



"XXX" Meeting in Chicago & NAIC Meeting in Salt Lake City

Compromise on "XXX" in Works

Meeting on April 2

The National Alliance of Life Companies (NALC) hosted a meeting in Chicago to discuss possible alternatives to the impending "XXX" regulation. A tentative agreement was reached by the attendees. This proposal will be presented to the Life & Health Actuarial (Technical) Task Force at their meeting in June.

Who Attended

There were 29 people present with at least 6 others on the speaker phone. Every possible faction of the industry was represented: mutual & stock, large & small, companies & consultants, industry representatives & regulators. In addition, the American Council of Life Insurance (ACLI), and the NALC were represented. Bob Barney of Compulife Software also participated. Mr. Barney has been very vocal to governors & insurance commissioners about his opposition to "XXX."

Basic Reserves

The new methodology (named "JVE" at the meeting) is very similar to the methodology contained in the "XXX" regulation. The primary difference is that a company must use its current premium scale for determining

mortality tables, these net premiums are calculated the same as for the basic reserves. Premium deficiencies, if any, will be calculated based on guaranteed premiums.

Basic Mortality Table

A new set of selection factors will be developed modifying the 1980 CSO table. It is anticipated that the selection period may be 20 years, with longer periods possible at the younger issue ages. It is also anticipated that these factors will reflect the new preferred classifications of underwriting. It will also be more reflective of current mortality levels with appropriate statutory margins.

Minimum Mortality Table

A more aggressive set of mortality tables will be developed for the minimum reserves. It is possible that the valuation actuary will need to justify the use of the mortality table. These tables may or may not be based on the 1980 CSO table.

Highlights

- ▶ "XXX". Special meeting in Chicago on April 2. The current scorecard is on page 7.
- ▶ Annuity 2000. Current scorecard on page 6.
- ▶ Illustration Regulation. Current scorecard on page 7.
- ▶ Unified Valuation System (UVS). See update from Tom Herget of PolySystems on page 5.

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segments and premium ratios. This would generally create traditional "humpback" reserves for the period of intended level premiums. For example, a 20-year term product with premiums guaranteed for 5 years would have to set up 20-year "humpback" reserves.

In addition, the 5-year exemption provided for in the current "XXX" regulation has been eliminated.

Minimum Reserves

Minimum reserves are defined similar to the definition contained in "XXX." Segments & premium factors, however, will be based on current premiums. Except for the difference in

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Phone: 515-674-4046

Fax: 515-674-3198

E-Mail Address:

Van.Elsen.Consulting

@worldnet.att.net

Mailing Address:

Van Elsen Consulting

123 North Walnut
Colfax, Iowa 50054

Planned Activities

The ACLI's Actuarial Committee will meet on May 12 to consider supporting the compromise. The NALC's Actuarial Committee will meet in April to consider supporting the compromise. In the meantime, 5 subcommittees have been formed to deal with technical issues of the recommendation. The full committee will meet in Washington, D.C. on May 13 to finalize the recommendation to the L&HATF. This meeting will be sponsored by the ACLI. Please contact our office if you would like to attend.

1. **Basic mortality table.** This group will recommend new selection factors for the 1980 CSO table. Rob Foster of CNA will be heading up this subcommittee. The report is due on April 17.
2. **Minimum mortality table.** This group will recommend new mortality tables for determining minimum reserves. Rob Foster of CNA will be heading up this subcommittee. The report is due on April 17.
3. **Draft regulation.** This group will be responsible for drafting the necessary changes to "XXX" to reflect the compromise. **Jim Van Elsen** of **Van Elsen Consulting** will be heading up this subcommittee. The report is due on April 20.
4. **"Loop holes."** This subcommittee will focus on finding problems with the proposed compromise. They will be trying to develop ways to get around the regulation so that potential loop holes may be closed. Lee Harrington of American General will be heading up this subcommittee. The report is due on April 27.

