RECORD OF SOCIETY OF ACTUARIES
1984 VOL. 10 NO. 4A

CHANGES IN THE CANADIAN REGULATORY FRAMEWORK FOR LIFE INSURANCE

Moderator: ROBIN B. LECKIE. Panelists: GERALD M. DEVLIN, RICHARD V. MINCK, DON MC ISAAC. Recorder: KAREN GAYE LONG*

This panel will examine current proposals and their status and implications for the regulatory framework of life insurance in Canada. Specific topics to be discussed:

- life insurance versus other financial institutions
- extended powers, level playing field, deregulation
- stock and mutual
- federal and provincial
- financial reporting, solvency, and the role of the valuation actuary
- possible changes to the Federal Insurance Acts.

MR. ROBIN LECKIE: There is an increasingly exponential change in the environment surrounding the operation of life insurance companies in North America. Economic volatility, new products, and new product design features, changes in our methods of distribution, and increasing competition from within and from outside the industry are now part of our way of life. This has naturally led to proposals by the industry for changes in the regulatory framework to give the companies more freedom. At the same time, regulators would like to ensure that change is well managed and in the interest of our policyholders. The Canadian situation is particularly interesting for three relatively unrelated reasons.

First, we have, and we would hope to see continue, a very strong and respected federal regulatory system under which the Canadian life insurance industry has thrived. However, regulation of life insurance is a shared area of federal and provincial jurisdiction and there are signs the provinces may be about to take the lead in reform of the industry.

Second, changes in the federal Canadian system are being pressured by the spill overs from activities in the United States and influenced by developments overseas.

* Mr. Devlin, not a member of the Society, is Executive Vice President, Canadian Life and Health Insurance Association.

Third, while the valuation actuary in Canada has had a very important role in the life insurance industry, our profession is seriously questioning whether this role needs to be expanded in reaction to the rapidly changing new products and economic environments.

This afternoon we are fortunate to have three highly qualified panelists to develop this subject. To open, I will be calling upon Dick Minck, Executive Vice-President of the American Council of Life Insurance and the newly elected Secretary of the Society of Actuaries, to outline developments in the United States. These developments may indicate the direction of possible developments in Canada.

Dick will be followed by Gerry Devlin. Although Gerry's professional background is legal, he is not unfamiliar to actuarial audiences. Gerry will be summarizing the current situation in Canada, in both federal and provincial areas, and the proposals that have been put forth by the life insurance industry for changes in the Canadian and British Insurance Companies Act and its regulations.

I will then outline a few miscellaneous actuarial issues. Finally, we will hear from Don McIsaac, Director, Life Insurance Division, Ottawa. Don will set out some of the regulatory considerations of proposed changes in Canada with particular emphasis on actuarial considerations.

MR. DICK MINCK: Our two countries share one of the world's longest borders, and because of many decades of friendship that border is very porous. For that, we in the United States are grateful. However, it means that many of our lousy ideas do find their way north, and you sometimes have the problem of dealing with them.

The United States has a somewhat different pattern of financial institutions and of regulation from that of Canada. However, the similarities in economies and cultures, together with the extent to which Canadian companies do business in the U.S. and U.S. companies do business in Canada may make it useful for Canadians to review current developments in the United States concerning the roles of financial institutions and their regulators.

First, for the period 1930 through 1970, the roles taken by various financial institutions in the U.S. could be fairly easily described. The roles of commercial banks, savings and loan associations, stockbrokers, insurance companies, savings banks and merchant banks were separate and distinct. Each group of financial institutions was regulated by separate agencies at the federal level and at the state level. These regulatory agencies had many experienced personnel and clearly established practices that had proven effective over the years in dealing with the institutions that were their responsibility.

The economy of the 1970's brought unparalleled inflation and interest rates that were far higher than had been experienced in the U.S. during this century. The responses of several different types of financial institutions to these conditions included undertaking new types of activities that differed from their traditional roles. Some of the new products developed within the last two decades have resulted in the blurring of the established lines of demarcation between the activities of different financial institutions. The several regulatory agencies have responded to these new products by asserting their responsibilities to regulate the products whether or not the agencies normally regulated the institution offering theproduct. More recently, some financial institutions -- especially some banks -- have expressed interest in entering other lines of business from which they are barred by existing laws. In order to do so, they have made strong efforts to have the legal barriers to the expansion of their activities removed.

I. FINANCIAL SERVICES DEREGULATION

For the last several years, the trend in Washington has been deregulation of many industries that had been subject to federal regulation for many years. And while deregulation has certainly been the rallying cry of some bankers, the term does not fully describe the basis for the struggle that has taken place between the several financial institutions.

Without question, the U.S. financial services industry has undergone and will continue to undergo dramatic change. Products, distribution channels, business partners, and applicable statutory and regulatory frameworks are all evolving rapidly. These changes are driven by changes in demand in the marketplace and changes in the U.S. economy and are made possible by new technology. But changes of this nature do not necessarily require deregulation.

Today's most staunch proponents of deregulating the U.S. financial services marketplace are the large banks. In the wake of the Great Depression and the attendant collapse of the banking system, Congress enacted a series of laws to protect the safety and soundness of banks in the future. Toward this end, Congress was determined to isolate banks from other commercial enterprises, such as securities, insurance and real estate. This separation of banking and commerce became the hallmark of banking reform. It also became an increasingly bitter pill for banks to swallow, particularly as they watched their nonbank competitors continue to broaden their financial empires.

For the last twenty years, banks have pressed Congress to relax the laws that have kept them largely confined to the business of banking. Until recently, their primary desire was to get broadened securities underwriting authority, particularly with respect to mutual fund shares and municipal revenue bonds. More recently, they have added to their wish list mortgage-backed securities underwriting, real estate brokerage, and insurance agency and underwriting powers.

Many observers felt that 1984 would be the year in which the banks' wishes were granted. The Reagan Administration strongly favored deregulating the banks and had developed an omnibus banking bill to accomplish this goal. Key members of Congress were lending their full support to the effort. Banks pointed to the emerging financial supermarkets being put together by firms not in the banking business as evidence that competitive fairness demanded extensive deregulation of banks.

For the most part, these observers were wrong. The banking legislation that was ultimately passed by the Senate and the bills that were reported out of key House committees were mostly remedial in nature. There are several reasons for this somewhat startling turnabout.

First and perhaps most significant, several perceived abuses cropped up in the deregulation process. The most notable of these are the so-called "nonbank bank" and "South Dakota" loopholes. Use of either of these loopholes suggests that the purposes of various federal laws are being side-stepped and that the orderly regulation of financial intermediaries is being jeopardized.

Closing the "nonbank bank" loophole has, in fact, become one of the priority agenda items of Congress. Initially, this loophole was utilized by nonbanking entities such as brokerage houses, finance companies and insurers as a means of entering the banking business. Definitional imprecision in federal law suggested that if a bank spun off either its commercial lending activities or its demand deposit taking functions, it would no longer be a "bank" for purposes of federal law, and the owner of such an entity would not be deemed a bank holding company. Then in the last six months, banks themselves discovered that nonbank banks might be used to avoid the strict prohibitions that the U.S. law imposes on interstate banking. Large banks have for years had the desire to conduct a national rather than an intrastate banking business, and nonbank banks appeared to be the way to get there, since acquiring a nonbank bank and using it to cross state lines did not seem to violate the letter of the interstate restrictions.

The "South Dakota" loophole represented an even more blatant attempt to circumvent federal law, in this case the prohibitions on bank insurance activities that were established by Congress in 1982. In general, the 1982 law prohibited national banks, bank holding companies, and at least their nonbanking subsidiaries from engaging in anything but limited sales of credit insurance. A few banks felt that the law was ambiguous as to whether it reached <u>state</u> chartered bank subsidiaries of bank holding companies. Thus, they reasoned that if a state could be persuaded to include broad insurance powers as proper incidents of banking, and if the state would then authorize an out-of-state bank holding company to acquire the newly empowered state bank, the bank holding company system would have a full insurance capability, albeit on an indirect basis. In July of 1983, the bankers were successful in obtaining passage of just such a law in South Dakota.

The second major factor weighing against deregulation was increasing concern over the safety and soundness of the banking system. Third World loans, possibly unsound energy loans, and in some cases, plain mismanagement had precipitated a record number of bank failures. To many, it seemed an inopportune time to bestow upon banks new and risky powers.

In the midst of the banks' continued defense of the propriety of new powers, Continental Illinois collapsed and threatened a number of other banks and, in the view of some, the whole banking system. The Continental failure dashed any real possibility of expanding bank powers in 1984. Morever, the federal bail-out of Continental highlighted the unique position that banks occupy in the financial marketplace and the fact that banks are not just an average competitor in the marketplace. They do receive special treatment and would arguably be unfair competitors if permitted to engage generally in commercial activities such as the sale of insurance.

The third factor that mitigated against any wholesale deregulation this year was the efforts of a broad and effective coalition that allied itself against the large city banks and the Administration. The insurance companies and the insurance agents worked shoulder-to-shoulder to considerable effect. The coalition included virtually every U.S. insurance trade group. Also part of this coalition were the mutual funds, the investment bankers, travel agents, real estate brokers, and others. The strength of this coalition was demonstrated when the Senate overwhelmingly passed legislation to close the South Dakota loophole despite opposition from large and small banks, bank holding companies, the Administration, virtually all the federal and state bank regulatory agencies, the National Governors' Conference, and the Chairman and ranking minority member of the Senate Banking Committee.

