THE ACTUARIAL UPDATE

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PROPERTY/CASUALTY NEWS

Hedging Catastrophic Risk: NAIC Gets Derivatives Report

At the October meeting of the National Association of Insurance Commissioners (NAIC), the Academy's Index Securitization Task Force presented its report on evaluating the effectiveness of index-based insurance derivatives to transfer catastrophic risk off insurers' balance sheets. At the request of the NAIC, the task force has examined ways to measure basis risk, which is inherent in this new form of risk transfer. This alternative risk transfer mechanism, which transfers risk to the capital markets, could give insurers additional risk-bearing capacity by supplementing traditional measures such as reinsurance.

The NAIC securitization project is of interest to property and casualty insurers, as well as other types of insurers, because index securitization can [illegible]ed to transfer both catastrophic and non-catastrophic risks to investors.

An Opportunity

"Index securitization presents an important opportunity for the profession," said task force Chairperson Fred Kist. "Regulators are searching for a [illegible]ter comfort level in evaluating these transactions, and we hope the information we're providing will be a step forward in that effort."

The Academy's report, "Evaluating the Effectiveness of Index-Based Insurance Derivatives in Hedging Property/Casualty Insurance Transactions," was prepared in response to a request from the NAIC Securitization Working Group. The NAIC's working group will be considering industry proposals to change statutory accounting treatment for index-based insurance derivatives — using underwriting rather than investment accounting treatment — if the transactions can be shown to be effective in hedging the insurer's exposure.

The report describes, in detail, four steps in defining the hedging transaction and testing it for effectiveness:

- Define the risk exposure to be hedged.
- Identify the index-based derivative structure to be used to hedge the exposure.
- Develop a viable economic argument that identifies a causal relationship between the exposure to be hedged and the index or indexes underlying the hedging instrument.
- Demonstrate mathematically that the hedge is effective.

The report also suggests that a good index should be easy to understand, consistent with the emergence of the loss process, capable of being modeled, and flexible enough to allow parties to customize trans-

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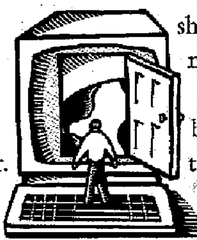

- **Take a look** at the Index Securitization Task Force's report on using index-based insurance derivatives in catastrophic risk transfer. Read the report on the Public Statements page, (www.actuary.org/1999.htm), and link to a hedge analysis spreadsheet and a bibliography of source materials for regulators.
- **Find a colleague's** phone number and address in seconds: Link to the online Directory of Actuarial Memberships at the bottom of the Academy's home page (www.actuary.org/index.htm.)

Cash Balance Plans

Meaningful Disclosure Needed, Academy Testifies

Cash balance pension plans are not, by themselves, inherently unfair to older workers, and they can offer advantages both to employers and employees, Senior Pension Fellow Ron Gebhardtsbauer told the Senate Health, Education, Labor, and Pensions Committee at a September 21 hearing.

However, Gebhardtsbauer said, conversions to cash balance plans are typically complicated and may reduce projected benefits for certain older employees. Workers therefore n[illegible] meaningful financial information for retirement planning when their pensions are changed.

T[illegible] hearing, which was televised on C-SPAN2, was held as the debate on cash balance conversions continued to make headlines and as Congress, the IRS, and the Equal Employment Opportunity Commission were investigating complaints that the shift to cash balance plans has shortchanged older workers.

Gebhardtsbauer testifying at televised hearing of Senate Health, Education, Labor, and Pensions Committee

Although cash balance plans may reduce projected benefits at early retirement, Gebhardtsbauer said, the accrued pension benefit cannot be reduced. Cash balance plans can be designed that immediately start to add to the accrued benefit so that the buildup of benefits is not interrupted.

But when pension plans are changed, he said, workers should be informed. The Academy "strongly believes that employees should have meaningful information about changes to their pension plan," he told the Senate panel.

However, he also indicated that disclosure rules should not unduly burden employers. The private pension system is already subject to expensive and complex requirements, he noted, and consideration of any new disclosure requirement should take into account administrative feasibility and costs. He also said that legislative proposals to prohibit or restrict reductions in participants' projected benefits "could lead many employers to not provide pension plans."

