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RESPONSIBILITIES OF THE ACTUARY IN CHANGING TIMES

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MR. JOHN C. MAYNARD: The theme of this meeting is "Economics and Financial Security". The words summarize the purpose of the meeting which is to help actuaries understand the economic environment in which they live and work. This session is meant to be an introduction to the rest of the meeting and, in it, three actuaries will be discussing their responsibilities under today's conditions. Mr. Lancaster will be speaking from the viewpoint of an actuary of a life insurance company; Mr. Trowbridge from that of a consulting actuary. I will be making a few comments with both a general and Canadian flavour.

We are living in a period without historical precedent. This is confirmed by the trend in interest rates. Interest rates on top grade bonds in the western world moved in the range $2\frac{1}{2}\%$ to 6% in the 150 years from 1800 to 1950; in the 25 years since 1950 there has been quite a steady rise from 3% to 10%. Prices have gone up rapidly too, and the two together present an uncertain future.

An actuary cannot avoid making an appraisal of the future and making decisions. Yet, facing uncertainty in many directions, he may well ask himself what attitudes and techniques he should arm himself with as he goes about his task. This kind of heart searching is difficult and probably inevitable. We must take care to ensure that we do our thinking in a positive and healthy manner and not become deterred by the doubts which will lie in the pathway. There can be no stopping short in the search for sound and wise solutions. Our professional thinking is not only an academic exercise; many people are depending on us.

We are bound to have doubts about the equation of world dynamics. Will the trends in population, food, resources, and contamination lead to some new state which is favourable to the human race? Everyone will wish to seek wisdom on this question in his own way. For what it may be worth, let me tell you of one experiment I made recently. One weekend I sat down with the weekly newspapers and made a list of the news items which appeared to have the greatest long-term impact. Here are some examples from the list:

- The development of atomic power is impeded because of control of contamination and supply of uranium.

- At an international conference on economics, commissions were set up to study energy, raw materials, developments, finance.

- The Economic Council of Canada believes that rates of growth will be slower in the next decade.

- Requirements are being considered for miles per gallon in new automobiles and insulation in new buildings.

- New initiatives are being introduced in Japan to adjust to slower growth--they are in the form of support for small businesses and the free market system.

This list is not unusually significant but it would seem to be a reasonable sampling of current events. Can any generalization be attempted? It is the belief of this observer that this can be done. Many human adjustments are being made which lead to slower consumption of physical resources and these adjustments are taking place at a much faster pace than could have been expected a decade ago. If this view is correct, then it is encouraging. It means that human society on this continent is at least at the first stage of an adjustment to world dynamics. It also suggests that later stages of adjustment can be successful.

Actuaries are as well equipped to understand these world trends as any professional group and some are now doing so. We also have our immediate responsibilities to think about and I know Mr. Ed Lancaster is planning to speak to us in this vein.

MR. EDWIN B. LANCASTER: I will cover this subject principally as an actuary with a life insurance company involved in the life insurance, health insurance, and pension business - both individual and group. By way of introducing my comments on the responsibilities of the actuary in changing times, I would first like to briefly discuss some of the effects of recent economic changes on individual and group life, health, and pension business. I would like to examine such effects through observations of certain recent trends in rates, composition and volume of business issued, investment income, expenses, and levels of surplus for the industry or certain representative major companies.

Consider the following:

- The average 20-year cost index for ten major companies for a $10,000 Whole Life policy issued at age 35 has decreased from $6.62 in 1973 to $6.29 in 1975, reflecting mainly the fact that investment income increases have outpaced expense increases, but also an increasingly more competitive market.

- The corresponding 20-year cost index for a 5-year term policy has dropped from $8.54 to $8.30 during a period when the Consumer Price Index increased by 21%; again reflecting increased competition.

- In Group insurance, retention illustrations keep getting the sharp pencil treatment and there is a considerable movement toward extending the grace period from one month to three months, especially in Group Health, thus effectively eliminating any assets attributable to open and unreported claim reserves.

- I suspect margins in both individual and group annuity rates are under continuous pressure.

- The 1975 increase of 2% in the amount of Ordinary life insurance sold in the U.S. was the lowest in 25 years. (No doubt attributable to the recession.)