Time ran out on final passage of a banking bill this year, but indications are that the matter will be taken up again when Congress reconvenes in 1985. I think there is a good chance that the insurance industry will ultimately get the legislation it needs to make it clear that the South Dakota loophole was in violation of existing federal law.

One final word on the South Dakota loophole. The fact that Congress failed to close this loophole means that there will be continued pressure on the states to liberalize their banking laws. Some states other than South Dakota might be more convenient places in which to locate a banking operation in new fields, and the bank lobby has worked hard to have other states follow South Dakota's lead. The most significant effort in this regard is in New York where the banks were able to persuade a special commission appointed by the Governor to recommend legislation permitting over time the total integration of the banking and insurance businesses. Based on that recommendation, legislation was introduced this year which is still pending and which will undoubtedly receive serious consideration next year.

Federal and state legislation aside, banks have actively pursued other means of gaining a more significant presence in the insurance industry. Two of these means warrant mention here; these efforts may in the final analysis be far more significant than efforts to implement sweeping legislative changes.

First, banks have worked closely with their regulators to engineer an expanded range of authority. An example of this strategy in operation is a recurring proposal from the Federal Deposit Insurance Corporation (responsible for providing deposit insurance to both state and national banks) that would facilitate broader bank entry into the insurance business. A similar proposal for thrifts has been offered by the Federal Home Loan Bank Board. In another vein, the Federal Board has received a number of requests to interpret existing law in such a way as to expand bank insurance agency activities. For example, a major bank recently petitioned the Fed for authority to market "IRA Completion Insurance", a proposal which amounts to little more than the sale of decreasing term insurance without any relation to the bank's credit risk. Although the Council objected to this proposal as going beyond what Congress had in mind when it established the bank insurance limitations back in 1982, it is possible that the Fed may some day see fit to grant this and similar applications. As the only recourse to such action lies in the courts, this approach may require a long and expensive opposition to check the growth of bank powers into insurance.

Second, banks have been eager joint venture partners with insurers in arrangements for the distribution of insurance products. For some time, insurers have capitalized on the broad insurance agency authority afforded state banks and thrifts and have used these institutions as retail outlets for annuities and other products. More recently, insurers have entered into arrangements with banks for the placement of their agents in a bank's lobby. While the bank is not directly compensated under these arrangements, the lease arrangement is customarily based at least in part on the volume of insurance sales.

These types of ventures are increasing in popularity and may prove to be an effective means of product distribution, but they may make it increasingly difficult to preserve the present separation between banking and insurance.

II. REGULATORS' PROBLEMS

The development of new products and the entry into new lines of activities by financial organizations have presented regulators with serious new problems. These problems have shown up in the area of protections afforded buyers of these products and most especially in the area of regulating the operations of companies with a view to solvency. Many financial institutions have an insurance or guaranty scheme to protect their customers, and the financial stresses of recent years together with the more complex organizations and more varied activities of financial organizations have increased the risks of such insurance or guarantee funds being triggered. Regulators at both federal and state levels have experienced difficulty in keeping insolvencies from occurring.

As an example of difficulties arising from new products or new activities, a number of life insurance companies have sold very substantial amounts of single premium deferred annuities in recent years. Deferred annuities had, of course, been sold by companies for many years without generating undo regulatory problems. However, recently, contracts with high interest rate guarantees during the accumulation period, very high interest rates being credited initially and with "bail-out" provisions, have been sold not only by insurance agents and brokers but also by stockbrokers. These contracts and their basis of sale have generated problems for several groups of regulators.

At the federal level, the Securities and Exchange Commission has had to review the problem of whether the contracts and methods of sale are such that some companies should be registering their products. This decision will presumably have to be made on a company-by-company basis according to the facts of each case. Most companies will argue that their contracts fall clearly within the exemptions provided by statute and that nothing in their sales practices would make them registerable securities.

At the state level, the guarantees contained in some of these contracts have given insurance commissioners some new problems to consider. The traditional methods of regulating for solvency involve the use of book values for both assets and liabilities and no specific provision for the timing of liabilities. The "bail-out" provisions in some contracts that allow the buyer to take his money out immediately and without penalty if the credited interest rate drops below a specified amount has given contracts with such provisions some of the risks characteristic of demand deposits. The importance of matching assets to liabilities is greatly emphasized by such contracts. However, some additional weapons may have to be added to the regulators' armory in order to produce the same degree of comfort that they have had in the past in regulating companies selling the products that were not so interest sensitive.

Another group of regulators faced with problems is the court systems -- both state and federal. New products, sales techniques and organizational complexities have given courts the problems of interpreting laws designed in different circumstances whenever financial organizations get into serious trouble. Their activities and the problems they face have been highlighted by the Baldwin-United case.

III. BALDWIN-UNITED

The financial problems of the Baldwin-United Corporations have shed some light on potential problem areas in the regulatory framework currently in place in the United States. I would like to go into that area in some detail to give you a feeling of the complex problems that regulators have had to deal with. It now appears that the policyholders who bought insurance contracts from the companies that were part of the Baldwin-United organization will eventually receive both principle and accrued interest. However, this result will come about only after many serious problems involving many conflicting claims are resolved.

A. THE PROBLEMS

In 1977, the Balwin-United Corporation was formed to be a parent of the D.H. Baldwin Company and the United Corporation. D.H. Baldwin was a manufacturer and marketer of pianos and other musical instruments; the United Corporation was a closed-end investment company with assets consisting primarily of cash and marketable securities. The merger with the United Corporation took place early in 1978. By 1982, Baldwin-United had subsidiaries in both life and property and casualty insurance, in mortgage insurance, in municipal bond insurance, in the savings and loan business, in trading stamps, in mortgage banking, in leasing, in electronic data services, and, incidentally, some still in the business of making and selling pianos. These subsidiaries, in some cases, owned and were owned by one another, and a chart of the corporation setup was almost unintelligible when limited to two dimensions and four colors. In addition to the operations controlled through subsidiary corporations, Balwin-United had a share in a partnership that acquired a number of banks in Colorado in 1980. Apparently, the complexity of the organizations and their criss-crossing ownership permitted the officers of Baldwin to persuade the Federal Reserve to approve a situation in which a holding company owned both banks and other financial institutions, including insurance companies. The Chief Executive Officer of Baldwin-United, Mr. Morley P. Thompson, served in that role from 1981 to May 17, 1983. He had been the president of the D.H. Baldwin Company from 1970 to May 17, 1983 and was responsible for assembling the conglomerate.

By May of 1983, it became apparent that the Baldwin-United organization was in serious financial trouble, and they retained the services of Victor Palmieri and Company, Inc. -- a firm that had been involved in the reorganization of the Penn Central Railroad Company. In July of 1983, six insurance companies owned by the Baldwin-United organization, were placed in rehabilitation by Arkansas and Indiana courts. Rehabilitators appointed by the courts were granted title to the assets of those six insurance companies which inluded the ownership of most of the Baldwin-United subsidiaries, either directly or indirectly.

In September of 1983, petitions for reorganization under Chapter 11 of the Bankruptcy Code were filed by creditors against the Baldwin-United Corporation and its subsidiary, the D.H. Baldwin Company, in the Federal Bankruptcy Court. In January of 1984, petitions for reorganization under Chapter 11 of the Bankruptcy Code were filed by five subsidiaries of Baldwin-United all of whom were operating in the mortgage banking business. All nine of the Chapter 11 proceedings are now jointly administered and are proceeding to go through the Bankruptcy Court. Baldwin-United, D.H. Baldwin and all of the leasing subidiaries are in default on all of their outstanding debts. On August 8 of this year, D.H. Baldwin and Baldwin-United filed a motion with the Bankruptcy Court to consolidate the two estates; a hearing on that motion is scheduled for the end of this month.

Baldwin-United still owns some corporations directly and has both preferred and common stock in other subidiaries. Thus, they have some claims against both the insurance companies and the subsidiaries owned by the insurance companies. On the other hand, the rehabilitators have asserted major claims against Baldwin-United. Absent a settlement between the several parties, that is, the rehabilitators, the management of Baldwin-United, and the various creditors, very substantial amounts of litigation seem likely. This fact was pointed up by the Baldwin-United management in a Form 10K filed late last month with the Securities and Exchange Commission. Two paragraphs in a 76-page submission which was supported by several hundred pages of exhibits, gives some idea of the current situation:

> "Given the history and complexity of, and diversity of interests in, the Baldwin-United group of companies, absent a consensual settlement among the parties involved, there is the distinct possibility of years of litigation involving certain asserted claims, claims of preference, fraudulent conveyances, mismanagement and other matters, yet unknown....
>
> By July 25, 1984 unaffiliated entities, with certain exceptions, asserting claims against the Company (Baldwin-United) and Baldwin were required to file claims with the Bankruptcy Court. There were approximately 3,000 claims filed. Of these, approximately 6,500 were for an aggregate amount of approximately $10 billion, and the remaining claims were for amounts not yet quantified. The Company believes that approximately $4 billion of such quantified claims may be duplicative. The largest single quantified claim ($3.7 billion) has been made by a number of holders of SPDA contracts who have asked to be certified as a class. No detailed analysis has yet been made of these claims and it is not possible to estimate what portion of these claims will be allowed nor their impact on any ultimate payment to the Company's and Baldwin's creditors and equity holders".