During the hearing, it was pointed out by a committee member that some actuaries had been quoted as promoting cash balance plans as a way to hide information from employees whose benefits might be reduced. Asked by Committee Chairman Jim Jeffords (R-Vt.) whether there was a need for increased federal involvement, Gebhardtsbauer emphasized that the Academy supports meaningful disclosure and noted that s[illegible] of the current legislative proposals have adopted some of the Academy's suggestions on disclosure. He also noted that actuaries [illegible] bound by the Code of Professional Conduct, which requires them to be honest and to uphold the profession's integrity, and that actuaries who violate the code are subject to a disciplinary process.

Jeffords also asked whether the law should prohibit "wear-away" (the pension plateau that can result when older workers have to wait to accrue additional benefits until a cash balance plan's formula catches up with the previous plan's). Gebhardtsbauer said that the Academy generally did not support or oppose specific legislative proposals. However, he added, "You have to be careful whenever you change the law to make sure that it doesn't have unintended consequences."

Legislation (S.1600) introduced by Sen. Tom Harkin (D-Iowa) and supported by Jeffords provides that when a defined-benefit plan is amended, a participant's total accrued benefit can never total less than the sum of what has been accrued under the old plan, as of the amendment's effective date, plus any post-amendment accruals.

In addition to proposals that would require more disclosure and prohibit wear-away, the cash balance debate has also led to calls for employees to have a choice between their old plan and their new plan. Rep. Bernie Sanders (I-Vt.) has introduced legislation that, among other provisions, would penalize plan sponsors who did not give their employees a choice between plans.

Analysts say that Congress is likely to continue considering in 2000 such issues as wear-away, disclosure of information about conversions, and plan choice.

IN BRIEF

Novak Moderates Health Forum

Donna Novak, the Academy's incoming vice president for financial reporting, moderated a discussion on national health policy September 20 at the Missouri Women's Health Summit in Springfield. Novak appeared at the invitation of the summit's chairperson, Rep. Roy Blunt (R-Mo.), House chief deputy majority whip.

The policy discussion focused on long-term care proposals, patient protection legislation, and measures to extend insurance coverage to uninsured Americans, especially women and dependent children. In addition to Novak and Blunt, the panel included Missouri public health officials, health care providers, and state elected officials.

The Academy cosponsored the event as part of its public education program, which in the past two years has included forums with President Clinton, Vice President Albert Gore, and with Republican and Democratic members of Congress.

The keynote speaker at the Missouri forum was Deborah Steelman, a former health policy official in the Reagan and Bush administrations and an adviser to Texas Gov. George W. Bush's presidential campaign. Steelman, a member of the National Bipartisan Commission on the Future of Medicare, remains a leading advocate of offering premium supports as an alternative to traditional Medicare. She expressed optimism that the program will be put on a sound financial basis after next year's elections.

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ASB Adds New Pension ASOP

The Actuarial Standards Board adopted Actuarial Standard of Practice (ASOP) No. 34, *Actuarial Practice Concerning Retirement Plan Benefits in Domestic Relations Actions*, at its September meeting. This ASOP will guide actuaries who perform services in connection with the measurement, allocation, or division of retirement plan benefits in domestic relations actions, such as separation, divorce, prenuptial, postnuptial, and support agreements. The standard will be effective March 31, 2000.

At the September meeting, a third exposure draft was approved for the proposed standard *Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves*. It is enclosed with this issue of the *Update*. (An earlier printing was sent out in October in order to release the draft before the November 16 public hearing on it in San Francisco.)

The board also approved three other exposure drafts: *Using Models Outside the Actuary's Area of Expertise (Property and Casualty)* — formerly known as *The Use of Models with Nonactuarial Components*; *Compliance with the NAIC Valuation of Life Insurance Policies Model Regulation*; and a proposed revision of ASOP No. 5, now called *Incurred Health and Disability Claims*. The ASB encourages comments on each of the drafts.

The second exposure draft on using models and the exposure draft on compliance with the NAIC model regulation are enclosed with this issue of the *Actuarial Update*; ASOP No. 34 and the ASOP No. 5 revision will be released in December.

***Hedging**, continued from page 1*

actions. A good index also should not create a moral hazard and should not be subject to manipulation, according to the report.

