RECORD OF SOCIETY OF ACTUARIES
1981 VOL. 7 NO. 3

REGULATION AND THE ACTUARY: THREE NATIONAL APPROACHES

Moderator: RICHARD HUMPHRYS. Panelists: EDWARD A. JOHNSTON, JOHN O. MONTGOMERY

Follow-up to General Session panel on international insurance regulation.

MR. RICHARD HUMPHRYS: This session is to discuss the approaches presented at the General Session this morning. In general, we will discuss to what extent the differing approaches are valid because of differences in products and other circumstances in the different jurisdictions. The morning session did not allow time for questions from the floor or for discussion among the panelists.

To start the discussion off, I have a question for Mr. Johnston. In North America we have both guaranteed cash values and guaranteed loan values as part of our system. Fellows of the Institute of Actuaries have long felt that this creates potential liquidity problems of a very serious nature. Would you please comment both from the traditional background of a British actuary and from the information you have on the European approach as to how you see this matter.

MR. EDWARD A. JOHNSTON: In Britain, the guaranteed cash value situation has sometimes been approached by providing a non-guaranteed scale at a given premium level and a guaranteed scale for an extra charge. In 1974, in Great Britain, there was considerable disintermediation as a result of the then high guaranteed rates. A sharp rise in interest rates with sharply falling market values caused a run on certain offices offering high guarantees and subsequent bankruptcies. Consequently, we cannot have one asset standing behind two benefits, one of which is short-term and the other long-term.

In 1974 certain of the offices had appropriate long-term assets to cover their long-term liabilities, but insufficient short-term assets to cover their short-term liabilities. The Government's reaction has been to require a market value asset cover for the cash value liabilities. This will be embodied in the new valuation regulations.

Over the years there has been a steady stream of public complaints about cash surrender values. The public feels that cash surrender values should be guaranteed. As a result of the problems in 1974, this stream of complaints subsided for a time but has now reappeared. These public complaints cannot be satisfied if you are to have long-term savings at competitive rates.

As far as Europe is concerned, we have agreed to go our own ways. Each member country has agreed to recognize the others' rules. A British company writing business in France is subject to French rules on its business written in France.

MR. HUMPHRYS: Does this not cause a problem with companies seeming to be less than fully solvent?

MR. JOHNSTON: I think it is a fallacy to believe that worldwide assets are available even now to support worldwide liabilities. With the concern of foreign jurisdictions to have sufficient assets to offset the liabilities in their own jurisdictions, the comparison of worldwide assets to worldwide liabilities does not make as much sense now as it may have in the past. Solvency can be the sum of the pieces where each state recognizes the viability of the rules in each other state.

As an aside, I should mention that in Europe the actuaries have little freedom. Prescribed bases are usually required for valuation.

MR. HUMPHRYS: Since minimum cash values are required in the United States, do you have any comments on the above, Mr. Montgomery?

MR. JOHN O. MONTGOMERY: The new model legislation on valuation and nonforfeiture values provides a dynamic approach to nonforfeiture values for the first time. The nonforfeiture interest rate will be 125% of the valuation rate of interest. For indeterminant premium products, the nonforfeiture value assumptions are subject to the Commissioner's discretion in most states.

MR. RICHARD A. BURROWS: Does this not present some problems with respect to Universal Life?

MR. MONTGOMERY: For Universal Life the cash values still have to satisfy the basic tenets of the nonforfeiture laws. However, interest rates are usually only guaranteed for one or two years at the most. Therefore, there does not appear to be a problem.

With respect to indexed products - for example, those at 75% of the prime rate - we generally require segregation of the assets matching these liabilities. We require the average yield on the assets to be compared to the required interest on the liabilities on a quarterly basis. No additional reserves are required if there is an adequate margin.

MR. MICHAEL COHEN: How about individual policies with guaranteed cash values?

MR. JOHNSTON: At present there are not large blocks of such business, and I would not like to see large blocks, at least with liberal cash values. If rumors are circulating with respect to the solvency of a company, everyone rushes to cash in their policies if there are liberal cash values. Therefore, a crisis is precipitated. If no liberal cash surrender values exist, you have a tactical advantage.

MR. ALEXANDER C.M. ROBERTSON: Is this not an over-reaction?

MR. JOHNSTON: I don't think so. The companies with high guaranteed values have always wanted to change. The experience in 1974 was just a good reason. Traditionally, products have not had high guaranteed cash values in Great Britain.

Incidentally, you can support a ten year bond (policy) with a ten year equity investment if there is a market value or cash surrender value.

MR. HUMPHRYS: You can prescribe that the market value assets should always be in excess of the guaranteed values. However, there are bound to be large swings. When do you take action?

MR. JOHNSTON: The swings are acceptable if they are temporary. The problem is in defining "temporary".

MR. ALAN W. SIBIGTROTH: It seems to me that innovations with respect to policy forms design are sometimes stymied because of policy forms approval procedures. It is important to have a regulatory agency that listens and that has a method by which you can appeal their decisions.

Is there some liaison role that would further the co-ordination and education process between the actuaries and the regulators?

MR. MONTGOMERY: We are trying for uniformity through the N.A.I.C. However, there will always be some problems because there will be states that want to go their own way. Many commissioners are ready to transfer their authority to approve policy forms to some central authority connected with the N.A.I.C. With this in mind, the technical subcommittee will be split up. It is basically a matter of politics and credibility.