5. **Communications.** This committee includes actuaries representing the ACLI and NALC. It will be the group responsible for coordinating the activities of the other groups, as well as putting together the package for the ACLI & NALC Actuarial Committees. They will also be responsible for making the presentation to the regulators in Kansas City in June. Steve Smith of First Colony will be heading up this subcommittee. The initial report is due on May 5.

If all goes well, **Jim Van Elsen** & Steve Smith will be making a joint presentation to the L&HATF in June. If it is accepted, the suggested modifications will need to work through the normal process for NAIC adoption of a model regulation. This could be expected to be completed in 1999. The effective date of the regulation is hoped to be January 1, 2000, although there may also be 51% language. In addition, if well received, efforts will be made to modify, or delay, "XXX" where it has already been adopted. Wisconsin, for example, will be asked to move back the effective date until January 1, 2000, as well as to make the proposed changes to the regulation. It is also anticipated that New York will consider adoption of the revised model.

Why Not "XXX?"

Much has been written lately about the deficiencies of "XXX." Steve Smith & **Jim Van Elsen** both presented papers to the L&HATF in Salt Lake City. Copies of these papers may be obtained by contacting our office.

In these papers and others, several problems have been identified.

1. **5-year exemption.** It is anticipated that the existence of this exemption would result in many longer term periods having only 5

years of guaranteed premiums. Curiously enough, this is the very situation for which "XXX" results in inadequate reserves.

2. **Guaranteed premium games.** Under "XXX," and to a greater extent under the current unitary approach, actuaries can dramatically influence the level of reserves by having large ultimate guaranteed premiums. For the most part, this opportunity is eliminated under the proposal.
3. **Deficient reserves.** There are many instances where "XXX" results in deficient reserves. The most common occurrence is when the initial guaranteed period is shorter than the current level premium period (i.e., 5-year guarantee on a 20-year term). The reserve resets to zero at the end of the guarantee period. It may be several years before the reserves for the second segment are sufficient to provide for future benefits.
4. **Super-sufficient reserves.** The reserve penalty for long-period guarantees is exorbitant. It is not unusual for a policy with a \$2 per \$1,000 premium to have initial reserves of \$40 per \$1,000. This is due to the extremely conservative nature of the 1980 CSO table. It is particularly damaging to preferred classifications which were not anticipated in the 1980 CSO.
5. **Spotty adoption.** As part of a state's valuation regulations, "XXX" will affect all companies licensed in a state that adopts it. Without uniform adoption, many companies will become disadvantaged in the term marketplace.

6. **State variations.** While many states are moving toward the model regulation, there are other states which are taking different approaches. In particular, California & Connecticut will not adopt "XXX" in its current form. This will significantly complicate the valuation & product development of term products.
7. **"Fire sale."** The persistent "fire sale" that keeps burning on term insurance will eventually damage the industry's reputation. How many times can we keep marketing "Buy now before 'XXX'?"
8. **Replacements.** Companies are currently experiencing good persistency on term insurance. For a policyholder who purchases a 20-year product with a 20-year guarantee, there is no incentive to move the coverage. This better persistency will result in better ultimate mortality experience as well as better amortization of acquisition costs. With only a 5-year guarantee, however, there is a concern that policyholders may be encouraged to update their coverage to maintain guaranteed premiums. This will result in lapsation and increased costs to consumers.
9. **Increased insolvencies.** The reserving method currently being used by many companies (unitary) is adequate for the first 2 - 5 years. Thereafter, the reserves tend to be inadequate. In total, the reserves are probably adequate, due to the large volumes of recent sales. If these sales were to fall dramatically, reserves would become inadequate very quickly.

"XXX" Response

It is reasonable to assume that companies would make adjustments if "XXX" is adopted. The following are some of the possible responses.