Evaluating Basis Risk

The task force's presentation of the report, by Kist and task force Vice Chairperson Glenn Meyers, discussed the insurance industry's interest in securitization, described the risk elements of index-based derivative transactions, and identified statistics that can be used to evaluate basis risk in transactions involving these derivatives. The Academy presentation addressed how actuarial approaches can evaluate basis risk and pointed regulators to several statistical measures they can use to establish guidelines that determine if the hedge is effective.

Meyers said that insurance securitization could represent a large new market for investors. Meyers noted that index-based insurance derivatives have had limited use by insurers and investors since their introduction in recent years. However, he added, "History has shown that it takes time and experience for investors to become knowledgeable about, and comfortable with, a new type of security. It took a number of years for liquid markets to develop in mortgage-backed securities and credit card securitization, for instance."

The Academy's report was prepared with substantial input and research from the Casualty Actuarial Society's Valuation, Finance and Investments Committee. A copy of the report is on the Academy's web site (www.actuary.org/1999.htm). More information is also available from Casualty Policy Analyst Greg Vass (202-785-7865, vass@actuary.org).

In addition to Kist and Meyers, the Index Securitization Task Force members are James Bartie, Stephen Cernich, Douglas Collins, Kevin Dickson, William Dove, Bruce Fell, David Lalonde, Daniel Lyons, Stephen Philbrick, Judy Pool, Chris Suchar, and Kirby Wisian.

COMMENTARY — STUART WASON

Why Do We Need Peer Review?

In recent months, a number of Canadian Institute of Actuaries members have asked why the Institute continues to pursue the topic of peer review. Academy members may be interested in the response I gave when I addressed the Institute's annual meeting in June:

Stuart Wason

Part of the Institute's Statement of Purpose states: "The Institute is dedicated to serving the public through the provision of actuarial services and advice of the highest quality." This is supported by Guiding Principle number one, which states (in part): "the Institute holds the duty of the profession to the public above the needs of the profession and its members." Further, Rule 2 of the Rules of Professional Conduct states that "a member shall perform professional services with integrity, skill and care."

These statements certainly reinforce and drive home the need for our members to complete their work in a manner which ensures high quality. We do this because the provision of quality work enhances the image of our profession. Such an image is vital if the users of our work are to continue to turn to actuaries for advice.

You may say that this is all well and good, but why go further than requiring the member to comply with our existing standards of practice, compliance and discipline processes?

Well, I suggest that the recent (June 8) remarks by David Brown, chair of the Ontario Securities Commission, to the Institute of Chartered Accountants of Ontario may be of interest to all of us.

During his remarks, Brown was openly critical of accountants and their work, citing numerous examples of his commission. One quote in his remarks came from Berkshire Hathaway's 1998 annual report, in which Warren Buffet comments,

> "a significant and growing number of otherwise high-grade managers . . . have come to the view that it's okay to manipulate earnings to satisfy what they believe are Wall Street's desires. Indeed, many CEOs think this kind of manipulation is not only okay, but actually their duty . . . but when operations don't produce the result hoped for, these CEOs resort to unadmirable accounting stratagems."

David Brown goes on to state (and similar words to these may sound quite familiar to many of us):

> "The Ontario Securities Act requires financial statements of reporting issuers to be prepared in accordance with generally accepted accounting principles (GAAP) and audited and reported upon in accordance with generally accepted auditing standards (GAAS). The act also provides the commission with specific rulemaking powers with respect to the accounting and auditing standards to be applied in financial statements and auditors' reports filed with the commission. To date, the commission has chosen not to exercise these rulemaking powers in any manner that overrides the standards set out in the CICA Handbook [the handbook of the Canadian Institute of Chartered Accountants, the Canadian equivalent of the Financial Accounting Standards Board].
>
> "Stated simply, the Commission relies first on the CICA to establish appropriate accounting and auditing standards and second on the public accounting firms who audit the financial statements of reporting issuers to rigorously enforce those standards. Public accountants are therefore the unquestioned gatekeepers of the information that goes into — or is kept out of — financial statements.
>
> "An extraordinary level of trust is reposed in the auditor, a trust that is unparalleled amongst professions, with the possible exception of judges. There are few external checks and balances. In fact, it bears noting that the accounting profession itself has worked hard to support the contention that it is best suited to perform this crucial 'gatekeeper' function.
>
> "If the commission is to continue with its current approach, it must be satisfied that the standards-setting process, and the public accounting firms, who are also important players in that process, are acting independently and in the public interest.
>
> "We have a growing concern that this may not be the case."

