

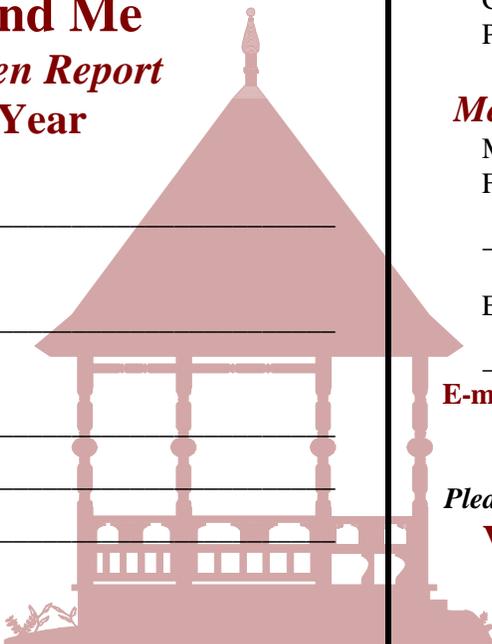
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NAIC Meeting in Atlanta

Focus on Equity-Indexed Products

New WG's Proposed

The Life Insurance (A) Committee has recommended that a new working group be set up to focus on the regulatory aspects of the new equity-indexed products. The American Academy of Actuaries (AAA) has also begun setting up a task force on the same issue headed

by Donna Claire of Claire Thinking. These products, which were initially limited to single premium deferred annuities, are now being seen in the market in other forms. At least one company has introduced a universal life product with equity-indexed features.

In Atlanta, the regulators continued to express the concerns about these products that were raised at the Anchorage meeting. In addition to the new working group, charges are expected to be given to the Annuity Working Group, the Life & Health Actuarial Task Force (L&HATF), and the Life Disclosure Working Group.

Annuity Working Group
An ongoing charge that this working group has is to "review various types of annuities and suggest to the parent committee where a resolution if necessary should be sought." As such, this group can be expected to be monitoring the developing regulatory framework for this product. In past meetings, this working group has heard reports from industry about various aspects of the product.

L&HATF

The actuaries will be examining the reserving and nonforfeiture aspects of these products. One issue that has risen on the nonforfeiture front is whether terminating policyholders should be entitled to some portion of the appreciation in the index even if they terminate before the end of the period.

They can also be expected to

comment on other topics relating to this product. At this meeting the task force heard reports from UBS Securities regarding investment strategies and financial instruments used by companies that sell the products and from AAA on statutory accounting and valuation issues.

Life Disclosure Working Group

This working group is expected to receive a charge to develop a new model regulation on non-variable annuities. The disclosure aspects of

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The four regular editions of *The Van Elsen Report* will follow the quarterly NAIC meetings. Additional editions will be issued if events warrant.

equity-indexed annuities are expected to be a part of this model. It is likely that the working group will also be considering the disclosure aspects of other equity-indexed products.

James Hunt of the Consumer Federation of America expressed concern to the Annuity Working Group that companies do not adequately disclose that the index used does not include reinvestment of dividends. He also indicated that there is "great potential for disappointment" in this product.

Other Issues

The following are other issues that have arisen during the discussions about this product.

1. **Registered security or not?** Per Rick Morse of New York, Susan Nash of the SEC has indicated that the SEC is looking closely at these products to determine whether they should be registered. This determination would be outside of Rule #151. Jerry Fickes of New Mexico indicated that "this thing looks an awful lot like a security to me."
2. **Investments.** Concerns center around the types of securities that are being purchased including the various hedging instruments.
3. **Accounting.** Of particular interest here is the valuation of securities and liabilities. There are also GAAP issues that will need to be resolved.
4. **Guarantee fund.** There are two issues in this area. The first relates to whether these premiums are assessable. The second question, which may not have the same answer, is whether the guarantee fund

has any responsibility for the equity-index guarantees provided for by these contracts.