1. **5-year guarantee.** Many companies may merely reduce their guarantees to be 5 years or less. It is anticipated, however, that competitive forces will move companies to other solutions.
2. **Substantial premium increase.** Companies could choose to give consumers the option of paying a higher premium to pay for guaranteed premiums. This increase, however, is probably too large to gain much of the market.
3. **Withdraw from state.** Depending upon the importance of a state to a company, a company may decide to withdraw from a state that has "XXX." It would appear, however, that this is a severe solution to a short-term problem.
4. **Multiple companies.** Many large companies have subsidiaries or affiliates that are licensed in different states. Many larger companies could adjust their writings such that they continue to have pre-"XXX" products in most states that have not passed "XXX."
5. **Reinsurance.** The international reinsurance market does not recognize the value of the large deficiency reserves caused by "XXX." It would be very easy, therefore, to coinsure the business overseas with very little additional cost. The reinsurer would carry the coinsured liability, and probably provide a letter of credit supporting the liability. They will also carry a deferred acquisition cost asset which will be slightly less than the liability. In essence, the reserves will disappear into the ocean.

West Virginia "XXX"

While everyone was focusing on Wisconsin, West Virginia adopted "XXX," effective on January 1, 1998. It was hoped that the regulation would be amended by the legislature to add the "Illinois provision." Unfortunately, this did not occur.

As such, "XXX" is currently effective in West Virginia. The commissioner of West Virginia, however, has recently released a statement regarding this situation. The following is a quote from that release:

"The Commissioner is aware of the potentially disruptive effects of implementing a Triple X rule in West Virginia before similar rules or regulations are implemented in other states. An emergency amendment to the existing rule soon will be filed with the West Virginia Secretary of State. At the same time, the Commissioner will begin the process of permanently amending the rule. Both changes will insert the Illinois language into the rule, and both changes would be retroactive to a time just before the original effective date of January 1, 1998. Once changed in this way, the rule would not apply at all until triggered according to the Illinois language."

"Given the favorable response to a similar change in the rule in the recent Legislative session, the Commissioner anticipates that these latest attempts to change West Virginia's Triple X rule will be successful. The Commissioner also realizes that implementing Triple X even for a short period of time would substantially burden many life insurers conducting business within West Virginia, and in doing so largely defeat the purpose behind the changes. Consequently, until such time as the changes are either effected or rejected, the Commissioner will

not require compliance with the West Virginia Triple X rule.”

If you need a complete copy of this release, please contact our office.

It would appear from the above that West Virginia will move the effective date of the regulation back. If they fail to do so, there will be many companies forced to withdraw from the state because of the large deficiency reserves which would develop.

“XXX” Casualty?

We recently received a release from Westfield Companies concerning the sale of Westfield Life to Guarantee Life of Omaha. This transaction is expected to be completed on June 1, 1998. The following statement was in the release.

“We decided to sell Westfield Life for several reasons. One of the primary reasons is the fact that our current

product line had to be redesigned to meet a rapidly changing marketplace with a special focus on a competitive term portfolio.”

Codification

The Executive Committee & Plenary adopted the final Codification Project. In doing so, they also reestablished the Codification Task Force to focus on implementation. The life reinsurance Q & A's were deleted from codification and referred to the L&HATF.

A surprise during the process was the announcement of Patrick Shouplin of the AICPA. It appears that companies will be able to receive “clean” opinions from auditors not using codification.

Father's Corner

It's been a very active 3 months for Sarah. Most important to Sarah during this time has been Taekwondo. She just recently competed at the Midwest

Regional Championships for Taekwondo. She earned a gold medal for her forms. She was also a qualifier in sparring. This will allow her to compete at the AAU National Competition in Boca Raton in July and the AAU Junior Olympics in Norfolk in August.

Sarah earned her high red belt (red with a black stripe) in January and just earned her black belt recommended. If all goes well, she will test for her 1st degree black belt in June.

On the basketball front, Sarah's team had a very successful season. They were undefeated in the Newton (home of Maytag) YMCA league. The highlight for Sarah was making her first basket halfway through the season.