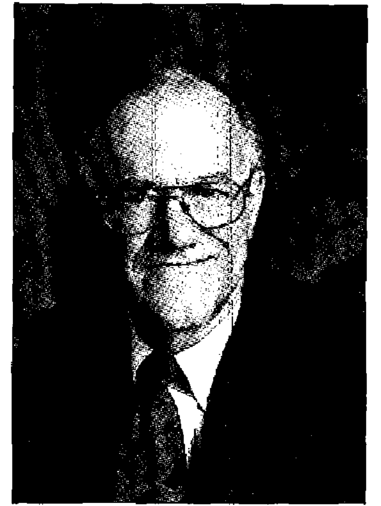
How could this happen in such a well-established profession as accounting, which has a most extensive set of standards for its members? What should we be doing in our own profession to make sure that we do not begin to suffer the same lack of trust as may be occurring with the accountants?

I suggest that the process of peer review, which most of us already conduct in one form or another, is one which, if properly framed and developed by the actuarial profession, will enhance the very significant trust placed on our profession by the users of our work.

STUART WASON IS PRESIDENT OF THE CANADIAN INSTITUTE OF ACTUARIES.

John Biggs: Views From the Top of TIAA-CREF

As chairman and CEO of the Teachers Insurance and Annuity Association-College Retirement Equities Fund, the nation's largest pension fund, John Biggs is one of the most prominent actuaries in corporate America. TIAA-CREF was founded by Andrew Carnegie to serve teachers and researchers; today, it manages more than $260 billion in retirement annuities for about 2 million people employed at universities, teaching hospitals, and other nonprofit institutions. Recently, Biggs spoke with the Academy's Jeffrey Speicher; these are excerpts of their conversation.



John Biggs

How did you become an actuary? Were you a math major?

I was a Greek major at Harvard, but I had the equivalent of a major in math. After I graduated, I was admitted to the Harvard Business School but declined the offer. For whatever reason, I had had enough schooling. I was carrying a hefty debt: I owed all of $500 to Harvard. I wanted to pay off my student loan as soon as possible, so I went to work for General American in St. Louis. I got married a year later and had a family when I was fairly young. The actuarial profession was ideal, because when I passed an exam, I got a $500 raise. What could be better than that?

How did you get to TIAA-CREF?

I left the life insurance and pension consulting business in 1977 to go into higher education. I was vice chancellor for administration and finance at Washington University in St. Louis and, soon after, I was elected a trustee of TIAA-CREF. As an actuary and investment person, I brought a rather unusual package to higher education, where I ended up getting a Ph.D. in economics. People have since joked that I got my Ph.D. just to create the perfect résumé for TIAA-CREF.

TIAA-CREF has been a pioneer in defined-contribution pensions. Do you think defined contribution will remain the dominant form for pensions in coming years?

Since the TIAA has been around since 1918, we have more history with defined-contribution plans than anybody else in the world. They have been a good fit for the academic community because of the mobility that they provide.

I think a defined-contribution plan is what most people are eventually going to want. Employees want to see the money accumulating and have some personal role in shaping it. And it is a powerful recruiting tool to tell people "We are going to put 6 percent into your plan, or you put in 5 percent and we will put in 5 percent, etc." The problem — and we know this from our higher-education experience — is that it's not a complete pension plan. Twenty to 30 years from now, people will be retiring with less relative income than people who are retiring now.

We do elaborate models for colleges and universities that show employees what they have to put into a defined-contribution plan to get adequate benefit ratios. Very little of that is being done in corporate America. If it were being done, people would find that their pensions will be providing 25 percent to 30 percent of their final salaries, not 65 percent to 70 percent as a generous defined-benefit plan would.

TIAA-CREF has always maintained that a proper defined-contribution plan ought to have about 15 percent going in over the course of a career to provide a real pension. We have always treated it as a pension plan; we do not see it as an account for asset accumulation that is dumped out in a lump sum at age 65.

Two years ago, TIAA-CREF lost its tax exemption. How did that happen?

