

.....CPS BULLETIN.....

The Newsletter of CPS Actuaries and Computer Programming & Systems, Inc.

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Introduction

We were very pleased with the response we had to our first issue of **CPS Bulletin**. Thanks to everyone that provided comments to our first issue. If you would like us to send copies to other individuals in your organization, please let us know through our web site at www.cpsincorp.com.

A number of articles have been written recently regarding the NAIC's proposed revisions to the Actuarial Opinion and Memorandum Regulation. Our first piece this month outlines the changes that are being proposed, and also looks at the issue of asset-liability matching as it relates to life insurance policies.

Our second article provides information about buying a home computer. It examines certain requirements and features that we recommend you consider when purchasing a computer. It also addresses some issues that are important if you plan to use your home computer for work purposes.

If you have any topics you would like us to consider for future issues, please let us know. ***Please stop by and visit us at Booth 35 at the NFCA's annual meeting in Chicago.***

Assets, Liabilities and the AOMR

The NAIC has drafted a revised Actuarial Opinion and Memorandum Regulation (AOMR). The proposed regulation would require nearly every fraternal, regardless of size, to perform an asset adequacy analysis when filing its actuarial opinion.

What is the AOMR?

The AOMR was first adopted by the NAIC in July, 1991 and was subsequently adopted by the state insurance departments. The AOMR requires each insurer to designate an "appointed actuary" and notify each state where it is licensed of this appointment. The regulation spelled out the wording for two types of actuarial opinions. One is a Section 8 opinion, which is used if asset adequacy analysis (i.e., cash flow testing) has been performed. The other is a Section 7 opinion, which is used if an insurer meets certain requirements with regard to size (in terms of assets), surplus, investment quality and non-exposure to interest sensitive products (such as annuities). A Section 7 opinion does not require asset adequacy analysis.

What are the proposed changes?

The proposed AOMR removes the Section 7 actuarial opinion. Thus, only Section 8 opinions would be permitted; this would require an asset adequacy analysis. Only insurers licensed in only one state would be exempt from filing a Section 8 opinion.

When are the proposed changes scheduled to take effect?

The revised AOMR is still in draft form, which means that it still has to go through the lengthy regulatory approval process before it is adopted. According to the NFCA's Legislative Regulatory Highlights bulletin dated August 25, 2000, final action on the revised AOMR is

See [Assets, Liabilities and the AOMR](#) on page 2

INSIDE THIS ISSUE

- 1 Introduction
- 1 Assets, Liabilities and the AOMR
- 3 Buying a Home Computer
- 4 Interest Rate Monitor
- 4 NAIC & State Update
- 4 About CPS

not anticipated until June, 2001 at the earliest.

How will this change impact fraternal?

Performing a full asset adequacy analysis could be extremely costly, especially for small fraternal benefit societies. Moreover, if the analysis indicates that additional reserves should be established, surplus will be reduced.

What is meant by a “full asset adequacy analysis”?

A full asset adequacy analysis starts with your current assets and liabilities and projects them forward for 20 or 30 years using different interest rate scenarios. The projection would consider, among other things, premium income on currently in-force policies, expenses, death and surrender benefits, and investment income. A Balance Sheet and Summary of Operations would be created for each year of the projection.

What can be gained from this analysis?

The analysis will provide insight into whether your assets match your liabilities. It will also demonstrate the interest rate scenarios (i.e., increasing or decreasing) in which an insurer is most vulnerable.

Why is matching assets with liabilities so important?

Future solvency of a society depends on an adequate matching of its assets with its liabilities in order to ensure that assets are available to meet the liabilities as they arise. For instance, if a society invested all of its assets in 30-year bonds and interest rates increased, then those assets may have to be sold at a loss in order to meet cash demands. Matching assets and liabilities also “immunizes” the society against changes in interest rates. Whether interest rates move up or down, a society in a matched status would find that its liabilities and value of its assets move up and down in tandem, thus insulating the society from the vagaries of the market.

What are the risks of having an asset portfolio that does not match the liabilities?