The rehabilitators of the insurance companies filed a plan in October 1983 under which they would make a number of options available to the contract holders of single premium annuities and to the life insurance policyholders. Their basic plan was to make the annuity value as of May 1, 1984 available to annuitants in full at the end of a three and a half year period. During this period, they would credit interest at approximately 5 1/2%. They also made some funds available immediately under several options. For example, a policy loan of up to 75% of the amount accumulated through May 1 could be taken. Several other options would permit the withdrawal of lesser amounts of cash.

Hearings on this plan were held in the rehabilitation courts of Arkansas and Indiana in January of 1984. Amendments were filed to the plans during these hearings. On March 23, the Arkansas rehabilitation court approved the plan as amended. One month later, the Indiana rehabilitation court approved similarly amended plans.

Baldwin-United and D.H. Baldwin corporations are appealing in state courts from these rehabilitation court orders. They say that the rehabilitation plan contains artificially high interest crediting rates and restrains them (and anyone else) from asserting claims against the insurance companies. I have listed all of these claims and counterclaims of the several courts involved just to give some idea of the complexity of trying to resolve the problems raised by the bankruptcy of the Baldwin-United conglomerate. Another measure of the difficulties is the estimate of litigation fees for the various parties in the various courts. One recent estimate is about $4 million per month.

B. ENHANCEMENT PLAN

Early this year, a group of stockbrokers who had sold single premium deferred annuity contracts issued by the Baldwin-United United insurance companies proposed a plan that would enhance the benefits being made available under the rehabilitation plan. Not all of the stockbroker firms that had sold such contracts were willing to participate in such an enhancement program. Additionally, some 20% of the contract holders had purchased their contracts through insurance agents or brokers, and they would not be covered by the stockbrokers' enhancement plan. The desire to afford equal benefits to all contract holders led to the rehabilitators and the National Association of Insurance Commissioners to urge life insurance companies to examine the possibility of participating in such a plan. After examining the several options, a group of companies concluded it would be desirable to make such a plan work.

The terms of the brokers' proposal involved putting up an amount of money that would be sufficient to increase the interest credited to contract holders during the three and a half year period from May 1 until such time as funds were fully available by approximately 2% per year. The single premium equal of such an additional payment would amount to approximately 5 1/2% of the amount accrued by the contract holders through May 1, 1984. If all the stockbrokers were to participate in the plan, their cost would be approximately $200 million. In order to provide equal benefits to those policyholders who purchased their contracts from insurance brokers or agents, the life insurance companies would have to contribute approximately $50 million.

In reviewing alternatives, the life insurance companies who decided to participate in an enhancement plan had to give appropriate weight to potential assessments by the state guaranty funds both as to amount and timing in the event that an enhancement plan is not put together.

Estimating the amount of any assessments was complicated by the form of the Guaranty Association laws currently in effect in some 35 states. These laws typically limit the amount of an assessment for a particular line of business to 2% of the premiums that were written during the previous year by a company for that line in that state. In addition, companies are most commonly allowed to deduct 20% of such assessment from their premium tax bill in each of the succeeding five years. However, the difference between assets and liabilities for the Baldwin-United insurance companies amounted to $800 million as of the end of 1983. If the guaranty funds were to make up this deficit, it would take many years because of the caps currently contained in state laws. For example, some estimates have been made that the maximum assessment nationwide for annuities would be about $100 million in the first year. The guaranty funds of some states could take as long as 30 years to collect enough money to cover the guarantees of those states. The consequent impact on state premium tax collections would be similarly devasting. Thus, in calculating the net financial impact of the alternative of letting the state guaranty funds take care of the Baldwin problem, companies had to assess the likelihood of current laws staying in effect after it became clear to state legislatures first that protection for other policyholders against other possible insolvencies involving annuities would not exist until the Baldwin-United claims were paid up and, secondly, that the future tax receipts of the state would be seriously diminished.

Another difficult question was that of determining what the claims might amount to against guaranty funds and when they might come due. The Baldwin-United contracts contained interest guarantees averaging about 7%. However, they also contained "bail out" provisions saying that the contract holder could withdraw his funds without penalty at any time the interest rate credited dropped below 11 1/2%. The interest rate being credited from the time of the take-over by the rehabilitators through May 1, 1984 was 9 1/2%. Finally, state guaranty fund laws typically provide that they will be triggered upon insolvency or, in the case of companies undergoing rehabilitation, when a final order of rehabilitation is ordered. However, there is some question as to whether any of the orders entered in the rehabilitation courts to date are "final" orders.

A key element in the decision of companies to participate in an enhancement plan was the action taken by the Metropolitan Life Insurance Company in volunteering to become the lead carrier in such a program. The Metropolitan agreed to issue their own contracts to replace the Baldwin-United policies, provided they would get clear title to enough assets to support guarantees of 7 1/2% during the three and a half year period. Another requirement before such a plan could be put in effect would be the agreement by 75% of the contract holders to release any claims they had against either state guaranty funds or the individuals who sold them contracts in exchange for the new policies and the enhanced interest rates being offered. Participating life insurance companies would also participate in a reinsurance program with the Metropolitan Life.

Two major problems still remain before this program could be put into effect. First, additional assets are needed in order to be able to provide the desired guarantees. If all the stockbrokers were to agree to participate, and if $200 million could be realized from the assets constituting shares of affiliated companies, the available funds would be adequate. In order to realized $200 million from the affiliated assets, an agreement would have to be worked out between the rehabilitators, the Baldwin-United management and the creditors, all of whom have claims against these assets. At this point, the Baldwin-United management and the creditors have offered a settlement that would produce $170 million if a number of conditions were to be met. One of the conditions is that a satisfactory solution be reached at the Internal Revenue Service with regard to the other major problem.

The second major problem is that the insurance companies filed joint income tax returns with other Baldwin-United corporations for the years 1978 through 1983. Those returns have been audited for the years 1978 through 1980, and the IRS released its examination report for those three years in May of this year. In July, the IRS filed in the pending Chapter II Bankruptcy proceedings claims against Baldwin-United aggregating $450 million. It's likely that similar issues to those raised for the years 1978 through 1980 may arise for the years 1981 through 1983. The claims filed by the IRS include amounts estimated to be due from those years, even though examinations by the IRS have not been completed for those years. The magnitude of the potential claim and the possibility of the IRS pursuing the assets of the insurance companies makes it impossible for the Metropolitan Life to issue new contracts now in exchange for the assets. Therefore, the enhancement plan cannot proceed until such time as Metropolitan can obtain clear title to an adequate supply of assets.

C. OTHER PLAYERS

The Baldwin-United debacle has provided additional work for other lawyers. For example, aggrieved groups of policyholders have retained counsel and filed class-action suits in courts in four or five states against some of the stockbrokers who sold Baldwin-United contracts. A dozen stockbrokers have offered to settle these class-action suits on the basis of putting up approximately $130 million collectively. That money would go into escrow and be used as part of the enhancement plan. In the event that the enhancement plan were not to be installed by the middle of 1984, the funds would be paid directly to the policyholders. In exchange for these additional funds, the policyholders would waive all claims against the stockbrokers. The terms of the agreement would also provide that the funds received by contract holders would serve to reduce any claims that might subsequently be made against state guaranty funds on a dollar per dollar basis. The agreement has yet to be approved by the courts -- in this case, Federal District Courts in which the lawsuits have been filed.

In addition to the insurance commissioners, the attorneys general of many states have shown an active interest in protecting the citizens of their state. They have been reviewing possible actions against brokers, state insurance guaranty funds and the Baldwin-United Corporation with its subsidiaries. A meeting was recently held in Atlanta involving insurance commissioners and attorneys general or their representatives at which some 37 states were reportedly represented. It seems likely that the pace of activity by the state regulators will be stepped up during the next several months.

The Securities and Exchange Commission, of course, has regulatory authority over the subsidiaries who sold the Baldwin-United contracts. They also have regulatory authority over other actions in which brokerage firms were involved with Baldwin-United, including raising of funds for the company through the sale of either stock or bonds. In addition, in May of 1983 the SEC commissioned an investigation of Baldwin-United which involved possible violations of the registration, reporting, disclosure and accounting provisions of the Federal Securities laws. Baldwin-United has been advised by its counsel that an enforcement proceeding will possibly be put into effect against the company in some point in the future. It's not clear whether the outcome of such a proceeding will result in fines or other financial losses for Baldwin-United.

D. TESTING THE REGULATORY STRUCTURE

The complexities of the Baldwin-United organization have resulted in strains that have tested the regulatory structure of both the states and the federal government. Some people have expressed dismay that the failure of the companies and the consequent potential losses to purchasers of annuities was not prevented by either the federal regulators of securities sales or the state regulators of insurance sales. However, the cause of the financial collapse included the acquisition of companies for which excessive sums were required and the writing of contracts containing guarantees that proved to be dangerous to make. The Federal Securities laws do not address either of these problems, and the state insurance commissioners stepped in to rehabilitate the insurance companies fairly promptly. It's far from clear whether anyone would support legislation that would give state insurance departments the right to keep companies from issuing contracts with very favorable guarantees or the right to prevent companies from acquiring any subsidiaries until and unless such acquisition was approved by a regulator. Absent such legislation, it's difficult to see how Baldwin-United's downfall might have been prevented by regulators.