We cannot overemphasize the importance of these developments to companies marketing these products. Changes in laws and regulations have the potential of making this product unprofitable or eliminating it entirely. One should not rule out the possibility of these changes being retroactive.

Several states have changed their position on this product and are either no longer approving them or have significantly increased the information required for approval. This would include Illinois, Minnesota, New Jersey, New Mexico, New York, North Dakota, and Oklahoma.

As an example, Illinois now wants to see all advertising materials, description of hedging strategies, methods for reserving, and methods for valuing derivatives. They will also be requiring this information from companies that have already received approval of their product.

N-F Work Proceeds

The L&HATF delivered to the "A" Committee an interim report titled: "Insurance Nonforfeiture Benefits and Related Issues." This paper represents the task force's current position on concepts to be used to write a new nonforfeiture law for life, annuity, and health insurance products. The following are the key concepts outlined in the report:

1. **Nonguaranteed contract provisions.** Companies will be required to establish operational plans for managing nonguaranteed elements in the future.
2. **Nonforfeiture benefits.** Minimum values would not be

specified by statute. Other approaches would be permitted, including redetermination based on past or future expected experience.

3. **Cash benefits.** Would not be required.
4. **Nonforfeiture plan.** Would be required where there is a material prefunding of benefits. The plan is a commitment by the company for the determination of nonforfeiture benefits in the future.
5. **Operational plan.** Detailed plan for all guaranteed elements and for nonguaranteed elements.
6. **All lines of business.** Applies to life, annuity, and health insurance.
7. **Fairness.** Requires disclosure of the plans to the purchaser and actual adherence to the provisions of the plans.
8. **Regulation.** Subject to state laws and appropriate Actuarial Standards of Practice.
9. **"Dual" approach.** As currently written, companies could

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continue to comply with existing nonforfeiture regulations.

In receiving the report on behalf of the "A" Committee, Commissioner Bartlett of Maryland observed that the project had little chance for acceptance by the commissioners unless the industry or consumers express support for it.

AAA Presents Report on Section 7 Exemption

The AAA Task Force on State Variations in Valuation Laws gave a report on the small company exemptions in the Actuarial Opinion & Memorandum Regulation. This report was requested by the L&HATF at its meeting in Alaska.

Originally, the AAA task force had recommended that all companies be required to file annual Section 8 opinions (with asset adequacy analysis). In exchange for this, companies were going to be permitted to file actuarial opinions recognizing the preeminence of the valuation laws of the state of domicile. Currently, actuarial opinions are based on the valuation laws of the state where the opinion is filed.

The report recommended the elimination of the category of company that files Section 8 opinions every three years. Companies with \$100 million or more of assets would be required to perform asset adequacy analysis every year. The report states that: "Many actuaries for these companies have found that after the first asset adequacy analysis is completed, it is not that difficult to perform asset adequacy analysis annually. In fact, many companies have found it to be easier to update their analysis annually with asset and

product liability changes than to perform a completely new analysis every third year."

It also recommended the establishment of four types of exemption tests. The task force recommended testing concepts. It anticipated that the L&HATF would set the actual values for the tests. These tests are as follows:

1. **Surplus tests.** Capital & surplus not greater than a "specified" percentage of cash & invested assets. Conceptually, this is not too different from the current eligibility test.
2. **Liability tests.** Section 8 opinion would be required if reserves for the following products are greater than a "specified" percentage of total liabilities: annuities, guaranteed interest contracts, interest sensitive life, long term care, non-cancellable health insurance, participating life, single premium life, structured settlements, and universal life. This is a longer list of products than for the current eligibility test.
3. **Asset tests.** Section 8 opinion would be required if the sum of the following asset classes is greater than a "specified" percentage of surplus plus AVR plus IMR: non-investment grade bonds, CMO's without significant prepayment or extension protection, zero coupon bonds of high duration, equity-linked notes, asset-backed securities, and investment real estate. The current eligibility test only measures non-investment grade bonds.
4. **Derivative tests.** Section 8 opinion would be required if the company had any derivatives

open during the year and it had not complied with the documentation requirements for hedge accounting. This is a new exemption test.