Societies with a large concentration of short-term assets (e.g., bonds maturing in 5 years or less, or certificates of deposits) are at risk if interest rates decline. This is due to the fact that maturing assets may have to be reinvested at interest rates below the rates assumed in calculating premiums and reserves. A prolonged period of low interest rates would then reduce investment

income, decrease surplus and possibly jeopardize solvency. Alternatively, a society that has a large amount of assets in long-term bonds is at risk when interest rates increase.

Why should a society invest in a bond that matures in 10 years when a comparable yield can be obtained from a CD maturing in 1 year?

If interest rates decrease over the next year, the CD will have to be reinvested at a lower rate. By purchasing the 10-year bond, the rate is locked-in for the next 10 years. Of course, if interest rates were to increase, the CD could be reinvested at a higher rate and the society would have “guessed” correctly. However, insurers should not be trying to time the market. Fraternal should have a long-term view with regard to their investments. Laddering bond maturities (i.e., having some bonds mature each year) is preferable to trying to time the market.

What should a fraternal consider now in order to be prepared for the adoption of the proposed AOMR?

- Review the scheduled maturities of your bond portfolio. Ordinarily, bonds should be maturing each year for at least the next 15 years. If there are years where you do not have bonds maturing, then you should consider filling these gaps when you make any bond purchases. If a majority of your bond portfolio will be maturing within 5 years, you should begin reorienting it now by investing any positive cash flow in longer-term assets.
- Obtain the call date information (i.e., call price and first call date) for any bonds and preferred stocks you own. This information should be included in Schedule D of the annual statement. Call features are an important part of any asset adequacy analysis.
- Review your cash investments and consider re-investing any excesses above cash requirements in higher-yielding assets. A society could always borrow funds (using a bond that is maturing in the near-term as collateral) if there is a need for cash.
- If you are currently exempt from filing a Section 8 actuarial opinion, consider writing to the NFCA. Let them know that you wish to continue to be exempt and that the proposed exemption for societies licensed in only one state should be expanded. ❖

Buying a Home Computer

In this article we review computer purchases by a non-expert user and focus on certain important considerations that are sometimes forgotten in deciding what to buy. These are:

- What is the computer going to be used for?
- What type of customer service will come with it?
- What about disaster recovery?
- How can files from an old computer be transferred to the new computer?
- Is a bigger monitor better?
- What software should be on the computer?

Page 4 of this Bulletin provides a chart of the specifications we would recommend if you were to purchase a desktop PC (as opposed to an Apple Macintosh). If you would like us to review the specifications of a computer you are about to purchase, fax us the specifications page and we will give you our opinion (and also advise if we think the price of the system is unfair).

When buying a home computer, you should first determine the primary uses of the computer. If you intend to develop digital photos, download music from Internet sites such as Napster or play video games, then you will want to purchase as much storage (i.e., RAM and video and hard drive space) as you can afford. If you plan to use the PC primarily for word-processing, spreadsheets and surfing the Internet, then less storage is required.

The quality of a company's customer-service is an important consideration, especially for those who do not have friends or co-workers to call on if things go wrong. Extensions of the customary one-year warranty by one or more years should be considered. "On site" service usually costs extra, but the support will be given at your home. Most manufacturers maintain support lines (some are free and some require fees). Consumer Reports magazine is one source that provides information on the quality of support and prices charged by leading manufacturers.

In practice, most people do not back-up their computers consistently. Few people believe that a hard drive crash can actually happen to them. However, hard drive crashes occur more often than many people realize and having a disaster recovery procedure in

place can save a lot of headaches. We recommend that you purchase a Zip drive for backing up your PC. Pricier alternatives include a re-writable CD-ROM or a tape drive. These alternatives can be used for more than just backing up your files (for example, the re-writable CD-ROM allows you to create your own CDs).

If you currently own a computer, you will no doubt wish to transfer some of your old files to the new system. If you do not have any backup files, one way to transfer files is to e-mail them to yourself. This may be time-consuming if you have a number of files you want to transfer. You could also zip the files using zip software and transfer the files via a floppy disk. If, however, you have a large volume of settings, data, preferences and applications to transfer, you may wish to use specialized software and cable combination software such as Aloha Bob's (www.alohabob.com). If you have an e-mail address book or you use AOL Instant Messenger and have a "buddy list", you'll want to be sure that you transfer those files to the new computer so that you will not have to re-create them.