Some defects appear to have shown up in the laws establishing guaranty funds. As a result, the ACLI has submitted a series of proposals to the NAIC to make changes in the model guaranty fund legislation (and, subsequently, in the laws of the several states) to correct these defects. Those proposals will be considered by the NAIC, and we hope that favorable action will be taken at the December meeting. If the banks in Colorado and the savings and loan companies owned or controlled by Baldwin-United had similarly gotten into financial difficulties, we would have been faced with an even more complex problem, and state and federal bank regulators would have joined the group trying to deal with it. By adding additional layers of laws and regulations and additional groups of regulators, as well as different groups of customers with different types of claims, this could have multiplied the possibility of lawsuits and increased the number of courts taking an active role in disposing of the remaining assets of Baldwin-United. Even in the current situation there seems to be some risk that a very substantial portion of those assets will be required to pay legal fees rather than going to the several claimants. This procedure has been described as "legal melt-down". In short, if the current barriers between financial institutions which restrict their areas of operation were to be taken down, the difficulties faced currently by regulators would become substantially greater. Such an occurrence would lead to a great deal of confusion and, ultimately, to a very substantial realignment of state and federal laws and of the duties of regulatory agencies. During the period of change, I believe that the public will be the losers.

MR. GERRY DEVLIN: After hearing Dick Minck talk about the changes that deregulation has produced in the U.S. financial sector, progress in Canada may seem slow. Yet, the slower pace of change has enabled us to avoid some of the mines that have exploded in a few American financial institutions. And it has given us breathing space to examine some of the fundamental issues raised by the evolution of financial services in Canada.

Because of time constraints, I will limit my discussion to three themes:

1. what our member companies have asked for and why,

2. what's happened at the federal level and in Quebec, and

3. concerns that have been emerging from the debate on diversification of financial services.

The more technical details I'll leave to our moderator, Robin Leckie. Like you, I'm also anxious to hear what our panelist Don McIsaac has to say about the changes we can expect to federal insurance legislation, now that a new government is in place.

One of the important reasons behind our request for changes to the federal legislation is the importance of the U.S. market to Canadian companies. In 1983, Americans bought $36.6 billion worth of life insurance and annuities from Canadian companies, accounting for 75 percent of the industry's foreign business. If our legislation does not allow us to take advantage of new marketing opportunities now developing in the United States, Canadian companies operating in the U.S. could be placed at a competitive disadvantage. In addition, U.S. companies operating in a more restrictive Canadian environment could press for retaliatory action.

That is one of the reasons why reciprocity was a major theme in our brief for legislative change to the federal government. Reciprocity between Canadian and foreign-based companies, in terms of the activities they can pursue and the investments they can make, is essential. This fact was recognized by the Honourable Roy MacLaren, the minister formerly responsible for the federal insurance legislation, when he spoke at our annual meeting last May. He stated that U.S. - owned insurance companies are a good example of the benefits our country can receive from foreign businesses.

To assure reciprocity among life insurance companies operating in Canada we also requested equal treatment of stock and mutual companies. One of the urgent concerns of our submission to the federal government was the need to enable mutual companies to form downstream holding companies so that they can diversify their activities through subsidiaries.

This use of subsidiaries is a crucial element in our approach to diversification. To avoid regulatory entanglements as financial institutions enter new fields, we feel that the core activities of these institutions should be preserved, with diversification taking place through subsidiaries. While we have requested that the list be broadened of in-house ancillary activities life insurance companies may engage in, any other business not directly related to life insurance should be handled through subsidiaries.

Preserving the core activities of insurance, trust, securities and banking is sound in principle and supports the current regulatory approach of regulation by institution. Any attempt to regulate by function could prove difficult because banking as a function has never been defined under Canadian legislation. The federal government regulates the banks, not the function of banking. Any definition of banking raises enormous constitutional difficulties because of so many "near banks" like credit unions and caisse populaires which are now provincially regulated.

In addition, the relative size of the banks would make fair competition impossible if full integration of financial services by function were to take place.

At the end of 1983, the 12 schedule A banks had total assets in excess of $347 billion and Canadian assets of just over $223 billion. In contrast, life insurance companies had Canadian assets at the end of 1983 of $50 billion, excluding $10 billion in segregated funds. Trust and loan companies and credit unions, which restrict their business mainly to Canada, had total assets, respectively, of some $92 billion and $37 billion. Add this up, and you can see that the total Canadian assets of the twelve largest Canadian chartered banks exceed by a wide margin the combined assets of the trust and loan companies, the life insurance companies and the credit unions.

Since our approach to diversification through subsidiaries is based on reciprocity only a partial integration of financial services is possible. While insurance companies, securities firms and trust companies should be able to engage in each other's core activities through subsidiaries, the banks of course by law are restricted to 10% ownership of themselves and of others and therefore would have to remain restricted to accepting deposits and other powers now specified in the federal Bank Act.

While I have been focusing my remarks on the reforms needed to allow fair diversification for all life insurance companies in Canada, the submission we made to the federal government more than a year ago also included proposals (1) for replacing the detailed quality tests for investments with less restrictive guidelines, (2) for giving participating policyholders a voice in the management of their company and (3) for sweeping away some of the regulatory cobwebs that have gathered since the legislation received its last major overhaul, more than 50 years ago.

In response to our proposals and the desire of the other financial institutions to offer full financial services, the federal government formed an inter-industry advisory committee to consider some of the larger issues. This means that questions such as ownership of trust companies or securities firms will not be dealt with until the committee has made its recommendations.

We did, however, receive a positive response to some other requests when the previous Liberal government was in power. By expanding the interpretation of ancillary business now permitted through ministerial discretion Mr. MacLaren agreed to allow the mutual companies to form downstream holding companies. He also indicated that life insurance companies would be permitted to finance annuity and insurance premiums, offer custodial and safekeeping services, market each other's products, enter the financial leasing business and set up subsidiaries to engage in any activity permitted of a life insurance company directly.

It's too soon after the federal election to predict what course the new Conservative government will take. However, the new minister of finance, the Honourable Michael Wilson, did promise to revise our legislation as soon as possible, as part of his election platform. We are seeking early meetings with Mr. Wilson and the Honourable Barbara McDougall, Minister of State for Finance. We anticipate that Ms. McDougall will pick up where Mr. MacLaren left off.

The Quebec government, on the other hand, moved swiftly to update the legislation governing the 15 life insurance companies chartered in that province. One reason for the speed was the fact that the province didn't have to deal with the issue of banking, because it's regulated at the federal level only. Another was the provincial government's desire to give companies incorporated there lead time for integrating financial services.

Bill 75, which became law this summer, enables Quebec-chartered life insurance companies to move into the market of offering securities, deposit-taking and fiduciary products. With the prior approval of the finance minister, Quebec-chartered companies are allowed to carry out <u>any</u> lawful business. The new act also removes restrictions on territory and on the nature of business that can be carried out by subsidiaries. The limitation on use of assets for diversification purposes is 50% in Quebec as opposed to 15% requested in our federal brief.

Now that the doors have been opened, we are carefully monitoring the situation in Quebec. And we are paying close attention to some of the concerns that have emerged since we first made our submission to the federal government.

In Canada, life insurance companies can incorporate either under federal or provincial regulation. Approximately 90 per cent of the life insurance business in Canada is underwritten by federally incorporated companies. But, the provinces regulate agent licensing and marketing practices for all companies operating in their jurisdiction.

Although we have not approved of it as Association policy I believe our members would support multi-licensing of all individuals selling financial products and services including life agents, so long as they are well-qualified before they can sell them. Changes in Quebec legislation now permit a wide range of multiple licensing of people selling financial products and services. Of course the use of its distribution system would always be subject to the decision of each financial institution and its sales force.

The issue of diversification was also raised in our submission to the Ontario government's recently formed task force on financial institutions. Another concern of the Ontario government is consumer protection, stemming partly from losses consumers have suffered through the mismanagement of a few trust companies, which were provincially controlled.

The Ontario Superintendent of Insurance is pressing for a compensation fund, for the same reason as deposit insurance that protects depositors at banks, trust companies and credit unions. While we are proud of our historic record of stability, we realize that some consumer protection mechanism may be the price we'll have to pay for competing with deposit-taking institutions subject to deposit insurance. But, we feel the compensation fund is a simplistic approach that places the financial burden on sound companies and their customers. We are currently exploring alternatives which include coinsurance, which is already in use in Great Britain, standards of conduct for corporate management and the use of corporate actuaries as regulatory watchdogs.

Our current disposition is to achieve a consumer protection system that would be operated by the industry -- that is, if political pressure makes it inevitable that we must have such a system.

Of course, the regulatory framework alone does not determine the evolution of financial services. Many unregulated changes have been taking place. For example, one of the large securities firms has set up deposit accounts with chequing privileges for its customers. And the large financial conglomerates are making new acquisitions every day.

Although I don't have enough time to cover all the developments, I hope my remarks have shed some light on the changes that are beginning to shake the regulatory framework of Canada's financial services industry.

Our main message to the regulators is: give us the flexibility needed to compete, to meet consumer demands and to respond to a fast-changing financial sector. We're not asking for any special treatment, nor are we asking for any new powers that could jeopardize the interests of our policyholders or shareholders. By taking the time to examine the financial services industry in detail, we hope our federal and provincial governments will produce legislation that combines both opportunity and stability for the benefit of Canadians and the Canadian financial system.

MR. LECKIE: Before we hear from Don McIssac, I would like to highlight five areas of concern which are seemingly unrelated but which, I feel, should be borne in mind in shaping the insurance industry.