Sheldon Summers of California recommended that the task force consider allowing the preeminence of the state of domicile's valuation laws only if a company files a Section 8 opinion. This was adopted by the L&HATF.

Frank Dino of Florida then recommended that if Section 7 opinions retain the preeminence of state of domicile, that "good & sufficient" language be reinserted into the Section 7 opinion. This was also accepted by the task force. See the two editorials on page 6.

Valuation Laws to be Studied

The L&HATF announced that it will be asking the AAA to begin a study on developing new valuation laws and regulations for all life, annuity, and health insurance products. Such a study will be "zero-based" and will not necessarily use the current concepts of valuation. The following is being considered to be part of the Academy's study:

1. Valuation actuary concept for small companies.
2. How RBC requirements should be made consistent with the reserving standards, especially for the C-2 and C-3 components.
3. Consideration of changes to IMR.
4. Standards for reinsurance.
5. Impact of codification.
6. Likelihood of uniform adoption.

The L&HATF will have a conference call in a week or two to better define the request. This project was also included in the task force's

recommended charges for 1997.

Update on "GGG"

An AAA work group gave the L&HATF a report clarifying Actuarial Guideline XXXIII ("GGG"). Included in this report was recommended revisions to the guideline. This revised guideline was exposed by the task force for comment. The L&HATF hopes to adopt a revised Actuarial Guideline XXXIII by the summer meeting.

The AAA report begins by categorizing benefits into elective and non-elective. Non-elective benefits are those which require the occurrence of an insured event. These would include death benefits and nursing home benefits.

Elective benefits are those which may be freely elected by the owner without the occurrence of an insured event. These would include full surrenders, partial withdrawals, and annuitization.

Non-elective benefits require incidence rates for valuation. These rates will be used to calculate expected non-elective benefits. They will also be used to discount the elective benefits for survivorship.

In calculating the reserves for elective benefits, all combinations of elective benefits must be considered. An example would be a maximum free partial withdrawal followed by annuitization. In calculating the present values, the values of the elective benefits are discounted by survivorship using the above incidence rates.

The CARVM reserve will be the greatest reserve which is equal to the present value of a combination of elective benefits plus the related present value of non-elective

benefits.

The report discusses many issues related to the selection of valuation interest rates. This should go far in clarifying which rate to use when an annuity has several different types of insurance coverage combined in its benefits.

The report also discusses some of the practical aspects of CARVM calculations. The focus is that the valuation actuary must *consider* all benefit streams. It is not necessary to *calculate* the values for all streams. As written, the guideline would be effective on December 31, 1997 for all contracts issued on or after January 1, 1981. There is no grading

Good Luck Deon!!!

Deon Mitchell has been with us since August as an intern from Drake University. Deon recently completed his requirements for graduation and is considering his opportunities. We wish Deon all the best in his new career.

provision permitted. If it proceeds quickly, it could be adopted by the NAIC by the fall meeting. This would leave very little time for some companies to implement prior to the effective date.

Update on "MMM"

Another AAA work group delivered a report to the L&HATF regarding a proposed actuarial guideline on variable annuity minimum guaranteed death benefit reserves. As written, the guideline would be effective on December 31, 1997 for all contracts issued on or after January 1, 1981. The guideline would permit a

three-year grading with approval from the domiciliary commissioner. The recommended guideline was exposed for adoption. It is anticipated that the guideline could be adopted by the "A" Committee in March.

"Prudent Person" Set Back

The Financial Condition (EX4) Subcommittee held a special meeting to consider the proposed "Prudent Person" Model Investment Law. The model is known officially as the Investment of Insurers Model Act (Defined Standards Version). The special meeting was held so that the model might be moved to the Executive Committee for final adoption by the NAIC.

The subcommittee narrowly passed the model to the Executive Committee, only to have it defeated after extensive discussion.

Much of the discussion centered around the need for the Academy to evaluate the actuarial aspects of the new model law. The new law would require companies to "prudently" manage their invested assets appropriately for the liabilities.