Dan Rostenkowski, the longtime chairman of the House Ways and Means Committee, along with Pat Moynihan of the Senate Finance Committee, had fashioned a compromise position for TIAA-CREF. As long as we stayed strictly within the limits of serving colleges and universities, we could remain tax-exempt. Our life insurance and group insurance business was taxable, but not our core business of college and university pensions. We thought it was a good compromise. But when Republicans took control of the House in 1995, the Ways and Means staff, who had been pushed around by Rostenkowski, wanted to get even. We had become the largest player in the pension business, with $250 billion in assets, and it became impossible to preserve our exemption.

Did losing tax-exempt status hurt your business?

Far from it. The surge in new business was just extraordinary, right from the beginning. Loss of the protected tax status freed us to offer new products that had been off-limits to us.

For example, we began to offer IRAs. In the first year, we pulled in $800 million in IRA rollovers, and they are still coming in at that rate. Another exciting project was the family of mutual funds we opened, which reached $1 billion in assets faster than any other mutual fund family in the history of the business. Finally, after Congress clarified the tax status of state tuition saving plans, we entered that field very aggressively. We have won the business of New York, California, Vermont, Kentucky, Missouri, Colorado and Minnesota.

I think that the actuarial exams have so much more substance than an MBA that it is kind of a farce to think that anyone would choose an MBA instead of the actuarial exams. . . . I would much rather have the right person who can learn, rather than the assumed right credential.

Eventually, we think that our tuition savings business may equal the size of TIAA-CREF's entire pension business.

Were there any temptations to go public?

We could never do it, because we are a public charity. We are organized as a charitable institution. There's no way we could go public.

In order to change our status as a charitable trust, we would have to pay the state of New York for the benefits of 85 years of being a charitable trust. And, if the state attorney general has any imagination at all, he could easily put a $10 billion price tag on the transaction. So it's not going to happen.

Looking back at the 1950s, and the skills you acquired when you were taking the actuarial exams, does your work now relate to what you learned then?

I am sure that my actuarial training is paying off in all sorts of ways for me. I chair the investment committee here, where we invest, in the general TIAA portion, about $1.5 billion a month. On the CREF side, which is primarily in stocks, we are investing about $4 billion to $5 billion a month. Having had an actuarial background makes it possible for me to know what they are talking about, and understand the deals, and occasionally intervene and question something with a lot of vigor and confidence.

I think that the actuarial exams have so much more substance than an MBA that it is kind of a farce to think that anyone would choose an MBA instead of the actuarial exams. But the MBA is a credential that a lot of companies understand and value. I would much rather have the right person who can learn, rather than the assumed right credential.

In your organization, do you use actuaries in nontraditional roles?

Oh, yes, sure. The president of our life insurance company subsidiary and our chief financial officer are actuaries. The head of our auditing and consulting group in TIAA-CREF is an actuary. We use many actuaries, compared to other companies.

Let's talk about the Social Security debate for a moment. You've been outspoken recently in your opposition to individual accounts. Are you in favor of the status quo in benefit design?

Absolutely. I think that the Social Security system as it stands provides a proper floor of benefits. This is my personal view; many people here at TIAA-CREF for whom I have great respect do not agree with me. I am a strong advocate of defined-contribution plans, but social insurance is not a private system. It is a public system, one that we are all in together and that makes special provision for lower-income people.

Do you also oppose private investment of Social Security assets?

No. In fact, I think it is extraordinary that in the early 1980s we decided as a nation to prefund Social Security benefits without discussing investment policy. We required a whole generation to prefund their Social Security benefits with investment options limited to 2-year government bonds. Had we invested in private securities at that time, we now would probably be deciding how to share the benefits, not how to finance a deficit.

I am a trustee of a pension fund for Episcopal ministers, which, like Social Security, has a defined-contribution input and a defined-benefit output. We've had the fund invested 50 percent to 60 percent in stocks and the balance in bonds, and we've been able to give fabulous benefit increases in recent years. In fact, it's now sufficiently well-financed that we are considering very different benefit additions.

Had we just done that with Social Security, we would be in a very different situation today. Looking forward, obviously we will not expect future returns to match those of recent years, but I strongly advocate investing in private securities whenever we can. Also, purchases of private securities are considered "disbursements" under arcane government accounting rules, so that we'd solve the strange accounting paradox we now have.

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Academy Presents Five Reports to NAIC

During the October meeting of the National Association of Insurance Commissioners in Atlanta, the Academy presented five reports related to life practice.