First, will the proposed new reporting of income from common stocks and real estate lead to a weakening of the financial strength of the industry? The CLHIA committee, of which I have been Chairman, has recommended a new approach to the appropriate reporting of income from non-fixed interest investments, such as common stocks and real estate. In 1977, the Canadian regulatory authorities introduced a revised approach to the systematic reporting of capital gains from stocks into income. Seven percent of both realized and unrealized gains and losses were amortized into income each year. No similar treatment, however, was made available for real estate. Thus for real estate, capital gains have been reported as extraordinary income in the year of the gain while unrealized gains have not been recognized in income. Our industry committee is now recommending that the amortization rate for stocks be increased to 15% and that a similar approach be adopted for real estate. The hope is that the change for stock reporting can be made effective in 1984 while the change for real estate might be introduced in 1985.

There are many actuarial reasons for suggesting these changes, chief among them, improved equity between generations of policyholders and a more responsive reporting of income as earned. However, there are concerns which I believe all actuaries should be cognizant of. For example, the change will increase significantly the volatility of reported earnings. Will this be understood? The proposed change in the method of reporting stock income will also increase the reported total earnings of the life insurance industry in Canada in 1984 by approximately 30% without any change in the underlying profitability or performance of the industry. Bringing unrealized real estate gains into income will further increase reported earnings. In effect, there will be a release of a hither to hidden reserve into earnings. Management must take care not to be deluded into believing there has been some fundamental improvement in our industry as a result of these improved reported earnings. Any move to increase pay out to policyholders based on these higher reported earnings would have the effect of weakening the ultimate financial position of the industry.

As a footnote, I personally believe that this is exactly what happened in 1978 when the last major change in financial reporting was introduced. Reported earnings were substantially increased, and ratios of reported surplus to assets doubled. Since then, surplus ratios have been visibly declining and real surplus has probably declined more than reported, if, as I suspect, there has been a progressive weakening of actuarial reserve assumptions.

The second point I would like to raise is whether the current federal system of taxation of the financial services industry in Canada can continue. At the moment, the tax take is minimal, which may make the banks, the trust companies and the insurance companies feel good, but I wonder for how long. Let me focus on one of the major reasons why most financial institutions are not paying tax at what the outside world considers an effective corporate tax rate - the government's desire for integration of corporate and individual taxation. In theory, profits are taxed at the corporate level and then passed through relatively tax free through dividends to individuals or other corporations. Full deductibility is available for dividends passing through financial institutions. This all seems very reasonable. However, the result may be that no significant federal tax is paid by the financial institutions.

Consider a very simplified example. Assume investment income of a company is 10% of its assets. Assume that profits are 1% of assets, that is, 10% of investment income. This is a fairly normal situation. Then if stock income is 10% of investment income, taxable income for the company will be zero. That company can in turn pay dividends on its earnings and the receiving individual or company will receive credit for an assumed tax paid. The point is, any financial institution is usually able to manage the size of its stock portfolio to produce zero taxable income. Consider the effects on the federal tax base as each level of taxation is able to take credit for deemed taxes paid at a higher level to reduce its taxable income to zero and then pay increased dividends as a result.

Note that the proposal to increase the amortization formula for the reporting of income from stocks, which increases profits by 30%, will not have any impact on the tax formula. Thus, reported income will be higher while taxable income will remain low.

I think there are a number of issues of this nature, including actuarial issues which affect taxation and which need to be reviewed. In doing so, it is necessary to look at all financial services, not just life insurance companies. Any tax reform for the financial sector must incorporate the surrogate taxes levied by the provinces - premium taxes in the case of the life insurance industry, capital taxes in the case of banks - to arrive at tax neutrality. Similarly, there should logically be a change in the treatment of unit linked policies so that they are on the same tax basis as conventional products, as is the case in the United States and the U.K.

A third issue is, to what extent is the capitalization of the financial services industry becoming inflated? For example, financial institutions in a low tax position are encouraged to raise capital through preferred share offerings. Similarly, other financial institutions are encouraged to make investments in the preferred share offerings of other financial sector companies. What happens when a company makes a preferred share offering and at the same time buys the preferred shares of other companies? Is its capital increased, or not? It is clear that if two companies each buy $50 million of each others newly issued preferred shares, the financial system is not strengthened. Yet our current approach treats the exchange as reflecting a $100 million infusion of capital. This is one example of how inflated capitalization can occur, encouraged by the tax system, and about which I understand the regulatory authorities are quite concerned.

There are other ways to inflate the apparent capitalization of our companies. For example, sell off the real estate on which gains have been accrued, retain the real estate on which losses exist. Or the valuation actuary can progressively weaken the actuarial reserve assumptions, thereby apparently increasing surplus. Or the quality of the asset portfolio can be weakened, or assets and liabilities can be mismatched. All of these may provide an appearance of strength where strength does not exist.

This brings me to the fourth issue. Should we have guarantee funds in Canada? We are proud of the fact that no federal insurance company has ever failed to pay on its obligations. But can we ensure that there will not be a Baldwin-United in Canada, or a Paramount Life at the federal level? Will our customers continue to place deposits with life insurance companies in competition with insured deposits in other financial institutions?

I do not like the idea of guarantee funds as it tends to encourage bad management and to penalize good management. Nevertheless is there really an alternative? If not, then a quid pro quo our profession and our industry should insist upon is a strong regulatory system to ensure a minimum of abuse. That must go hand in hand with any proposal to introduce guarantee funds.

My final question is with respect to the role of the valuation actuary in Canada. Are the current CIA guidelines for valuation actuaries adequate? A great deal of responsibility was placed on the actuary in the 1977 revisions to the C & B Act. The Canadian Institute of Actuaries rose to the challenge and developed financial reporting regulations in support of the valuation actuary. Individuals occupying these exalted positions also rose to the challenge and as a result the system has worked quite well and the industry has been given the needed flexibility to adapt and thrive. However, just as the industry is dynamic, not static, so the role of the valuation actuary must change in changing circumstances. The Institute's Council has raised a number of issues even while the Institute's Financial Reporting Committee remains very busy. There are also major developments to take place in the United States following from the Joint Society Academy Committee on the Role of the Valuation Actuary.

My list of the issues in Canada include:

1. Can the valuation actuary be expected, in all situations, to develop assumptions which are appropriate both for the emergence of income and for a statutory statement?

2. Is the valuation actuary reporting on solvency? If not, should she be?

3. Is the valuation actuary responsible for analyzing and reporting on the relationship of asset and liability cash flows? On the quality of the investment portfolio? If Baldwin-United had been a Canadian company, would the valuation actuary, with current accountabilities, have prevented the fiasco? If not, would he be subject to professional discipline?

4. Is there a reporting requirement between valuations? What does a valuation actuary do when she finds something wrong? Is there any obligation to go to the Superintendent of Insurance after consulting senior management?

5. How independent is the valuation actuary? How independent should he be? Should he be appointed at an annual meeting rather than by the Board? Should the valuation actuary be the company's Chief Actuary? I might mention that the CIA Council approved a recommendation that the appointment take place at an annual meeting. I, personally, think that would be a mistake. The valuation actuary should be the Chief Actuary.

6. Is there a need for a similar role in other financial institutions? I strongly believe there is a need for that role. Wherever deposits are made and assets are held someone should be accountable for the relationship. Some of this can be done by an external auditor, but I believe clearly some of the analysis extends beyond accounting principles.

MR. DON MCISAAC: Approximately one year ago, the CLHIA submitted a brief to the federal government calling for a complete revision of the federal insurance legislation and containing approximately 200 specific recommendations. In a detailed reply, the Minister responsible for the insurance legislation at the time indicated that by far the vast majority of the 200 recommendations appeared to be acceptable. The Minister called for further industry and government study of a few proposals but reserved judgement completely only in respect of two proposals relating to an extension of powers for life insurance companies, namely, the proposal to authorize life insurance companies to carry out certain limited trustee powers directly and the proposal to allow life insurance companies to become involved, through subsidiaries, in other areas of the financial services industry, including deposit taking institutions.

At the current time, Canadian life insurance companies are prohibited from owning more than 30% of the shares of corporation except those that fall within a specified list. Included in the list are property and casualty insurance companies, foreign life companies, mutual fund companies, real estate companies, data processing companies and investment advisory firms. However, such major players in the financial services sector as deposit taking institutions and investment dealers are not included in the list.

The Minister indicated that a decision regarding extended financial services and powers could not be taken in isolation from decisions about other types of financial institutions, such as trust and loan companies and banks. Soon thereafter, the Minister appointed the so-called Industry Advisory Committee consisting of representatives of all types of major financial institutions as well as consumers, to provide him with advice on major policy issues.

The Industry Advisory Committee met several times during the first half of 1984. The Committee did not discuss detailed proposals for amendments to all the legislation relating to insurance companies and other financial institutions. Instead, it focused attention on the major policy issues affecting decisions regarding the direction in which financial institutions should be permitted to evolve in the future.

By the summer, there seemed to be, not what could be called a consensus, but rather a sharing of views emerging among Committee members. Rather than having the Committee issue a report, the Minister responsible at the time decided that the Department of Finance, aided by the Bank of Canada, the Office of the Inspector General of Banks and the Department of Insurance, would try to put together a policy paper which would take account of the advice provided by the Committee at the meetings. The Committee would then be given an opportunity to comment on the paper before it was turned into a policy recommendation for the Government.