Another bright spot this winter was the piano festival held in Des Moines. Sarah received a Superior rating for her piano solos.

Van Elsen Consulting

Van Elsen Consulting is an actuarial consulting firm. James N. Van Elsen, FSA, MAAA is the firm's owner and is responsible for the work completed. We specialize in serving the needs of smaller life insurance companies. Most of our experience relates to product development for individual life (universal life, traditional life, and term insurance) and individual annuities.

In addition, this firm is an advocate for the interests of smaller life insurance companies. We commit significant resources to work within the regulatory environment to help reduce the burden on the smaller companies. As your company prepares for the future, please consider Van Elsen Consulting. We have always represented smaller company interests and are ready to help.

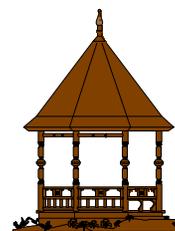
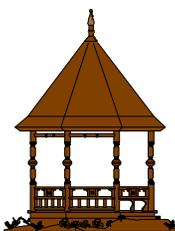
James N. Van Elsen, FSA, MAAA

Lois Mast

Mike Staudacher

Beth Ann Van Elsen

Sarah Ann Van Elsen



Unified Valuation System Moves Closer to Unveiling

by R. Thomas Herget

March 13, Salt Lake City. The American Academy of Actuaries' Valuation Law Task Force made its quarterly report to regulators, exposing its interesting intentions. Before revealing the intriguing direction, some background is necessary.

Statutory valuation rules and procedures are embedded in states' valuation laws and regulations. These have evolved since the early 1900's and have served relatively well until recently. The 1990's have seen the introduction of wildly innovative products.

These products are causing the statutory reserve system to creak and strain under the burden of fitting these products into existing paradigms. Frustrated, the L&HATF concluded that maybe statutory reserving needs to be revised in total. L&HATF has grown weary of expending so much effort in fitting square pegs into round holes.

The industry and the Academy have spent much time battling in the statutory valuation arena as well. Admission is not cheap. The AAA's recent Equity Indexed Annuity report consumed thousands of hours and would cost in the millions were it a consulting project. No one is eager to continue efforts like this to support the statutory aspects of reserve determination.

Last spring, L&HATF asked the Academy to recommend a new reserving method. L&HATF gave the Academy a "blank sheet of paper" to develop new principles and methods. In response, the Academy formed the Valuation Law Task Force. This Task Force is now very close to presenting L&HATF with its initial report containing a model valuation law regulation.

The scope of this project extends to every life, health and casualty company actuary who practices in the U.S. As more and more luminaries start attending these Academy meetings, one can sense the imminence and importance of the Task Force's report.

The Task Force has met monthly since last spring. The meetings are well-attended (between 40 and 60 participants). They are open to all Academy members and any interested party as well.

Analysis of existing practices has been thoroughly performed. Studies of other countries' environments has been scrutinized and summarized. Objectives have been deliberated and determined. Ideal characteristics and all audiences of a reporting system have been ascertained.

Now the final result is being cranked out. It's probably time to pay closer attention to it. So, enough on background.

At the recent Salt Lake City meeting, Task Force chair Bob Wilcox presented the major features of the Unified Valuation System (UVS). The recommendation is for a complete ejection of statutory rules. It would be replaced by GAAP. The major appeal is that GAAP is already articulated. It is in place in nearly all companies. Most actuaries are familiar with it. It has abundant authoritative literature. While not perfect, it is understood by most insurance people and is used to manage most companies.

But the most significant element of the UVS is its emphasis on total solvency. The UVS advocates a focus on calculating a new type of Risk Based Capital. This RBC will not be formula-based but instead be based on actuarial judgment. The actuary would use techniques similar to those employed by cash flow testing. The testing would cover all risks and all lines of business. The actuary will strive to calculate what amount of assets would be necessary to provide an x% assurance that the company will remain solvent. Of course, x is yet to be determined; the regulators might do that. The actuary needs to be able to determine an entire range of values to support "x." The UVS also calls for a strong central authority, composed primarily of actuaries, to support industry (managements' and regulators') acceptance of the significant role of the actuary's judgment.

