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From the Editor

by James R. Thompson

This issue of *small talk* tries to accomplish two main objectives: to discuss the peculiar problems of smaller companies in modeling CMOs and to present our usual legislative update. The pace of regulation has been increasing. The NAIC is providing us with many issues to cover. It is sometimes difficult to know where to begin.

One of the most significant developments is in the area of proposed guideline *XXX*. This NAIC-adopted model regulation deals with the reserving of term insurance and UL with certain guarantees. It is supposed to provide more theoretically correct reserves than the current standard valuation law with the unitary approach, because it considers the relation between the gross premiums and mortality by segments. The result, however, is to increase reserves significantly, especially for policies with longer guarantees and in the more select premium classes.

States that have passed *XXX* have generally done so with the provision that it will take effect only if states representing 51% of the population also pass it. Many states have not passed it

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Codification Coming Your Way

by R. Thomas Herget

Statutory accounting for life, health, and P&C companies has always relied on prescribed and permitted practices. These practices were promulgated by each of the 50 states. There was enough diversity in these practices that by the late 1980s, the accounting community (particularly the audit firms) no longer felt comfortable issuing opinions based on statutory accounting. The concern was that there was no single set of practices that companies adhered to.

The NAIC responded to this by forming a committee of regulators to prescribe specific procedures and methods for compiling statutory financial statements. It was also its charge to define principles underlying statutory accounting.

For actuaries, it is certainly time to start paying attention to this regulation. It was approved at the NAIC's spring meeting in Salt Lake City in March 1998.

The codification documents can all be found on the NAIC's web site, naic.org. There is a preamble that attempts to identify the fundamental principles for statutory accounting. The preamble is followed by 90 Statements of Statutory Accounting Principles (SSAPs), which spell out the rules for codified statutory accounting.

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My personal opinion is that one might find the preamble weak in establishing the fundamentals for financial reporting. Also, its stated objectives are not always supported (and sometimes contradicted) by the subsequent reserve requirements.

Some of the concepts in the preamble are that "SAP is conservative … but not unreasonably conservative." "Statutory accounting should be reasonably conservative over the span of economic cycles." "Valuation procedures should … prevent sharp fluctuations in surplus." "The income statement …

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or are ignoring it. Although New York has had it (NY Regulation 147) for several years, most companies are accustomed to marketing with a non-New York strategy. Recently Wisconsin passed it with the effective date 1/1/99. Regulators are still pushing it.

At the March NAIC meeting, there was a significant development. After presentations by the industry opposing the current form, the regulators asked the industry to come back with a counterproposal to the current *XXX*. On April 2, industry representatives gathered near Chicago in a open meeting (even tuning in various regulators on a speaker phone). I was present. I watched in amazement as actuaries representing various companies, large and small, mutual and stock, both players in this market and those who have not, consultants who work with smaller companies and the American Council of Life Insurance and the National Alliance of Life Companies (working with generally smaller companies), brainstormed to see if they could agree on an alternative.

A verbal consensus was obtained. It will be written out in detail and presented at an ACLI meeting May 12. The NALC should also have been apprised of it. It may then go on to the June NAIC meeting. This reminded me of the Missouri Compromise from before the American Civil War. It is neither a unitary approach, which can result in zero terminal reserves for some long-level term insurance with a tail of YRT, nor is it like the current *XXX*, which will result in significant terminal and deficiency reserves for policies with level premium and guarantees over five years.

As I write this editorial, there is nothing in writing, but I understand the general principles. One deals with the terminal reserves, which are humped for a level-premium term insurance product with no YRT tail. The mortality table need not be the one in the current *XXX*. It will represent more recent (and hence lower) mortality and should have a longer select period than 15 years. There should be provision for the more select classes. The net effect will be lower terminal reserves.

One principle is that different contract designs should not produce different terminal reserves. Thus, if one has a 20-year level term with a 20-year guarantee, the same with a five-year guarantee, a 20-year reentry term with a YRT tail with a 20-year guarantee, and one with a five-year guarantee, the terminal reserve should be the same. It will be based on the current-level premium. No advantage will be gained by having or not having a YRT tail.

"This reminded me of the Missouri Compromise from before the American Civil War. It is neither a unitary approach ... nor is it like the current XXX ..."

The deficiency reserve is different. Those of us in pricing know that the deficiency reserve is often large or at least very significant. It is viewed as unnecessary because we know from profit studies that such a high reserve is unnecessary.