The EX4 Subcommittee is expected to continue work on the model until it can be resubmitted to the commissioners in 1997.

NALC

Enclosed is an informative page about the National Alliance of Life Companies (NALC). This is an organization that we belong to and support. At the present time, I am serving as the chair of the organization's actuarial committee. If you have any questions about the NALC, please call us.

Domestic Abuse Models Advance

The NAIC has had four model laws addressing unfair discrimination in insurance for victims of domestic abuse. The first of these, for health insurance, was adopted earlier in 1996. In Atlanta, work proceeded on models for property & casualty, life insurance and disability income. The Market Conduct & Consumer Affairs (EX3) Subcommittee voted to adopt the life insurance and disability income versions of the model law. They will move to the Executive Committee in March. The subcommittee also continued work on the property & casualty model.

The life and disability income models proceeded in spite of objections from industry groups. The first issue for the industry related to enforcement of the law. As written, the commissioner may take action on the basis of a single violation of the act. Industry spokesmen had advocated requiring a pattern of violations.

The second issue related to the use of abuse-related information. The law requires that determinations be "made in conformance with actuarial principles and otherwise supported by actual or reasonably anticipated experience." The industry had argued for the use of the word or.

Illustration Regulation Update

See pages 8 - 10 for our latest summary of the status of approvals for this regulation. Notice in particular the number of states that will become effective during the first

six months of 1997. A surprise on the list is Nevada, which indicated to us that they still are trying for a January 1, 1997 effective date. Failing that, they can be expected to adopt early in 1997.

The Life Disclosure Working Group continued to discuss answers for its published Q&A. A question of particular interest for term companies had to do with the presentation of term premiums. Originally, the working group had taken the position that only one premium scale could be illustrated. If this premium wasn't sufficient to guarantee full benefits, the death benefit was to be reduced in the illustration.

With some qualifications on its use, the working group agreed to the use of current and guaranteed premiums in the illustration for indeterminate premium term insurance.

Another issue related to the use of illustrations for groups issued prior to the effective date of the model. Even though the position isn't clearly supported in the regulation, the working group took the position that a compliant illustration would be required if individuals in the group made purchase decisions after the effective date of the regulation.

Peer Reviews

How do you feel about the work that you recently completed for the illustration regulation? If you are like a lot of actuaries, you did the best that you knew how, but have many questions.

Several companies are retaining outside actuaries to review the work of inside illustration actuaries. This is being done to give better assurance to the board of directors that the regulation is being complied with and

to protect the actuary against unintentional violations.

This type of review will also examine the level of documentation and prepare the company for the eventual insurance department examination.

Van Elsen Consulting has been retained by companies to perform such peer reviews. If you would like your work reviewed by someone who has been involved with the regulation from the very beginning, please give us a call.

Mortgage Experience Adjustment Factor

The IMR/AVR Study Group has changed the method for calculating the Industry Experience Factor (IEF). The IEF is used to calculate the AVR maximum reserve charge for mortgage loans.

The 1996 fourth quarter Average IEF is 6.5% for both AVR and RBC. In the future, the factor should be available within 20 days after the quarterly filing due date. It will be posted on the NAIC home page, Actuaries Online, and the AVS system.

Questions about the factor may be sent to Dan Swanson at the NAIC at 816-889-4431 or by E-mail at dswanson@naic.org.

Dan, incidently, is originally from Colfax. He began his career in insurance accounting working with me at Integrated Resources in West Des Moines.

Father's Still Bragging

Congratulations to Sarah, who just received her first-degree yellow belt in Tae Kwon Do karate. This will also serve as a reminder to all of Sarah's future boyfriends.

Section 7 Valuation Actuary Opinion

I have serious reservations about the AAA's report to the L&HATF on the small company exemption. I was also opposed to the AAA original report in May which recommended the elimination of the small company exemption. It is difficult to know how these new tests are going to be until there are actual percentages in each of the tests. When these percentages are established, a study should be performed to see how many companies will still be eligible for the exemption. Many companies will not benefit from the extra expense and effort of asset adequacy analysis due to their small size. If only a few companies remain exempt, then the tests should be revised.