Until recently, 15" monitors had been standard with most new computer purchases. However, as the prices of 17" and 19" monitors have fallen, more people have been moving to the bigger monitors. The difference of a few inches may not sound like a lot, but a 19" monitor provides 60% more viewing area than a 15" monitor. We recommend that you purchase at least a 17" monitor. You should also consider purchasing a monitor with a "no glare" feature to make the screen easier to view.

Many computers come with "free" software (such as financial software like Quicken or educational software like Encarta) and a package (such as Microsoft Office) that includes word-processing, spreadsheet and database software. If you plan on bringing work home from the office, you should consider getting similar software to make it easier to transfer files back and forth. For example, if you have Microsoft Word at the office and you have Microsoft Works on your home computer, you will not be able to open your Word documents in Works and vice versa. You may be able to negotiate a better deal for the software titles that you want at the time of purchase rather than purchasing them separately at a later date.

See [Buying a Home Computer](#) on page 4

Interest Rate Monitor

The following are some key interest rate benchmarks:

Benchmark	Current	3 Months Ago	1 Year Ago
Fed Funds	6.56%	6.44%	5.06%
Prime Rate	9.50%	9.50%	8.25%
30 yr mortg	7.60%	7.90%	7.64%

Source: www.bloomberg.com as of Sept. 14, 2000.

A note about interest rates: As you may be aware, the U.S. Government is expected to continue to use surpluses to buy back its bonds. If the present trend continues, then according to some, the national debt will be eliminated by the year 2015. Therefore, the Treasury will not have to issue as many long-term bonds in the future. Fewer available long-term bonds will increase the demand for all such bonds and decrease yields. Insurers that need to purchase long-term bonds in the future to match their liabilities may find it more difficult (and costly) to obtain the maturities they desire. ❖

The following table lists our system-requirement recommendations for buying a home computer:

	Standard Users	Game Players
Processor	Pentium	Pentium III, MMX
Clock Speed	300 MHz	450 MHz
RAM (memory)	64 MB	128 MB plus ability to expand
Slots & Bays	3 open slots and 1 open bay	3 open slots and 1 open bay
Hard disk size	3 GB	20 GB
Operating System	Windows 2000	Windows 2000
Video card	PCI card with 8 MB	PCI card with 32 MB
Software	Anti-virus program, an office suite like Microsoft Office	Anti-virus program, an office suite like Microsoft Office
Sound card	Sound Blaster or compatible	Sound Blaster or compatible
Modem	56.7Kbps speed	56.7Kbps speed ❖

NAIC & State Update

This section provides an overview of items adopted, proposed or considered by the NAIC and state insurance departments.

NAIC Urges Holocaust Survivors, Heirs to Check ICHEIC Web Site: The International Commission on Holocaust Era Insurance Claims (ICHEIC) has compiled a list from several sources that shows policyholders from that era in Europe. The web site address is www.icheic.org. The NAIC urges anyone who believes they have an outstanding claim to access this web site.

State of New Jersey: A new law (effective 2/13/2000) requires insurers and fraternal societies to permit a senior citizen (age 62 or older) to designate a 3rd party to receive copies of any cancellation or lapse notice. The copy to the 3rd party is in addition to the original notice that is sent to the senior citizen. You must notify your senior citizens annually in writing of the availability of this notification procedure.

About CPS

CPS Actuaries and Computer Programming & Systems, Inc.

CPS is an independent company with over 30 years of technology leadership. We offer a wide range of computer and actuarial services.

There are two major divisions that make up CPS. One is an actuarial consulting firm that specializes in the needs of fraternal benefit societies. The other is a computer consulting firm that develops software applications, manages computer networks as an outside consultant for a variety of companies, and develops, hosts and maintains e-mail and web sites. For further information regarding our services, contact us at 203-324-9203, or visit our web site at www.cpsincorp.com. ❖

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