and not expense liabilities. The guidance provided by the manual on this class of liabilities includes the following:

- Provider liabilities need to be established for both the "ICOS" piece — contracts that have ended but whose risk-sharing settlement has not yet been distributed — and the "IBNR" piece — contracts still in progress that may ultimately generate a risk-sharing settlement.

- While seriatim estimates are clearly preferable, aggregate estimates may be used, particularly on an interim basis between regularly scheduled seriatim calculations.

- The claim reserve estimates used for purposes of calculating the provider liabilities may well differ from those actually booked. In particular, in order to achieve conservatism in the provider liabilities, it would typically be necessary to use incurred claim levels that were lower than best-estimate.

- The LAE reserve needs to include the liability for the cost of calculating and distributing accrued risk-sharing settlements. An expense liability may exist here even if the estimated provider liability is zero, since the act of informing providers of the non-existence of a risk-sharing payment may generate expenses.

Premium Deficiency Reserves

Premium deficiency reserves for health coverages are receiving heightened attention in U.S. statutory accounting due to their explicit appearance in codification SSAP No. 54. Consequently, this section is probably the portion of the manual of greatest interest to the actuarial community; it is also the section that underwent the greatest amount of scrutiny and revision over the past several months.

The concept is similar to that of loss recognition in GAAP: If at the valuation date the insurer believes that its existing contracts for periods after the valuation date will generate losses, then an additional reserve should be established, thus transferring the timing of those losses into the current period.

This premium deficiency reserve would be calculated via a gross premium valuation as follows: PV future paid claims, plus PV future expenses, minus PV future earned premiums, minus current reserves (both claim and contract reserves, plus any expense liabilities relating to the future expenses included above). Investment income may also be incorporated as appropriate, but income taxes should not be considered.

In determining the need for and magnitude of a premium deficiency reserve, the actuary must exercise judgment in a number of areas, most notably in setting the time period of the calculation and in establishing the appropriate grouping of policies. Without being prescriptive, the manual offers considerable guidance on these topics, including the following:

- The time period used in the deficiency calculation could extend beyond the next renewal date of the policies involved, if there are reasons that the deficiency cannot be assumed to resolve itself at the renewal date. Such reasons might include regulatory restrictions on the magnitude of premium increases, regulatory inability to terminate one segment of business without canceling a larger block of business, or the company's unwillingness to take necessary corrective actions at renewal.

- The deficiency reserve calculation should also consider contracts that will become effective after, but have been issued before, the valuation date and for which (deficient) premium rates have been guaranteed.

- Lapsation assumptions may be made in the calculation and should be related to any premium increase assumptions made therein.

- Determination of the need for premium deficiency reserves is generally to be performed not in aggregate, but by looking separately at each distinct grouping of contracts. In determining the groupings, which should be internally consistent from year to year, the main factor should be commonalities in the development of premium rates. This often leads to groupings by product type and (possibly) size of group; however, cross-product groupings may be appropriate (e.g., jointly written group life and medical cover ages). Secondary criteria for establishing the groupings may include such items as marketing methods, geography, and length of rate guarantees.

- While materiality considerations are relevant, a block of business representing an "immaterial" portion of the insurer's revenues might nonetheless be capable of generating a deficiency reserve that would have a "material" impact on the insurer's earnings, particularly where non-proportional coverages are involved.

Rowen B. Bell, FSA, MAAA, is an associate actuary at the Blue Cross Blue Shield Association in Chicago. He can be reached at **rowen.bell@bcbsa.com.**

Treasurer's Report

Period Ending June 30, 2000

	JANUARY 2000	MARCH YTD	APR-MAY-JUNE	JUNE YTD
INCOME:				
Dues		$31,900	$3,570	$35,470
Seminars		1,440	48,417	49,857
Newsletter		46	124	170
Monograph		653	221	874
Interest		1,955	1,734	3,689
		$35,994	$54,066	$90,060
EXPENSES:				
Travel		$15,762	$13,457	$29,219
Honorarium		6,000	0	6,000
Printing		2,993	3,044	6,037
Postage & Mailing		4,632	1,507	6,139
Special Supplies		0	0	0
Functions		1,468	0	1,468
Conference Call		0	0	0
Seminar Management Fee		0	0	0
Research Projects		0	4,818	4,818
Administrative Charge		14,796	0	14,796
		$45,651	$22,826	$68,477
NET INCOME		**($9,657)**	**$31,240**	**$21,583**
FUND BALANCE	**$243,662**	**$234,005**	**--**	**$265,245**

Notes to Financial Statement:

Travel: GAAP Textbook expenses
Printing: Newsletter - 6/00 + GAAP text editing
Postage & Mailing: Newsletter - 6/00 intl mailing + miscellaneous
Research: Library Indexing Project

This Section has made the following financial commitments:
Distribution of expense monograph - up to $20,000
1995 Specialty Guides -$5,000 (to date - paid $2,020)
Library Indexing Project - $5,000 - completed
GAAP Textbook - $80,000 (to date - $58,670)

		JUNE YTD
ASSETS:		
Cash - Money Market		$265,245
LIABILITIES		
Accounts Payable		$3,544
Research Commitments		
1995 Specialty Guides	$2,980	
Distribution of expense monograph	$20,000	
GAAP Textbook	$21,330	
Total		$44,310
TOTAL LIABILITIES		$47,854
SURPLUS		
Surplus Before Commitments	$261,701	
Less Commitments Above	$44,310	
Unrestricted Fund Balance		$217,391
TOTAL LIABILITIES AND SURPLUS		**$265,245**

Thanks to the Annual Meeting Speakers!