Wow! Talk about heresy. Everything changes! No need for Actuarial Guidelines. No need for a multitude of practices. No more reinsurance regulations. No more SVO. Actually, no need to file a blue blank. The human resource savings could be astonishing, freeing up millions of dollars.

No more rules. But principles. And where there are principles, there are teachers. There will need to be significant educational strides made by the actuarial community to put the UVS into practice.

So, what are the next steps? Two responses will be forthcoming in the next six months.

One will come from the regulators. The L&HATF flashed a yellow light (not red) at its Salt Lake City meeting. Obviously, the UVS needs to be exposed to other elements within the NAIC. One regulator commented that providing uniformity in reserving practices would be a positive, proactive step in preserving state regulation rights.

The other response needs to come from the industry. The actuarial community will get this opportunity this summer.

The Task Force is not unprepared for resistance to its recommendations. The Task Force leadership is prepared to sell the benefits of these concepts to the financial community. It has already visited with key NAIC executives as well as made pilgrimages to the FASB and the AICPA.

So, hold on to your hats. Better make that life preservers. Batten the hatches. Statutory reserving has been sailing into treacherous waters. While its precious cargo of prescriptions and rules has been safely stowed for nearly a century, the ship's name might be the *Titanic*.

About the author. R. Thomas Herget is an FSA, MAAA, and Executive Vice President at PolySystems, Inc. He is a former editor of *The Financial Reporter* and is the current chair of the Society of Actuaries' Financial Reporting Section. He is also a member of the Academy's State Variations Task Force as well as a participant in the Valuation Law Task Force.

Annuity 2000 Update

The Annuity 2000 table has been adopted by the NAIC as a new valuation standard for individual annuities. States that have progressed on adopting the table are shown in the following Annuity 2000 Scorecard. Caution is advisable in reviewing this table. Many of the states contacted were not aware of the table. It is likely that many more states will be moving to adopt the table during 1998. Companies need to carefully consider the impact of the new valuation table. It may be necessary to review guaranteed settlement option rates on life insurance and annuity policy forms. It is conceivable that older guaranteed rates could result in higher required reserves, particularly for annuities.

Companies should also review their current settlement option and immediate annuity rates. It may be necessary to reduce purchase rates because of the increased reserves.

This mortality table won't be used for tax purposes until 26 states have adopted it. Again, this could be a pricing factor to consider for 1998.

Annuity 2000 Scorecard

States Adopting with June 30, 1998 or Earlier Effective Date

*Alaska California *Minnesota *Oklahoma *Oregon *Washington Virginia

States In Process with January 1, 1999 Effective Date

Arkansas Colorado Connecticut Illinois Louisiana *Ohio Wisconsin

States In Process

Alabama	In process.
Arizona	Under advisement.
Florida	Developing regulation. Effective date undetermined.
Nevada	Beginning process.
New Mexico	In process.
New York	Hope to have in place by end of this year.
West Virginia	HB 4283 in legislature with the effective date undetermined at this time.

* Specific State Comments

Alaska	Not yet adopted. Effective date of January 1, 1998 may change.
Minnesota	In process. Effective date of January 1, 1998 may change.
Ohio	Rule adopted. Optional for 1988, but mandatory January 1, 1999.
Oklahoma	In process. Effective date of January 1, 1998 may change.
Oregon	Effective October 29, 1997.
Washington	Effective date of April 1, 1998.

"XXX" Update

As you can see from the table on page 7, states that have adopted the regulation now total 21.89%. Another 9.91% are in process of adopting for a potential total of 31.80%. California, representing 11.97%, has chosen not to adopt "XXX," although they are currently reevaluating that position.

Currently, states representing 25.69% of the population do not appear to be adopting the regulation. The remaining states (representing 42.51%) have not taken a position on "XXX."