The development of a Department of Finance policy paper is actively in progress. However, as everyone knows, we now have a new Government and it is still too early to say if the new Government plans to continue the work plan established by the old Government. Nevertheless, we feel confident that the new Government will be taking action to see that legislation relating to life insurance companies and other financial institutions moves forward.

I do not think it would be appropriate for me as a Public Servant to try to speculate on exactly what type of federal institution will be allowed to do what type of financial services business. However, we are fairly confident the legislation and regulatory system relating to insurance companies will be modified as necessary to permit them to evolve in a manner that responds to consumer needs and demands in today's rapidly changing environment. We have seen changes in Quebec, we are seeing changes in the United States and we will see changes at the federal level in Canada. There is no doubt that life insurance companies must be given the scope to compete efficiently and effectively not only among themselves but with other players in the financial services scene. However, while enhancement of competition and efficiency must be important objectives, recent experience with failures of trust and loan and property and casualty insurance companies and the problems that these failures have caused the public have convinced us that solvency considerations must not be overlooked. From the perspective of a regulator and an actuary, some of the points relating to solvency that I think should be considered in the revision of the legislation are as follows.

The first point that I want to mention is that, from a regulator's perspective, the Department tends to support CLHIA's current position that if the life insurance industry is to be permitted to expand its field of activities significantly into other areas of the financial services sector, direct deposit taking, for example, it would be preferable if it were permitted to do so through subsidiaries rather than directly. Some of the liabilities of life insurance companies certainly correspond in nature to those of deposit taking institutions. However, a substantial proportion continues to be very different.

Life insurance companies still have a significant proportion of long term liabilities that must be valued using long term mortality, interest and expense assumptions. The nature of these long term insurance liabilities and the mix of assets necessary to cover them appropriately are different from those associated with the standard type of deposit liabilities. Consequently, if the life insurance companies are to be authorized to get into "the direct deposit taking business", it would appear to be easier for supervisory authorities to monitor solvency if this business were done through subsidiaries rather than in the life insurance companies themselves.

Another question that will have to be addressed in the revised legislation is the power to establish minimum continuing capital and surplus margins for life insurance companies. Minimum continuing capital and surplus requirements do exist now for property and casualty insurance companies and for deposit taking institutions such as trust and loan companies and banks in the sense that there is legislative authority to control the borrowing or the leverage ratio of deposit taking institutions. However, no statutory authority currently exists to prescribe continuing capital and surplus margins for life insurance companies, the principal reason being that in the past it was thought that the actuarial reserves would contain sufficient margins.

Since 1977 when the legislation was amended to give the valuation actuary more freedom in choosing valuation assumptions, the Department's experience has been that the margins in the actuarial reserves have narrowed considerably and can vary greatly from one company to another. This outcome is not surprising nor do we view it as grounds for general criticism of the actuarial profession. The new reserving system places the onus on the actuary to choose assumptions that are appropriate to the circumstances of a company and the policies in force and certainly one of its main objectives was to permit valuation actuaries to use more realistic assumptions. Nevertheless, there have been certain isolated circumstances where the Department has not been satisfied that the margins in the actuarial reserves, together with capital and surplus, have been sufficient to provide the cushion we believe is necessary to protect policyholders' interests. We believe there should be more specific power to deal with such circumstances and that there should be legislative authority to prescribe minimum capital and surplus margins on a continuing basis just as there is now in regard to the banks and trust and loan companies.

It is recognized that it is almost impossible to develop simple continuing captial and surplus requirements suitable for all life companies. Circumstances vary signficantly from one company to another. For this reason, we do not think it would be appropriate to try to set out specific requirements in the legislation itself. Instead, we think the best approach would be to follow the pattern established by the Bank Act and give the Minister the power to prescribe general requirements by regulation and direct requirements for a particular company by order. We have been trying to carry out some research on appropriate capital and surplus margins for life companies and Dr. Allan Brender, a member of the Society and a professor at the University of Waterloo, provided us with some help in this regard during a recent sabbatical. We do not have any definite conclusions to report yet. However, we do have some preliminary thoughts.

The first thought relates to par and non-par business. In Canada, both stock and mutual life insurance companies can issue both par and non-par business. Companies carrying on both par and non-par business are required by statute to keep separate and distinct funds and accounts for each of par and non-par business. However, segregation of specific assets between the par and non-par funds is not permitted. Shareholders can share in the profits arising from par business to the extent that the directors decide that the profits are distributable. However, the shareholders' share of par profits is limited to 10% or less, the exact percentage depending on the size of the company.

Lately, we have noticed that, as non-par business has been growing rapidly, the capital and surplus margins in the non-par funds have been declining significantly. To protect the interests of par policyholders, we believe that it may be desirable to establish separate minimum capital and surplus requirements for each of the par and non-par funds.

The second thought that we have in regard to minimum capital and surplus requirements is that they should probably vary by type of product. Our thinking in this regard is too preliminary to elaborate in detail.

However, to provide for the mortality risk of life insurance products, we might determine minimum capital and surplus requirements based on a percentage of the net amount at risk with the percentage varying by the term of the risk. Separate factors would be required to cover the mortality risk associated with vested annuities. Other factors might be developed to provide capital and surplus margins for financial investment risk, with the factors providing a strong incentive for matching.

The third thought that we have is that the minimum capital and surplus requirements for life insurance companies should be reasonably similar to the requirements applicable to other types of financial institutions to the extent that they are transacting similar types of business. For example, much of the deferred annuity business being transacted by life companies is almost identical from a contractual point of view to term deposit arrangements issued by trust and loan companies. Trust and loan companies report their liabilities for such contracts at book value and, depending on their approved leverage ratio, are required to establish surplus margins from 4% to 5%. If trust and loan companies are to be subject to minimum capital and surplus requirements for this type of business, there seems no reason why the life companies should not also be subject to requirements of the same order of magnitude.

As I indicated, our thinking on the subject is only very preliminary. Before any action is taken, we will need to crystallize our thoughts and carry on detailed discussions with the life insurance industry and the actuarial profession. The actuarial profession has a vital interest in this question because there is no doubt that if specific explicit margins of capital and surplus are required, valuation actuaries will be under pressure to keep margins implicit in the actuarial reserves to a minimum. I realize that there are mixed views within the profession as to whether such an outcome would be desirable. However, at the same time I have to say that if there are to be specific minimum continuing capital and surplus requirements, it would be very difficult for the regulator to live with a system which would give credit for surplus "hidden" so to speak in the reserves.

While on the subject of capital and surplus, if life insurance companies are permitted to own other financial institutions as subsidiaries, there will likely have to be a provision in the legislation that will prevent a double counting of the same capital. For example, if a life insurance company is permitted to own a trust company subsidiary, it should not be able to take into account, for purposes of its own capital and surplus requirements, the proportion of the capital and surplus of the trust subsidiary that the trust subsidiary needs to meet the captial and surplus requirements applicable to trust companies.

Probably of interest to the actuarial profession is the fact that the Department has reacted positively to the suggestion from the CLHIA that rules establishing detailed quality tests for the eligibility of investments should be abandoned in favour of a prudent investor approach. However, the abandonment of the detailed quality tests must be accompanied by some general rules, the objective of which will be to preserve solvency. For example, there should be a limit on the amount that can be invested in one corporation or associated group of corporations. The current 75% maximum loan to value ratio for uninsured mortgage loans should be retained. There should also be limits on the maximum proportion of companies's assets that can be invested in certain classes of assets such as real estate and common shares. For example, recent experiences have indicated that existing investment limits for real estate, namely, 15% of assets on direct investments and 10% of assets on indirect investments through subsidiaries are probably too generous, especially for companies having substantial proportion of liabilities that guarantee interest rates at market levels.

With the rapidly changing nature of life insurance products and the increased importance of matching the cash flow of investments with the expected cash flow of liabilities, it is likely that the revised legislation will contemplate the segregation of specific assets between par business and non-par business. As was indicated, this has not been permitted currently. A change of this nature will bring with it the concern for ensuring that all the "unattractive" investments are not allocated to the participating fund and raises the interesting question as to whether the quantitative limits applicable to different classes of investments should not vary between par and non-par business. For example, because of the distinctive difference in the guarantees provided by par and non-par contracts, it seems reasonable that the limits on equity type investments should be higher for par contracts than for non-par contracts. At the same time, there is also a question as to whether there should be a limit on the proportion of funds arising from participating business that should be permitted to be invested in passive investments, for example, subsidiaries, real estate, and perhaps common shares so as not to lead to significant intergenerational inequities. These two concerns are contradictory to a certain degree and are interesting issues for both the actuarial profession and the industry to consider.

Another point that must be addressed in future legislation relating to investments concerns tougher rules on transactions that involve a potential conflict of interest. The existing provisions generally prohibit insurance companies from lending or investing their funds with any shareholder that has more than a 10% interest in the company or in any corporation in which such a shareholder has more than a 10% interest. However, there is nothing to prevent the sale or purchase of assets between the supervised company and its parent or affiliates or other transactions of a similar nature. Until recently, this did not cause a problem. However, certain events of the last few years have led me to believe that more stringent control of non-arm's length transactions, particularly purchase and sale of assets, is necessary. In my opinion, the increased frequency of problems with non-arm's length transactions is related to the more difficult economic circumstances prevalent today. Experience seems to indicate that persons who are normally responsible sometimes do strange things when subjected to strong economic pressures.