I oppose the elimination of the category of companies which file Section 8 opinions every three years. I had originally proposed the elimination of this category based on what I understood to be the situation for these companies. Since that time, interviews with companies who are on the three-year program have led me to believe that my assumption was incorrect. The AAA's report states that "In fact, many companies have found it to be easier to update their analysis annually . . ." when, in fact, I don't believe the AAA has done anything to substantiate this statement of fact.

I am also concerned about the expansion of products subject to the liability test. A much more revealing list would be the list of products not included in the test.

The asset test suffers greatly from definitional problems. What is "significant prepayment or extension protection" for CMO's? What are "high duration" zero coupon bonds? What are equity-linked notes? I would recommend involving some of the individuals who have been working on the new investment laws. Again, it is difficult to know how I feel about some of these tests until the terms have been defined.

Both of the recommendations from the L&HATF are unacceptable. The first, recommended by Sheldon Summers, essentially preserves the status quo for small companies while permitting larger companies to pay less attention to valuation laws outside their state of domicile. It is difficult to see why small companies would support a change which subjected more of them to asset adequacy analysis while giving no benefit to the remaining companies.

The second recommendation, made by Frank Dino, would essentially have the effect of requiring asset adequacy analysis for all companies. Why should small companies support this?

It obviously is not necessary for the NAIC to have small companies' blessing to pass a change to the model valuation law. A change in law which reduces the regulatory burden for larger companies while imposing a larger regulatory burden on smaller companies should be seen as unfair. Larger companies that hope to benefit from this change must find other ways to accommodate the needs of smaller companies. If this isn't done, the current regulatory environment will remain substantially the way it is today.

Small Companies & the AAA

It is easy for small companies to fall into the trap of viewing the AAA as the "enemy" since there are very few smaller company actuaries on the Academy's task forces and committees. If this is the case, however, it is because smaller company actuaries have not come forward to assist these groups. The Academy is constantly looking for new ideas. Members who want to become involved are usually accommodated. Speaking as a former small company actuary, I know that the demands for time are great. If small companies do not do a better job of representing themselves, however, these actuaries may find that they even have less time as they comply with new regulations.

I would also admonish the Academy, however, to try harder to seek out qualified actuaries to better represent the diversity of the membership. If the Academy cannot accomplish this, it is in danger of appearing to be an advocacy group for larger companies and consulting firms.

Finally, I would urge the Academy to reevaluate its practice of permitting regulators to serve on task forces making recommendations to NAIC task forces on which they serve. This has the appearance of industry sitting down with the regulators in secret to work out arrangements before they are shared with the public. This is particularly true when the AAA task force represents only a small portion of the industry.

"XXX" Update

This summary shows the states that have taken some action on "XXX." New York started things rolling when they adopted their "XXX"-like regulation in 1994. North Carolina adopted their regulation this year with an effective date of 1998. This regulation allows a 3-year grade-in of reserves.

Just when it looked like "XXX" might die everywhere else, Illinois adopted it with a unique provision. Their regulation will not become effective until states representing 51% of the population have adopted it. Since that time, several other states have moved to adopt "XXX" with a similar provision.

As you can see from the table, the current Illinois provision percentage is 22.49%, assuming these states all eventually adopt the regulation.

A few other states are considering term reserves along different lines. California has issued a bulletin which permits the use of "XXX," but also permits other methods of justifying the adequacy of reserves. For purposes of Illinois' test, California does not count.

Even without California, however, the regulation could become effective in many states with as few as six additional states. *The Van Elsen Report* will continue to monitor progress on this regulation during 1997.