It would appear that it is not likely that enough states will adopt "XXX" in order for the 51% provision to be effective. With Wisconsin & Texas moving to certain dates, however, the issue becomes more complicated. This is a situation sure to cause chaos in the term & universal life insurance markets.

The Van Elsen Report will continue to monitor progress on this regulation.

"XXX" Scorecard

States Adopting with 51% Provision (11.97%)

Illinois Kansas Maine Maryland New Mexico North Carolina Utah

States Adopting without 51% Provision (9.92%)

New York Currently effective. Currently considering change.
 West Virginia Effective January 1, 1998. See article on page 3.
 Wisconsin Effective January 1, 1999.

States Not Adopting (25.69%)

Arizona No plan to adopt
 Arkansas No action intended until 51% of population adopts.
 California Current bulletin requires special analysis of term reserves. Does not meet the definition for the 51% provision. Considering changing position to adopt "XXX".
 Connecticut Defined as Valuation Practice. Similar to the California bulletin.
 Delaware No plan to adopt.
 Florida Regulation would conflict specifically with current law.
 Georgia No plan to adopt.
 Oregon No plan to adopt.
 South Dakota No plan to adopt.
 Tennessee Not going to adopt.
 Vermont No plan to implement.

States Currently In Process (9.91%)

Colorado In drafting process. No hearing date set.
 Minnesota Still in early stages of drafting process.
 Texas Hearing delayed until the end of April. The effective date, unchanged at this point, would be effective on December 31, 1998 for policies issued on or after December 31, 1998.

Illustration Regulation Update

The map on page 8 shows the status of the illustration regulation. Darkened states (such as Alabama) are those that we expect to have the regulation effective on June 1, 1998 or earlier. The hashed states (such as Arizona) are currently progressing on adoption. Bricked states (Georgia & Michigan) do not intend to adopt the regulation. The remaining states (not shown in the tables below) are on hold or in review status. Experience this year, however, shows us that a state may go very quickly from review status to having the regulation in effect.

The following summary was updated April 7. It is based on interviews with insurance department personnel and other sources. We believe the information contained in this summary is accurate at the time of printing. If you have concerns or questions about a specific state's status, we encourage you to contact us. Also, please contact us if you are aware of any errors in this table. **We will be publishing an update with each of our regular newsletters in 1998.**

States Expected to be Effective on Or Before June 30, 1998 (26 States)

Alabama ***Alaska** California ***Connecticut** Colorado Delaware ***Illinois** ***Iowa** ***Kansas** Louisiana Maryland Nebraska Nevada ***New York** North Carolina North Dakota Ohio Oklahoma Oregon ***Pennsylvania** ***Rhode Island** South Carolina South Dakota Utah Washington Wisconsin

*** See next page for additional comments.**

*** Specific State Comments**

- Alaska Planned June 1, 1998.
- Connecticut June 1, 1998.
- Illinois June 1, 1998.
- Iowa Liberalized \$10,000 exemption provision.
- Kansas Deviation from model regulation. As written, it applies to changes to existing policies which are achieved through a new sales effort or for which underwriting is required.
- New York Regulations for implementation have not been adopted. Effective date will be January 1, 1998.
- Pennsylvania Review annuity provisions.
- Rhode Island In legislature. Hoping for an effective date of June 30, 1998.

Status in Other States

State	Status	Effective Date	Comments
Arizona	Submitted to legislature.	Planned December 30, 1998	
Arkansas	Reviewed. Plan to implement.		
Georgia	No plan to adopt.		
Michigan	Don't anticipate adopting.		Rule has been issued which permits the use of the model regulation format. Do not intend to adopt other provisions.
Mississippi	Moving forward.	1998	
Missouri	In House.	Plan January 1, 1999	
New Jersey	Still pending.		
Texas	Published in Register.	Hope September 1, 1998	Closer to NAIC model. Still significant differences.