AG ZZZZ Guideline for Equity-Indexed Universal Life

Andrew Erman presented the report on a proposed actuarial guideline for equity-indexed universal life insurance (EIUL) products. The report was produced by the Academy's Equity-Indexed Products Work Group and it was presented to the Innovative Products Working Group of the NAIC's Life and Health Actuarial Task Force (LHATF).

The report centered on a simplified market-value reserving method for EIUL products that LHATF approved earlier in the year. The NAIC's executive committee is expected to review the guideline early next year.

The report's purpose was to clarify statutory and regulatory requirements for the valuation of reserves for EIUL policies. The guideline attempts to codify the interpretation of the commissioners reserve valuation method (CRVM) by establishing the computational methodologies that comply with the Standard Valuation Law and the Universal Life Insurance Model Regulation.

The guideline defines a method as consistent with CRVM when it meets "hedged as required" criteria, and it offers two other methods when the "hedged" criteria are not met. The guideline would apply to all EIUL policies, regardless of issue date, that are subject to CRVM and are otherwise subject to the reserve requirements of the Universal Life Insurance Model Regulation.

VAGLBs

The Academy presented its report on a simplified reserving method — called the keel method — for guaranteed minimum accumulation benefits offered with variable annuity contracts. (The method works for roll-up designs, but not for ratchet products.) Steve Preston and Tom Campbell, co-chairpersons of the VAGLB (variable annuities with guaranteed living benefits) Work Group, gave the report to the LHATF's Innovative Products Working Group.

The LHATF plans to discuss possible alternatives, such as multi-scenarios (in which the valuation actuary would choose the scenarios), in a conference call before the NAIC's December meeting. As for this year-end, the regulators said they would rely on the appointed actuary to reasonably reflect the risk with the products. The Academy hopes to present an analysis of the keel method for guaranteed minimum income benefits in December.

GICs With Credit Rating Downgrades

On behalf of the Academy's GICs (guaranteed investment contracts) with Credit Rating Downgrades Work Group, Donna Claire presented a report on reserving considerations to the Innovative Products Working Group.

As a result of its work, and as a result of input from regulators, the Academy group has expanded its scope to focus on other contractual provisions in addition to GICs that result in liquidity problems when downgraded. The Academy group concluded that the issue is not just a reserve issue, but a liquidity and risk management issue as well.

The regulators would like a recommendation from the Academy in time for a review by the LHATF at its meeting in December.

Variable Life Reserving Guideline

The Academy also presented a report on a proposed actuarial guideline for variable life products. Burt Jay, chairperson of the Variable Life Reserving Guideline Work Group, along with Debra M. Eckberg and Tom Kalmbach, gave the report to the LHATF.

The recommended guideline sets reserves at the greater of (1) a one-year term insurance reserve following an assumed one-third drop in account value or (2) an attained age level reserve for the remaining guarantee period with no assumed drop in account value. The LHATF was receptive to the recommendation and has exposed it for adoption until the December NAIC meeting, with a proposed effective date of December 31, 2000. The LHATF is expected to further discuss the guideline at its December meeting.

C-3 Recommendation for Life Risk-Based Capital

Finally, Bob Brown, chairperson of the Academy's C-3 Task Force, presented a report on a C-3 recommendation for life risk-based capital to the NAIC's Risk-Based Capital Working Group. Regulators expressed appreciation for the Academy's long and dedicated work on the project. (Details of the report were in the October *Update*.)

The NAIC working group voted to receive the C-3 recommendation and exposed it for comment. Some regulators expressed concern over the lack of assumption standardization, however. The exposure comment period extends through the NAIC meeting in December.

Mark Your Calendar for Retirement 2000

As major demographic and economic changes sweep the United States and other countries,

- What will retirement mean in coming years?
- What will retirement benefits look like?
- What new ideas in public policy will be needed?

Actuaries bring unique skills to the important debate over these questions. So mark your calendar for the Retirement 2000 conference February 23 – 24 in Washington, and join the discussion with other actuaries, economists, demographers, policy specialists, and benefit managers.

The conference is a joint effort of the Academy, the Asociacion Mexicana de Actuarios Consultores, the Conference of Consulting Actuaries, the International Foundation of Employee Benefit Plans and the Society of Actuaries. For more information, contact David Rivera at 202-785-7869 (rivera@actuary.org).

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