- The shift from individual to Group coverage has accelerated in recent years to the point where $\frac{3}{4}$'s of all Health premiums and over 46% of life insurance are accounted for by Group coverages. This reflects in large measure the economic squeeze that forces individuals to turn to their employer (or the government) for their insurance needs.

- Term insurance sales accounted for 43% in 1973 and 46% in 1974 of the total amount of Ordinary insurance sold as opposed to a reasonably steady 40% over the 1964-1972 period. This reflects a shift to lower-priced forms of coverage in these times of economic difficulties.

- The annual increase in the portfolio interest rate of the industry reached an unprecedented 31 points for the years 1973 and 1974 and has reached a record 6.4% for 1975.

- Recent new money rates easily exceeded 9%.

- The ratio of the industry's assets held in policy loans reached almost 9% in 1974 - the highest such percentage in over 30 years.

- Aggregate expenses increased substantially during recent years but have been held fairly steady as a percentage of premium income.

- Inflation has left its mark on medical care costs and recession has led to adverse financial experience in the disability lines.

All of the above have led to a profit squeeze for the industry, and a rather significant reduction in surplus funds. At the end of 1974, total surplus and capital funds for the insurance industry came to $18.6 billion, which was actually a full $1.25 billion below the 1973 level. As a percentage of assets (7.08% at the end of 1974) the industry's surplus and capital funds were at their lowest level in over 20 years. 1975 results will no doubt show some improvement due to the stock market recovery. A couple of points to be kept in mind in connection with the level of surplus are:

(1) The level of investment reserves also has decreased substantially recently so that the cushion for absorbing further asset losses is much thinner, and

(2) The effects of current competitive pressures and, I suspect, some loosening of underwriting standards for individual insurance and cutting of margins will not show up as impacts on surplus until some time has lapsed.

What I am trying to say is that it is difficult to see improvements in the immediate future.

One final aspect, with respect to recent trends, is the diversification of life companies into new areas. Our changing economy has put more pressure on some of the major insurers to look for new ways of utilizing their resources. The effects of the economy on the volume of business and the increasing competition have added impetus to the search by various life companies for ways to upgrade the earnings base of their sales force. Entry into the property/casualty business by some of the major companies was a very important development in this area. The need for protecting investment returns in an economy that has been beset by almost continuous increases in interest rates led to real estate investments with equity kickers - either directly or through subsidiaries. As I will discuss later, these types of diversifications create their own problems, especially for mutual companies, since the immediate and near future return is almost nonexistent, even though they have the potential for long-term profits and growth.

Now let us try to examine the actuaries' responsibilities in this environment of inflationary pressures on the components that determine the price of our product, and of increasing competitive pressures.

Nobody will deny that the marketing pressures at times like these are intense. Our products, rates, and underwriting practices are under continuous scrutiny. Resistance to further rate cutting or to loosening of underwriting standards is becoming increasingly more difficult. It is the nature of the product that makes it difficult to resist changes. After all, rate cutting or loosening of underwriting standards on individual insurance will not have any major effects on this or next year's results. By the time its effects are made known it will be a little late to remedy the situation.

I would venture to say that most of us are caught up in this competitive environment and spend much of our effort trying to produce more attractive products or improved rates. There is absolutely nothing wrong with this as long as we also make an effort to measure the effects of our various actions as well as the effect of our economic environment on the financial soundness of our companies. For example, how many have taken the time to measure the effects of the changing economy on our financial underwriting practices? How many have changed their financial underwriting rules to reflect the effects of such a changing economy? Again, how many of us have tried to measure the effects of the increased and increasing Social Security disability benefit structure on our disability income underwriting and on our disability claim experience, both individual and group? Have we attempted to measure the effects of a continuing shift from permanent to term coverage - especially to continuously lower cost term coverage? What I am suggesting is that the time has come to reflect upon the various trends and the various environmental factors to see whether we can measure their effects on the business.

I think it is incumbent upon the actuary to try to deal very objectively in this area of competitive pressures. The fact is that the changing economy, coming at a time when competitive pressures were starting to build up, has started to show its effects in our balance sheets.