Another change that may be necessary in the interests of the public is greater power for the regulator to deal with troubled companies. Perhaps, I am letting the cat out of the bag, but the fact is that most persons in the industry believe that the Superintendent has more power than he actually has. In connection with Baldwin-United in the United States, the regulators have been described as persons who arm themselves for battle, stand on the sidelines until the battle is over and then rush in and stab the wounded to death. Well, the fact is that the regulators may need more power to be able to participate in the battle.

Under the existing legislation, if the Superintendent believes that the assets of a company are not sufficient, having regard for all the circumstances to provide adequate protection to the policyholders, he must report this fact to the Minister. The Minister then can take a number of actions, including making application to a court for a winding-up order. However, before the Minister takes these actions, she must give the company an opportunity to be heard. In the case of one of the federal property and casualty insurance companies that failed, we were convinced that it was in the best interests of the policyholders to obtain a winding-up order as quickly as possible. However, through a series of legal maneuvers, the owners of the company managed to challenge the Minister's decision in this regard and to delay the winding-up for a period of six months, something that was certainly not in the best interests of the policyholders.

The problem is to find the proper balance between the right of the public to be protected and the right of the company and its shareholders to carry on business. This balance is not always easy to achieve. The dilemma that legislators and regulators always face in dealing with legislation relating to financial institutions is to develop legislation and supervisory practices that catch the companies operating at the fringe so to speak but that will still permit the soundly-managed companies to operate in an efficient manner without undue regulatory interference.

The subject of troubled companies raises the question that is discussed from time to time as to whether there should be a statutory obligation on the part of a company's valuation actuary to bring concerns about solvency to the attention of the regulatory authority. Reference is frequently made to the situation of actuaries in the United Kingdom in this regard.

Under the existing Canadian legislation, the valuation actuary has a semblance of independence in that he or she must be appointed by the Board and any change in appointment must be communicated to the Superintendent. Consequently, the Superintendent can and does enquire about reasons for change in appointment if so inclined. However, apart from the requirement for an annual valuation report, there are no statutory obligations placed on the valuation actuary.

The valuation report required from the valuation actuary is not, strictly speaking, a solvency certificate. All the actuary is required to say is that the actuarial reserves reported in the statement make good and sufficient provision for all unmatured obligations guaranteed under the terms of the policies in force. However, to the extent that the law stipulates that the actuary must also state that the assumptions used in calculating the reserves are appropriate to the circumstances of the company and the policies in force, a careful reading of the report, together with a review of the statement, should provide the reader with information on the actuary's view of the solvency situation. However, this is only true as at the date of the statement.

When one examines the United Kingdom situation closely, it is interesting to note that the obligation to approach regulatory authorities on solvency matters is imposed not by statute but rather by the actuarial profession itself in its code of conduct. If Canadian actuaries are to play a similar role in Canada, I think the impetus must first come from the profession itself. The Superintendent has expressed the view that it can be counter productive to try to impose obligations on a profession that go beyond those that the profession is anxious and willing to accept.

The Department of Insurance would welcome a greater role for the valuation actuary in monitoring solvency. We firmly believe that standards imposed by the industry itself and the professionals who serve it are preferable to rigid statutory requirements. Certainly in the context of narrowing capital and surplus margins in rapidly changing circumstances, there is room for the profession to play a valuable role in trying to establish and maintain reasonable solvency standards in Canada and we encourage it to do so.

There are a number of other issues of an actuarial nature that must also be addressed in the revised legislation. For example, the mutual companies have requested a provision permitting demutualization. The Department sees no objection to such a provision provided the disparate interests of various groups of policyholders can be properly protected. We think that the "rules of the game" so to speak should be in place before we start down this road. Of course, developing these rules is one of the toughest actuarial problems that can exist. The actuaries at the Department do not pretend to have all or even some of the answers and will be seeking input from the actuarial profession and the industry.

There has also been some suggestion that the legislation should impose some obligation on actuaries of life insurance companies to be more concerned about equities between different classes of policyholders, for example, par and non-par, and between different generations within class. I have already mentioned the possibility of different investment limitations for par and non-par. This might be a step towards regulating the equity question. However, by and large again, rather than developing special equity requirements I think the regulators would much prefer that the actuarial profession seize the initiative on these questions through the development of appropriate professional standards. Again, I urge the profession to do some thinking on this subject.

MR. GARY CORBETT: I find it somewhat ironic that as we in the U.S. are accepting the idea that you cannot determine levels of solvency by formulae and specific prescriptions of assumptions that we see, in the U.K., starting about 1982, the introduction of limitations on assumptions in the reserve calculations and specific formulae for minimum surplus and capital. These formulas employ arbitrary factors, such as 4% of reserves and X amount per thousand depending upon the term of the product. With the change in products that has occurred in recent years, which will continue, and with changes in the environment that cannot be predicted, why do regulators believe that they can write rules that will cause appropriate solvency and risk and surplus margins to be calculated when they seem to accept that those same rules cannot be used to calculate the basic reserves? It is accepted that they have to turn to the valuation actuary, acting under principles laid down in the statute, and guidelines from the profession, to calculate the basic reserves, using judgement in choosing assumptions and methods, yet we see a return to arbitrary rules for the risk surplus determination. I would like to hear from Don, or from any of the panel, on that question.

MR. MCISAAC: Our objective is try to make our attitude towards risk surplus a little less arbitrary. For example, we had in our legislation at the time some of the large stock companies were becoming mutuals a required level of surplus of 6%. I cannot tell you how theoretically sound or appropriate that number was but it had the virtue of being a nice big number for a lot of companies. At that time, we were dealing with a much more stable economic environment than we have today. Faced with what has happened to economic conditions, regulators in all countries are being asked by their publics and by their governments to come up with recommendations on just exactly what can be done to give us greater assurance. This afternoon you heard talk of compensation plans, and I mentioned the possibility of establishing capital and surplus margins. I hope that what comes out is not going to be construed as being arbitrary. Allen Brender is here this afternoon and he might want to make a comment. His paper discusses some very technical stochastic-type processes that could be used to derive desirable surplus levels. In practice when one gets down to writing legislations or regulations the only workable formula is one that is expressed in terms of numbers and that on first reading might appear to be arbitrary. I just hope that the effect will not be arbitrariness.

MR. LECKIE: Gary, as I understand it, when they were changing the C & B Act in 1977, there were some thoughts by the Department that there would be a minimum valuation basis prescribed and that if it was met it would be deemed as appropriate. The Canadian Institute of Actuaries was unhappy with anything being spelled out in the regulation such as some kind of minimum standard because it went against what was being described as appropriate. I believe the Department relented. Of course we do have the Canadian method and there are certain limitations in the law and the regulations. In Britain they found it was necessary to put in a floor. I would like to use an analogy to describe what I feel would be an appropriate minimum floor. The minimium floor would be much like having valuation actuaries swimming in a pool and the regulatory floor would be 5 feet below the level of the waters so that if in fact you feel like you are going to sink, you have some firm ground on which you can rest.

MR. ALLAN BRENDER: It is true that regulations in Great Britain are X% of net amount at risk and such percent of reserves and so on. It is also true that if you try to look into the history of risk surplus that these regulations are fairly arbitrary. The Faculty of Actuaries had a working party on this. They found that the regulations depended upon the findings of some Dutch professor in 1950 who looked at a few Dutch companies. You might say I looked at a few Canadian companies and hopefully that is a little different. I think for practical reasons of administration if you try to do anything in terms of surplus, you probably need some sort of formula. Its not what I would regard, from an valuation point of view, as the optimal way. What I would regard as optimal would be that the profession would have some sense of principles according to which we would model the companies. Each company would model itself using its own product mix, its own type of investment philosophy, its own ways of matching and so on. Perhaps we would prescribe certain assumptions about what the economy is likely to do. Then if we assume the model is fairly realistic we will have, for each company, a genuine required margin. I don't think we are there yet in terms of actuarial technology and methodology. Therefore if you believe what we need is some sort of floor what we have to do is design principles for the floor. Now what is being proposed is not a solvency measure that says the company is going to continue forever. It is more what is necessary if the company will in fact be forced into liquidation and I assume in Canada that the company wouldn't be forced into liquidation. You would run off the business. On that basis if you take a closed block of business what would you need to make sure that in fact the policyholder' demands and requirements would be met. I think that is far below what your management, in fact, would set as reasonable surplus to run your company.

Now in the end when you try and do this sort of exercise you are going to come out with numbers such as X% reserves and Y% of net amount at risk and so on. The risk can be related to those quantities and will be easy to administer from that point of view. The point is that you probably will end up with formulae similiar to the European Economic Community formulae but that doesn't mean they weren't arrived at in the rational way. I agree its totally irrational to have surplus and capital requirements which are unrelated to the valuation. They are a package that go together. The total solvency is the sum of surplus and reserves, but hopefully in this particular case that was taken into consideration. We are working in the Canadian context and trying to put forward some relatively reasonable formula to define a not too terribly stringent basis of solvency. Using a run-off philosophy we hope to come up with something decent. I think it's possible to do. True you are applying the same factor across the industry but there are ways one could try to take into account the individual situations of different companies.