The Financial Reporting Council, on behalf of the entire Section, would like to thank the following speakers at the just completed Annual Meeting in Chicago for their part in what turned out to be a very successful meeting.

Session 5 - Purchase GAAP
- Michael Eckman
- Daniel Kunesh
- James Milholland

Session 6 - Statutory Reserving Update - Annuity Products
- Jonathan Wooley
- Donna Claire
- James Lamson

Session 10 - Valuation and Financial Reporting of Long Term Care Insurance
- Mark Litow
- William Bigelow
- Peggy Hauser

Session 32 - Statutory Reserving Update - Life Products
- Michael Eckman
- Thomas Campbell
- Andrew Erman
- David Sandberg

Session 33 - GAAP Textbook Introduction
- R. Thomas Herget
- S. Michael McLaughlin
- Shirley Hwei-Chung Shao

Session 42 - Financial Reporting Hot Breakfast
- S. Michael McLaughlin
- Michael Eckman

Session 54 - Enterprise Risk Management
- Francis Sabatini
- Russell Osborn
- Max Rudolph

Session 66 - Managing Risk in Extreme Market Environments
- Peter Tilley
- Anson Glacy Jr.
- Haikady Nagaraja

Session 67 - GAAP For Non-Traditional Products
- Thomas Campbell
- Laura Hay
- Mary Saslow
- Deborah Whitmore

Session 70 - Fair Value Liabilities - A Debate
- S. Michael McLaughlin
- James Reiskytl
- Marsha Wallace

Session 87 - Banking and Insurance: Different Ways to Count the Same Beans
- H. Michael Shumrak

Session 88 - NAIC Actuarial Opinion
- Larry Gorski
- Micahel Boerner
- William Carroll
- Shirley Hwei-Chung Shao

Special Thanks To:

❖ Stephen Preston, the overall meeting coordinator for the Financial Reporting Section

And to sessions coordinators, not already mentioned as a speaker:

❖ Gregory Gurlik
❖ John Bevacqua
❖ Steven Lane Craighead
❖ Mike Lombardi
❖ David Rogers

Session 117 - Accounting for Policyholder Dividends
- Darryl Wagner
- Kenneth LaSorella
- Nigel Masters
- Patricia Matson

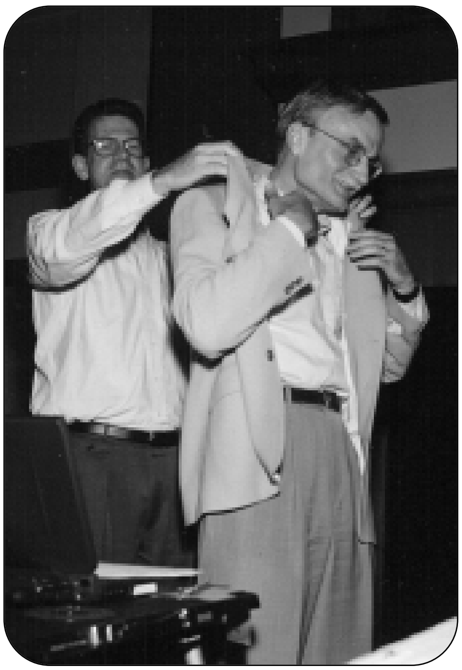
Session 130 - US & Canadian Demutualizations - Postmortem
- Barry Shemin
- Caitlin Long
- William Wheeler
- Robert Wilson

Session 133 - Research Opportunities Created by New AAA/SOA Life Company Model
- Arnold Dicke
- Luke Girard
- Stuart Klugman
- Harry Panjer
- Mark Tenney

Session 151 - Regulation XXX: Implementation Issues
- Mary Bahna-Nolan
- Larry Gorski
- Donald Maves

Financial Reporting Section Photos from Chicago's Annual Meeting

Retiring Section chairperson, Mike McLaughlin, explaining the Financial Reporting Section's tradition of having the retiring chairs sign the green jacket and pass it on to the new chairperson.



New chairperson, Mike Eckman, receiving the green jacket.

New Section chairperson, Mike Eckman, wearing the green jacket, presents a gift of appreciation to retiring chair Mike McLaughlin.

FRIDAY, JUNE 23 **SESSION 85**

10:00 a.m. - 11:30 a.m. Teaching Session

Specialty Track: Management and Personal Development

FOCUSING ON WHAT REALLY MATTERS

- CANCELLED -

99

A bit of actuarial humor. This was an actual session that was going to be held at the San Diego spring meeting on June 23, 2000, for the Management and Personal Development Section, but was cancelled.

SOCIETY OF ACTUARIES 1949

475 N. Martingale Road, Suite #800
Schaumburg, IL 60173
Phone: 847-706-3500
Fax: 847-706-3599
Web site: *www.soa.org*