The problems of competitive pressures are even more pronounced for companies that are major writers of both individual and group coverages. Usually the various lines of business operate as separate companies - each is concerned with its own competitive environment and I am sure there have been cases where differences in pricing approaches existed between, say, the individual and group lines. This is an area that needs

continuing scrutiny. I am talking about financial planning at the corporate level - planning that would attempt to measure the effects on the total company surplus of the various actions, whether underwriting or pricing, of the various lines of business. In recent years the annuity lines have been experiencing severe competition. That, together with the effects of statutory valuation requirements, has led to subsidies from surplus. At the same time the health lines are fighting to stay in the black, the individual life insurance lines are trying to come up with the lowest possible cost index for both permanent and term plans, and the assets in our balance sheet are being affected by the economy. Obviously, we have to start taking all of these items into account in our continuing financial monitoring of the company's position. Also, at least in our case, variable annuity products are quite a way from making positive contributions to surplus.

The diversification into casualty business is another area that has to be taken into account. As a brand new line of business, property and liability writings will lead to initial surplus drains of very substantial amounts with the pay-back not coming for a number of years.

The effects on surplus of all of the various lines of business actions will have to be monitored continuously. There will be need for a constant open line of communications among the various lines of business in order to assure a sound way of operations.

Equity among classes and generations of policyholders of a mutual company is another area that has to be watched very closely during these times of changing economic conditions. The times of offsetting interest and expense increases may well be coming to an end, especially in light of the highly progressive U.S. federal income tax. Dividend scales have to be changed very frequently at times like these if we are to reflect a fair price for all coverages. Non-par rates also have to be changed frequently for the same reason. We all know that it is costly from an administrative point of view to make frequent changes, but we always have to keep in mind that probably one of the basic reasons for the existence of a private insurance industry lies in this area of equity. Temporary measures of rough equity will be inadequate over the long term.

Diversification into different areas has resulted in other equity problems. Casualty business and certain forms of investment real estate are basically zero-interest investments for a period of time that may well span a significant portion of the time period of an entire generation of policyholders. Methods have to be devised to reflect some measure of the ultimate return from these areas in our current dividend scales. This, of

course, will lead to its own drain on surplus and will have to be closely monitored to make sure that over the long run it accurately reflects the true investment return from these areas. In addition, I find common stocks to be very difficult investments to handle when considering equity among generations of policyholders.

While we have developed (and have been perfecting since the early 1960's) new money approaches to pricing group annuity products and also to individual non-par immediate annuities, I must confess that I am troubled when it comes to extending these approaches to annual premium individual business. The technical and practical problems seem quite difficult. On top of these are the problems of individual insurance dividend illustrations. It is my understanding that insurance department pronouncements require that illustrative dividends be based on the same assumptions as those used in determining currently payable dividends. Such a requirement exerts what I believe to be a necessary discipline. That discipline seems straightforward when a portfolio interest rate is used since the same rate would be used for paying as for illustrating dividends and any increase in the interest rate would translate into an increase in aggregate dividends. However, this discipline becomes much more complex when a new money method is used, since an increase in illustrative dividends for a new class of policies does not have to be accompanied by an increase in aggregate dividends as long as the investment period rate for existing policies is not tied in to the rate for new policies.

Obviously, with increasing emphasis by the regulators in the area of cost disclosure, consistency in the approach to illustrative dividends takes on increasing importance. President Bragg has recently appointed a committee to review this area.

Finally, it seems obvious that good internal communication and careful planning within companies is highly essential; communication between companies and regulators will and must continue at an accelerated pace; and communication between insurer and policyholder is vital.

Most important, I would like to emphasize what I see as the special responsibility of the Actuary - he has to make a meaningful contribution to the sound, overall management of the life company. In today's competitive environment, life company management must take innovative steps to assure the continuing success of the company, and often these steps will present problems as well as opportunities. The Actuary must establish for himself a prominent role in these management decisions. Please do not misunderstand me. I am not suggesting that he simply be a "no, no" man but rather that he become an increasingly assertive member of the management team.

In filling this important role, the Actuary retains the responsibility to test every proposal and every venture on the basis of its actual and potential impact upon the financial soundness of the business. It is not an easy role. It is a role that creates friction and does nothing to contribute to the Actuary's popularity index, but that is the way it is and the failure of the Actuary to meet this dual challenge will place his company in real jeopardy.

In summary, I would say that the changing economy has brought on new challenges for our profession in such areas as equity to our policyholders, investment income allocation, and cost disclosure, but to a greater extent, the changing economy has brought into focus the basic responsibilities of the Actuaries--sound underwriting and pricing practices, financial planning, equity among policyholders, and financial stability of the industry, which, in turn, is reflected in the solidity of the products the insurers offer. In addition, it is the Actuary's responsibility to be an important and vital member of the management team.