MR. HUMPHRYS: The input from the industry is important. The regulatory authority should respond to protect the individual. In general, there are good relationships in Canada. At present there are not so many companies that personal contact is impossible. The regulation is generally a matter of keeping the fringe companies in line.

MR. JOHNSTON: Our main contact is not with the British Institute of Actuaries but with a company organization similar to the American Council of Life Insurance in the United States.

MR. MONTGOMERY: We hope that there will be an interface with the central N.A.I.C. office.

MR. HUMPHRYS: In Canada, having one federal agency does make the matter simpler. Both the industry body and the Canadian Institute of Actuaries (C.I.A.) have input. With the change in approach effected in 1978, a C.I.A. committee did look into the matter. In addition, that Committee was involved when changes were made to the life statement form.

MR. ROBIN LECKIE: Although there is some confusion, the general system in the United States works quite well. There are at least six special committees in the Society of Actuaries that interface with the regulators.

MR. MONTGOMERY: The Academy of Actuaries has two committees, one Life and one Health, that also interface with the regulators.

MR. ROBERTSON: I am basically concerned with the asset management of a mature individual company. In that case, the liability base does not change with movements in the markets for bonds and stocks. You can't roll over the whole portfolio. We are looking to using interest futures as a hedge.

MR. MONTGOMERY: They have been permitted in California.

MR. HUMPHRYS: We consider purchase of interest futures as an incidental power useful for the protection of policyholders. This kind of hedging is permitted for legitimate purposes.

MR. COHEN: Do you do on-site examinations in Great Britain?

MR. JOHNSTON: We do not have regular inspectors. However, in serious situations, where there is a reason, we are permitted to send in a firm of accountants. In general, we rely on the actuarial profession and the accounting profession to do their jobs. Annual certificates are required from the external auditors.

MR. MONTGOMERY: There is no substitute for on-site inspections. Especially to deal with complaints. Also, in California we have prior approval of health policy forms. Thus, we must visit the company in order to see what type of forms have been issued. In the United States, of course, the examination reports are public documents, although the working papers are confidential.

MR. HUMPHRYS: In Canada, we consider on-site inspection to be an important function. However, the reports are not published documents.

MR. RICHARD A. LAKE: Could you discuss why the health forms require prior approval in the state of California whereas the life forms do not?

MR. MONTGOMERY: Over one-third of the complaints that we receive are on health insurance. Thus, generally, the legislature feels that the health business is the more difficult business.

MR. HUMPHRYS: Legislation is often a response to the problems perceived at the moment.

MR. LECKIE: Do you see a problem with respect to guaranteed cash values and loans at low interest rates? I have noticed that some mutual companies have split the dividend scale by usage.

MR. MONTGOMERY: On cash values, generally, I would like to make the point that it would seem reasonable to encourage internal replacement of obsolete policy forms. Such internal replacement would include replacement of the policy loan clause.

MR. HUMPHRYS: In general, minimum surplus levels are not as common in the life insurance business as they are in the property and casualty business. Would you like to comment, Mr. Johnston?

MR. JOHNSTON: We have no formal ratio test. However, we will be introducing a solvency margin for life insurers. It will be 4% of the fund plus a percentage of the sum insured. This will be in addition to the technical reserves.

MR. MONTGOMERY: A task force of the N.A.I.C. is considering the question of financial ratios for life insurers.

MR. HUMPHRYS: We have a kind of earmarking of surplus, in that we have an investment valuation reserve, a provision for cash value deficiencies and a provision for negative reserves. This leads to a minimum of level of surplus. In addition, we are also working on surplus requirements to meet unknown contingencies.

You might like to see some statistics we have developed from the 1980 statements filed in Canada by approximately 55 life insurance companies. Most companies used their own experience in calculating or in estimating lapses. For participating business there is approximately a two to one ratio between those companies incorporating withdrawal assumptions, cash values and dividends directly in their reserving formulas and those companies which continue to reserve on the traditional basis. Only a very few companies are continuing to reserve on the basis of the Net Level Premium method.

We found that actuaries were more or less evenly split between those who substituted the cash values directly in the reserving system and those who made a surplus appropriation for cash value deficiencies.

The reserves for annuities are becoming a very substantial portion of the reserves for the life companies in Canada. For 1980, interest rates as high as 12% for the initial periods up to 15 years were used in the valuation.

Mr. Johnston, I am aware that in your U.K. legislation you have the ability to refuse registration to companies where the persons responsible are not "fit and proper" to conduct business. To what extent has this provision been used?

MR. JOHNSTON: It is very difficult to administer this provision. It was brought in ten years ago to handle a very obvious situation which had occurred. We believe that the Department is bound to observe certain rules in applying it. In general, it appears that if one had a criminal record one would not be considered "fit and proper". However, everyone is allowed at least one mistake.

In Great Britain we must have a reason to investigate a company. If regular inspections were required, then possibly this provision "fit and proper" would not have been needed.

MR. MONTGOMERY: We maintain a file on undesirable individuals. If anyone that is on the list applies, he would be refused registration.

MR. JOHNSTON: Do you have to give reasons?

MR. MONTGOMERY: Yes.

MR. COHEN: Could a company go to court in order to overrule you?

MR. MONTGOMERY: Generally they do not. They just apply again and again and eventually, if they are lucky, get accepted. This would be after a delay of a few years.