MR. NICHOLAS BAUER: I would specifically like to refer back to Robin's remarks about gain from stocks. The CLHIA is currently suggesting that these gains and losses be brought into income over a shorter period which will result in the gains and losses being recognized more rapidly than in the past. One aspect that hasn't gotten much play among actuaries is the implications on the Valuation Actuary's Opinion. The Valuation Actuary's Opinion pertains to both income recognition and solvency. I worry in the present situation where in fact the aggregate assets of Canadian companies stand below book value but stocks and real estate are above book value and bonds are quite a bit below book value. If we accelerate the bringing of gains in stock and real estate into income but leave the long and gradual recognition of income on bonds, this will certainly weaken solvency. I think the valuation actuary at that point has a duty to look at this when certifying as to the solvency of his company whether he does this directly or indirectly.

A second point which I would like to bring up, is related to the first but pertains to taxation. Robin mentioned that one of the principle reasons why in fact the financial institutions are not paying taxes is the deductability of dividends. In the case of life insurance companies, that is only partially true. I would say at least as great, if not greater, reasons can be found in the realized bond losses that were incurred over the last few years plus real losses which, as pointed out by Robin, are reflected in reducing both surplus ratios and earnings. In fact those surplus ratios would be looking even worse if it were not for the extraordinary gains that companies are bringing into income, such as real estate gains and revaluations. In recent years these have been a very meaningful proportion of total gains as compared to ordinary earnings. Because of these falling real earnings and falling surplus ratios I particularly worry that the CLHIA's timing as to the bringing into income of the stock gains is counter-productive. It will be inflating earnings at a time when the contrary is the case and also when, for the reasons Robin mentioned, the financial services industry in general, and the life insurance industry in particular, is under scrutiny from the Department of Finance. When one is looking at something like a $30 billion plus deficit, the raising of tax revenue is a very attractive thing to do.

MR. LECKIE: Don, to what extent is the Deparment's present position influenced by Bill 75 or other activities eminating from the Province of Quebec?

MR. MCISAAC: I think Bill 75 is certainly going to have an impact on the formation of federal legislation. I think when you look at the Bill you have to consider the contrasting background between the provincial jurisdiction and the federal jurisdiction. I think Mr. Parizeau, the Minister of Finance in the Province of Quebec, has pointed to the fact that they do not have to regulate banks in the Province of Quebec. He made a speech in which he said that the history of financial services legislation over the century has evolved from the regular decennial revision to the bank legislation. He particularly pointed to the fact that in 1980, when the legislation was last revised, it was thought worthwhile to get more players into the banking business. The outcome was that foreign banks were admitted to Canada rather than, for example, extending banking to other financial institutions. I think the thrust of the provincial government in Quebec, and this is only speculation, has been to attempt to shore up the financial services community in that province. In fact they have a timetable that calls for revisions of the Insurance Act through Bill 75 followed by revisions to the legislation affecting provincial trust companies followed revisions to the legislation affecting provincial credit unions or caisse populaires. It is clear that the Government of Quebec has placed a high priority on financial services revision and deregulation if you want to call it that. What the new Federal Government's attitude will be is really only speculation on our part at this time. Clearly, as Mr. Bauer mentioned they might want to place the emphasis of all their activities on deficit cutting or getting people back to work. In any case, I don't think we are in a similar environment because we do have banks and, as Gerry Devlin mentioned, the banks are certainly in the four pillars. They are the pillars and the rest of the industry are sapplings. They are just so much larger that they cannot be ignored in any plans for deregulation of financial services legislation. I believe its true to say that those of us in the Department of Insurance would like to see a more uniform approach to deregulation in Canada, that is each of the legislating organizations, both federal or provincial, proceeding at a uniform pace. It maybe that not all of the powers that have been offered by the Quebec legislation to Quebec life insurance companies will be available to Federal life insurance companies even at the end of the exercise. Maybe they are not all appropriate. I have some problem personally with some of the percentages of funds that can be invested in certain type subsidiaries under the Quebec bill. However there is no question at all that the existence of the Quebec legislation has created added urgency to revision at the federal level. It will be interesting if for example we see federal companies seeking authority to become provincial companies. I think that it would be a real curious development and one that would be unfortunate if the only reason was to gain new powers or some of these new legislative arrangements. To sum up there is no question that the legislation is there and we know what it says. We have a sense of its impact and it cannot be ignored in the context of trying to reshape the federal legislation.

MR. DEVLIN: Bill 75 is not in my terms an emancipation of the life insurance industry. The control features in Bill 75 are extremely interesting. It has a provision for example that the minister may refuse consent to the issue the letters patent to a new company if he considers that the plan of insurance or its objectives are not in the public interest or that the applicants have not provided evidence that they have complied with the act and regulations or that the applicants, the provisional administrators or the proposed officers of the company have not provided evidence that they have the administrative and technical knowledge and competence necessary to command public confidence in transacting the classes of insurance contemplated. What a fantastic degree of control! They even have provisions in the bill that will block the transfer of shares if a company were to be bought. The Inspector General can actually block the allotment of shares. They have provisions in terms of licensing that follow on the same the ones that I have just read out to you on the plan. The Inspector General shall issue a licence if the corporation furnishes all required documents and information, meets the conditions under the Act, adheres to sound commercial and financial practices (what is that!?), has directors and officers who possess the administrative and technical knowledge and competence required to administer the corporation in a manner that will command public confidence in transacting the classes of insurance contemplated. If that is not an intervention I haven't seen one.

Coming back to what I think is the key issue for your consideration as actuaries, we are living in a very interesting time with people who want to expand and want to get into a lot of different kinds of businesses. Does this freedom or greater range of opportunities have a concomitant degree of greater accountability from a regulatory point of view, if we really have at the root of our concern the soundness and the solvency of these corporations? Dick, has the experience with Baldwin-United driven regulators in the United States to get a little more interested in regulatory control or do you think in the current environment in the United States that more regulatory control is really possible?

MR. MINCK: I feel inspired to poetry if the chairman will allow me a little licence. It is two lines from a distinguished actuary, Henry Holt Jackson, and it went something like this; 'Neither you nor I nor he can know just how big surplus ought to grow'. The quote was slightly out of context, but we had a committee at the ACLI that worked very hard, perhaps 7 or 8 years ago, looking at capital and surplus requirements. We have a patchwork of laws, as you would expect in the States. At that time I think that the least amount of capital needed to open an insurance company anywhere in the United States was $12,500. The most was $2 million plus a lot of convincing of the New York Department that that would be enough and maybe that translated into $4 million before you were through. Within that context our committee looked at the question of just how much capital and surplus should a company have, depending on what line of business it was in, what sort of plans it had, how quickly it was going to expand, and the answer they came up with, firmly, clearly and finally, was that they didn't have a clue! They thought that probably the best way to get a handle on it would be to require a company to form a fairly complete plan as to just what they were going to do for the next 5 or 10 years. The company would run out models showing just what surplus it would take under different assumptions to support that kind of business. Someone qualified in the regulatory profession would then review that plan. They didn't find another way to proceed outside of that. That sort of idea has been used for some years by the New York Insurance Department. Quebec, I think, is fairly close to New York in some respects. I am not sure that I know how well the system works. I would say there have been relatively few insolvencies in New York but on the other hand most companies don't do business in New York. It is unclear whether regulators are being inspired by something like Baldwin United to try to get a closer hold on companies' operations but it is fairly clear that they do want to take some sort of action. The hard part is trying to decide what would be helpful in this situation. As I said before, the things that Baldwin did were not the kind of things that you would want to pass laws against doing, unless you could pass a law that requires the management of any insurance company to exhibit sound judgement before they do something.

MR. CHARLES MCLEOD: I was wondering how far will the increased financial difficulties being experienced, or at least being talked about, by almost all types of financial institutions in both Canada and United States limit the moves towards or interest in financial diversification by different types of financial institutions because either the regulators are going to put more limits on those institutions diversifying or those other financial institutions don't look as attractive as they did five years ago?

MR. MINCK: I think the failures of several large banks as I mentioned earlier constituted a very real road block to the passage of bills that would permit banks to diversify. Regarding the question of the grass looking greener, I think the more trouble you get into in your own business, the easier you think the business of the other fellow is. I believe some of our member companies would be willing to let a few big New York banks have some group health insurance if they want to get started in the insurance business.

MR. MCISAAC: I could respond from the point of view of what I think the Canadian situation will be. I think that the regulators would probably be prepared to go ahead with shaping the type of legislation that is being sought. What I think is more likely to happen, and I think this is part of Dick Minck's comment, is that the companies might be given the opportunities but they won't seize on it simply because the environment is not right. That is what one could hope for from prudent management, I would think.

MR. DEVLIN: I believe, Don, that we cannot take a too theoretical or philosphical approach to diversification. In the Canadian situation, and maybe in the American as well, diversification is by and large a mutual company issue. We now have all kind of companies interested in buying financial institutions. You can go beyond holding companies to almost any large distribution system. Large distribution systems that also sell insurance include Sears, Eaton-Bay and Kroger Stores in the United States. Maybe some day we will see Dominion Stores in Canada selling life insurance. There is no limitation to who can own a life insurance company in Canada under our laws today, except those that I mentioned in Quebec. So we are not left with the philosophical debate on should we or shouldn't we have diversification. It will strictly be left up to those institutions who can do so to decide if it is financially viable. Some I'm sure will and some won't. Some will want to run strictly a life insurance company. Others we already know, for example Trilon, Crownx and E-L Financial, are broadening out. I also mentioned others, like Sears and the big retailers, so it looks like anybody with a distribution system wants to get maximum use out of that distribution system. So I think that networking, at least done from the point of view of diversification will continue on at a fairly rapid pace.