I have every confidence we will face the new challenges head-on while, at the same time, place renewed emphasis on our traditional responsibilities. In doing so, we will assure the continuous growth of private life insurance, health insurance, and pensions on a sound basis.

MR. MAYNARD: As an addition to the picture of economic trends which we were shown at the earlier sessions, I should like to comment on recent Canadian economic trends and their effect on actuaries.

For many years economic indicators in the United States and Canada have been closely related. However in the past two years the Canadian economy has been diverging. In 1975 the cost-of-living index in Canada went up by 10.4% compared to 9.2% in United States and the rates today are further apart at 9.6% and 6.8%. This unhappy trend in Canada has been accompanied by strong increases in federal government deficits and in the supply of money. Attitudes have been changing rapidly however. A major issue in the summer 1974 federal election was whether wage and price controls were necessary, and the winning party took the position that they were not. Yet by October 1975 the position was judged serious enough that a sweeping set of controls on prices, profits, wages, and dividends was introduced suddenly.

The introduction of controls may not produce results quickly and it is likely that Canadians are facing a painful and

protracted adjustment to price stability. At the present time there is encouragement in the support which public opinion has been giving to the need for restrictive measures. Among these measures has been the recent policy of the Bank of Canada to restrict the money supply and to accept an increase in interest rates.

Actuarial thinking in Canada is being challenged by a new form of financial reporting for insurance companies which is expected to be effective in 1978. This follows a series of discussions during the past three years between representatives of the Canadian Institute of Actuaries, the Canadian Institute of Chartered Accountants, the Canadian Life Insurance Association, and the federal Department of Insurance, with the final proposals being those recommended by the federal Superintendent of Insurance for inclusion in the federal Insurance Acts. A feature of the plan is that both statutory statements and published statements would use the same liabilities.

In response to changing levels of expense, interest rates, dividend scales, and to the request for greater freedom to recognize the deferment of acquisition expenses, the proposals provide for a new approach to the valuation of liabilities for Ordinary life insurance. A new reserve method is described and actuarial reserves are permitted which equal or exceed reserves calculated on this method. These minimum reserves are modified net premium reserves which are subject to two controls:

(1) The modification to the net level premium is such that the initial expense allowance is the lower of actual acquisition expense or 150% of the net level premium.

(2) The minimum reserves are not lower than reserves by a gross premium valuation which provides for future administrative expenses and reasonable dividend expectations.

There are other differences. Reserves must cover cash values, but this can be done by using termination rates in the calculation. Also, the actuary will recommend the valuation interest rate and will be expected to explain the relation between this rate and the yield rate on assets.

The actuary will be required to submit a report and will be required to state his opinion that the reserves are appropriate in addition to being adequate. In his report he will make clear that he has given attention to the choice of bases and methods, the amount and recoverability of acquisition expenses, provisions in gross premiums for maintenance expenses, provision

for a reasonable dividend scale, and the earning power of assets held. The result is that many characteristics of the business will be investigated in the course of the valuation and much reliance will be placed on the actuary's judgement. The system as a whole represents a distinct enlargement of the actuary's responsibilities.

The development of this new system is ambitious and will require a good deal of effort. It should have the result that the regulatory system is better adjusted to changing conditions, and the same system should suit the companies better for purposes of management.

It is time to turn our attention to the whole field of our thinking processes. It is fortunate that Lambert Trowbridge will be our observer, because of his ability to explain a complicated problem in simple terms.

MR. CHARLES LAMBERT TROWBRIDGE: I propose to first tackle rather directly the question asked--what are the actuary's responsibilities in changing times? Only after we have examined these responsibilities will I have much to say about the changing times themselves. The two earlier speakers have done about the same, but perhaps in the opposite order. I will put forth the premise that the actuary bears at least four responsibilities with respect to change. He owes these to his employer (or client), to the public, and to himself.