"XXX" Scorecard

State	Status	%	State	Status	%
Colorado	1997 Spring hearing	1.32%	New Mexico	Awaiting hearing	0.61%
Illinois	Passed	4.60%	New York	Similar regulation previously adopted	7.23%
Kansas	Review status	0.99%	North Carolina	Effective 1/1/98 with grading to 1/1/2000	2.67%
Maine	Passed	0.49%	Utah	Review status	0.69%
Maryland	Waiting legislative approval	1.92%	Wisconsin	Hearing in Jan	1.97%
Total				22.49%	

This summary was updated December 18. This summary of state approvals of the Life Insurance Illustration Regulation is based on interviews with personnel in each of the insurance departments as well as other sources. The information contained in this summary is believed to be accurate at the time of printing. If you have concerns about a specific state, we encourage you to contact that state or Van Elsen Consulting. We ask that if anyone is aware of any errors in this table, or if the status changes for a state, please contact us. We will be publishing an update with each of our regular newsletters in 1997.

States shown in bold are expected to have a regulation effective in 1997.

Illustration Regulation Scorecard

State	Status	Effective Date	Comments
Alabama	Model passed	1/1/98	Essentially the NAIC model.
Alaska	Hearing in Jan or Feb	7/1/97	Essentially the NAIC model.
Arizona	On hold		
Arkansas	Review status		
California	Model passed	7/1/97	Essentially the NAIC model. The bill repealed the Yield Index, effective 1/1/97. Disclosure in bold required for over age 60.
Colorado	Hearing on 1/1/97	Anticipate 3/1/97	The NAIC model was unchanged.
Connecticut	On hold		
Delaware	Plan to adopt	Early 1997	
District of Columbia	On hold		
Florida	Review status		
Georgia	Do not plan to adopt		
Hawaii	No plan to adopt		
Idaho	On hold		
Illinois	Review status		
Indiana	Review status		
Iowa	Model passed	2/1/97	Section 3D (\$10,000 exemption) changed from no to initial illustrated death benefit.
Kansas	Review status		
Kentucky	Review status		

Illustration Regulation Scorecard

State	Status	Effective Date	Comments
Louisiana	Adopted waiting legislative approval	Anticipate 7/1/97	
Maine	On hold		
Maryland	Review status		
Massachusetts	On hold		
Michigan	On hold		Currently require specified illustration. Still considering whether to adopt model or retain current rule.
Minnesota	Review status		
Mississippi	Review status		
Missouri	Review status		
Montana	Review status		
Nebraska	Review complete	Anticipate 7/1/97, could be delayed to 1/1/98	Minor changes.
Nevada	To be adopted. Hearing date has not been set.	Early 1997, 1/1/97 if hearing officer agrees	No changes to model.
New Hampshire	On hold		
New Jersey	Review status		
New Mexico	Review status		
New York	Review status	Late 1997	Minor differences anticipated.
North Carolina	Model passed	1/1/97	Minor differences to be fixed with technical correction regulation.
North Dakota	Model passed	1/1/97	Minor changes.
Ohio	Moving forward	Anticipate 7/1/97	No material changes.
Oklahoma	Review status		
Oregon	Hearing 1/8/97	Anticipate 4/1/97	Requires annual certifications to be filed with Annual Statement.

Illustration Regulation Scorecard

State	Status	Effective Date	Comments
Pennsylvania	Passed both Houses. Governor expected to sign.	Anticipate 7/1/97	NAIC model with minor changes, except that it also applies to annuities.
Rhode Island	Review status		
South Carolina	Proposed draft to legislature	Anticipate 7/1/97	Minor technical changes.
South Dakota	On hold		
Tennessee	On hold		
Texas	Review status on 3 rd draft	Anticipate 9/1/97	Many changes. Call for details.
Utah	Model passed	1/1/97	Minor changes.
Vermont	Review status		
Virginia	Review status		
Washington	Review status		
West Virginia	On hold		
Wisconsin	Hearing planned for 1/17/97	As early as 7/1/97 or as late as 1/1/98	
Wyoming	On hold		

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Our specialty is to meet the needs of smaller life insurance companies, although we are available for other assignments. Most of our experience relates to product development for individual life (universal life, traditional life, and term insurance) and individual annuities.

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