The mortality for the deficiency reserve will be much lower than that for the terminal reserve. There was discussion on the use of a valuation actuary approach. This might mean that the level of deficiency reserve might be determined by a gross premium valuation (GPV) or cash-flow testing (CFT). There might be some minimum mortality table, however. One concern I have is that the strict valuation actuary approach will mean that larger companies with more credible experience will have some advantage. Perhaps some minimum or default mortality would provide a level playing field. For further comments on this, see the article by Jim Van Elsen on page 21.

Another issue is codification. See the article by Tom Herget on page 1 on the results of the March NAIC meeting. Also note the comments by Commissioner D'Annunzio of Michigan (page 3). This is a reprint of a letter written to the *National Underwriter* prior to the March meeting. Note the comments from the NALC newsletter.

Another issue is the Unified Valuation Law (UVS). This is the revision to

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the Standard Valuation Law. The Academy committee produced a report in December. I have been following this on behalf of *small talk*. To paraphrase the Executive Summary of this report, the concept is "…far-reaching; it abandons the current rigid approach and focuses on providing necessary financial information on a consistent basis to all interested parties." The UVS should address the needs of regulators and others within a single system. This report was assembled after investigations into the valuation procedures in a variety of other countries.

The framework mentions 11 points. Of particular note, the UVS shall "support financial analysis at points in time and over time," "be built upon best estimate assumptions with explicit determinable margins," shall "address overall solvency, not just contract reserves," shall enable a comparison between assumptions and emerging experience, "balance practicality, cost and resource effectiveness," "be consistent for all companies and among regulatory jurisdictions," and "utilize actuarial judgment in preference to prescribed methods and assumptions." Members were asked to propose a new valuation law. One of our Section members, Norman Hill, has done so in his article on page 16.

Another issue is demutualization. We have two articles on this, one by Thomas Tierney on the New York situation and another by Chris DesRochers on the general issue. There are various other articles, including discussion of the smaller company exemptions for cash-flow testing, relations between federal and state authority, and banks in insurance.

Finally there are several on investments. We are trying to examine the problem of modeling CMOs. These have become increasingly popular. Modeling them is difficult. In the past, several service bureaus have done the modeling for life companies. Recent improvements in cash-flow testing software used by many companies have enabled larger companies with trained staffs to take this function in-house. The service bureaus have raised their prices so that it is not economical for a smaller company to use their services.

What options are available to the smaller company, which may not even have an investment department and which may use consultants for buying assets and performing the cash-flow testing? Several articles explore approaches to this. Note one by Dale Hall, another by Jay Glacy, and a related article on duration by the staff of CMS, a service bureau which has done work for clients in the past. Although it still does, their software is now making its way to brokerage houses. Thus smaller companies should be able to get this as a client service.

Finally, if you are coming to the Spring Meeting in Maui, I will be moderating a panel on having a positive influence on legislative and regulatory developments. There is much going on, and we all need to follow events and also learn how to influence them.

James R. Thompson, FSA, is a consultant with Central Actuarial Associates in Crystal Lake, Illinois and Editor of small talk.

Small Talk from the High Chair

by John E. Wade

The Smaller Insurance Company Section is particularly interested in helping the actuaries of smaller companies deal with the increasingly complex requirements of both standards of practice and regulatory requirements, as well as providing a forum for discussion of topics unique to smaller companies.

In the future, we would expect to continue to (1) provide a newsletter to report on various items of interest to the Section and (2) conduct sessions at both the Spring and Annual SOA Meetings on topics of particular interest to small companies. We would also like to participate in the Valuation Actuary Symposium where appropriate. And last, we would expect to continue our participation in the finance and investment management practice area and the life insurance practice area.

In addition to these continuing functions, we hope in the future that the Section Council will develop an issues survey that will help us to better profile our constituency and identify the issues that are important to them. Some of the obvious issues facing the smaller companies are compliance with market conduct practices and asset-adequacy requirements and dealing with issues of merger and acquisition, critical mass, and costs of technological competence.

We are getting ready to elect three more members for three-year terms. We would like interested parties to submit a letter of interest and biographical information to Lois Chinnock at the SOA by May 14. We can then prepare a slate of candidates for election.

John E. Wade, FSA, is Executive Vice President and CFO at American Memorial Life Insurance Company in Rapid City, South Dakota and Chairperson of the Smaller Insurance Company Section Council.