Responsibility #1 - To recognize changes that may be occurring or trends that may be developing.

a. It is easy to recognize change only if we have a clear picture of how things are, as well as a good picture of how things used to be.

b. If the most recent issue of AA quality bonds sold at a $8\frac{1}{2}\%$ yield, whereas similar bonds sold at a $9\frac{1}{2}\%$ basis 6 months ago, we have a strong indication that long-term investment rates have come down - at least temporarily.

c. A much less clean-cut case is the observation that rates of disability seem to be in a climb. Here the documentation is much more difficult, and objectivity sometimes gives way to prejudice.

d. Actuaries must guard against two kinds of errors:

   (1) The tendency to assume a change simply because someone asserts that a change has taken place.

   (2) The opposite tendency, to assume things are pretty much as they have been, unless the evidence to the contrary is overwhelming.

e. In many matters the actuary must rely on his own research and his own judgment if he needs to reach a conclusion. He will do best if he is aware of the possibilities and yet keeps an open mind.

Responsibility #2 - To assess whether the apparent change is permanent or merely a pendulum swing.

a. The human tendency to extrapolate from the recent past is very strong. Any dramatic turn, once we recognize that it has occurred, leads us to view the new condition as permanent - just as we once viewed the old.

b. For example, total fertility rates have fallen below the replacement rate. It has become fashionable to think that U.S. people have almost given up on human reproduction, and that these low fertility rates will continue. Perhaps they will, but perhaps they may turn closer to historical levels.

c. We feel more sure about the permanence of a new trend if we can find a solid reason for it. What reasons do we have as to why fertility rates are so low today - when they were so high for 15 years or so after WWII? Are we aware that having as many children, but having them later, could account in part for the low fertility rates of the last decade?

d. We must resist another human tendency, the tendency to rationalize (i.e., to give reasons for phenomena we do not understand, as if they were fact). We do better if we admit that we just do not know. Who can explain with any degree of assurance why social security disability claims have risen so markedly over the first half of this decade?

Responsibility #3 - To analyze the impact of such change on the actuary's employer or client, or on the actuary himself, or on what he considers his public.

a. There are changes that the actuary may find of intellectual interest, but where there is little direct impact on his employer or client. The actuary whose responsibility is the pricing of individual insurance products cannot be expected to be very interested, or especially concerned, with today's low fertility rates.

b. The Social Security actuary, on the other hand, recognizes that payroll tax rates are heavily a function of the relative sizes of the retired and the working populations. A generation hence the population in the working ages will be strongly affected by the number of babies born today, and the retired population will be heavily influenced by the post-WWII baby boom.

c. Sometimes it requires good analysis to see how an actuary's recommendations should be affected by change. Only very recently, for example, has the basic theory been developed as to the dynamics of private pension funding under inflationary conditions.

Responsibility #4 - To aid the decision-making process toward an intelligent response to change.

a. Few of us are naive enough to think that the actuary is always the key individual in the decision-making process, although there are surely times when he is. Yet he is likely to be influential if he brings actuarial skills to the problem at hand, and if he has earned the respect of those who are the ultimate decision makers.

b. At the very least he can suggest what he thinks may be appropriate action. Assuming his recommendation is basically sound and objective, and assuming he is a reasonably adept communicator, he has a good chance of influencing the decision and often will control it. Most of the time, for example, the employer-sponsor of a pension plan <u>will</u> take the actuary's recommendation as to an appropriate contribution.

c. Perhaps it should be pointed out that the appropriate action in many cases will be <u>none</u>. The actuary can lead his client to this decision more easily perhaps than to positive action. No immediate action, when it is deliberately taken after good analysis, is often the best management decision.

Everything said to date could be summed up by saying the actuary should be alert to changing conditions, he should be analytical enough to sort out the fact from the loose talk, he should be an imaginative problem solver, and he should be a skilled

communicator with those who make the decisions. Now, it might be helpful to pick out some of the areas of potential change where the actuary may find chances to employ the skills in which we have (hopefully) trained him. In true actuarial fashion, having used numbers for responsibilities, I will use letters for the kinds of change that we must be alert to. No one can be a specialist in everything, but changes I will letter A through E have something in them for every actuary.

Apparent Change Area A - Price, Wage, Interest Rate, and Other Economic Changes

Economists, and at least some actuaries, have long been aware that what we generally call inflation (here intended to mean an increase in prices of goods and services) has a spillover into rates of wage increase, and rates of investment return. Rates of price increase, rates of wage increase, and rates of return on capital should be positively correlated, although a formula connecting the three has not to my knowledge been demonstrated.

It is intuitively obvious that the cost of any fixed benefit pension plan (private or of a social insurance nature), expressed as a percentage of payroll, is a function of the relative rates of price increase, wage increase, and investment return. Actuaries are only beginning to work out the basic theory. No employee benefit plan actuary worth his salt can afford to ignore this exceedingly important area. Let me commend to you a paper to be presented at this meeting - Introduction to Dynamics of Pension Funding by Bowers, Hickman, and Nesbitt. Let me refer you as well to recent studies of the same problem as it affects OASDI design.

Inflation clearly has an effect on pension product design. The relative attractiveness, from the employee's point of view, of the defined benefit plan vs. the defined contribution arrangement is clearly a function of one's view as to what is likely to be the future relationship between rates of increase in employee earnings and rates of investment return. Unless investment earnings in stocks, fixed income investments, or whatever the plan chooses to invest in can be well above the rate of wage inflation, the defined contribution arrangement is likely to prove disappointing. ERISA seems to have the tendency of pushing pension plan designers in this direction.

Effect of inflation on product design is also seen in the areas of variable annuities, variable life insurance, cost-of-living features in pension plans or life insurance products.

Apparent Change Area B - Demographic Changes

I have perhaps already said enough words of warning about demographic change, especially that arising from low birth rates since 1965. We are already seeing empty grade schools, well-trained young school teachers who cannot get teaching jobs, and the "peaking out" of industries which cater to the young.

Where do we expect to find new life agents after, say, 1985? New actuaries? New scientists and engineers? Will we become a society of the old? What adaptations are necessary? Many of us believe Zero Population Growth may be a good thing in the long run, but can we handle the age shifts that must precede it?

From a life insurance marketing point of view, will we see a big decline in the juvenile market? In the young married market? Any important shift in the distribution of the population by age has its effect; not all of these effects unfavourable, but all of them can be disturbing.

Apparent Change Area C - Changes in Family Structure, Life Styles, Number of Earners, Values

The changes going on in this area are baffling, at least to this untrained observer. Perhaps this sort of change is exaggerated, and that things are not as different as they seem. But there *is* a high proportion of two-worker families, and values and life styles are different somehow. Perhaps financial security has as high a place as ever in our value system but we might be on our way to a society where personal consumption loses its zest, where work is not all that important, where leaving an estate is meaningless, and where reliance on government becomes the norm. If so, the effects on the work of actuaries will be profound.

Apparent Change Area D - Changes in Health Care and its Delivery

If I am sure of anything, it is that the entire health care industry, including insurers as well as providers of service, is in for mammoth change. What direction these changes will take is not nearly so clear. Actuaries have performed an important pricing role but have done little more than to keep health insurers barely solvent under conditions of very rapid inflation in both the use and the cost of health services. The insurance mechanism, of which nearly all health insurance actuaries are a part, has clearly contributed to this rampant inflation in the cost of health and yet has provided real protection to many people. New and imaginative solutions are needed. The actuary can have an important role, if he is willing to assume it.

Apparent Change Area E - Changes in Legislation, particularly Tax Law

In today's complex world dominated by lawyers and tax accountants, the actuary cannot serve his public without considerable knowledge in legal and tax areas. More and more life insurance is sold, and more and more employee benefit schemes are devised, with income and/or estate tax heavily in the forefront. These areas change continually and here actuaries are more likely the reactors to, rather than the instigators of, change.

I wish that it were otherwise. ERISA was a great opportunity for the pension world in general, and pension actuaries in particular, to have a significant influence. The results are not yet in and enrolled actuaries may play a real role before the books are closed, but I fear actuaries are necessarily helping clients react to ERISA rather than doing something real toward making ERISA livable.

Conclusion

Change is inevitable. Some of us are basic optimists, assuming that most change can be for the better; others have a built-in set that much change is wheel-spinning at best, and at worst downright harmful. All humans have some tolerance to change, but we all have limits on our ability to adapt. We may get more set in our ways, and less tolerant to change, as we grow older. My personal set is that I welcome simplifying change, but grow increasingly intolerant to complicating change.

Actuaries by their training know how uncertain many human events must be and this knowledge should make us more tolerant of ambiguity. If we can help others live intelligently in a changing and uncertain world, we will have made a contribution.