SOCIETY OF ACTUARIES

Article from:

Small Talk Newsletter

May 1999 – Issue No. 13

small talk

NEWSLETTER OF THE SMALLER INSURANCE COMPANY SECTION

ISSUE 13 MAY 1999

From the Editor

by James R. Thompson

As 1999 rolls along, we are approaching the big year 2000. Thus it is fitting that *small talk* address address the Y2K problem. There has been a lot of talk in the industry, and many of the larger companies have been busily updating their computer systems for the handling of the four-digit years rather than the soon to be ambiguous two digit years (is 00 1900 or 2000?). Do smaller companies feel that the larger ones have too much staff and nothing better to do than pay attention to this problem instead of more pressing ones like writing new business or getting the last new product installed on the system before the sales crush?

Well, time is slipping for complying. Mike Lombardi's lead article deals with this problem and its importance to any companies. Smaller companies that have done nothing should take note. We also have another article by Ara Trembly, who is a staff writer for the *National Underwriter* and some comments from the newsletter of the National Alliance of Life Companies (NALC). All are worth reading.

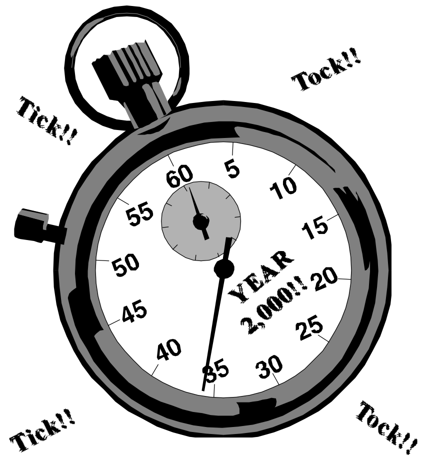
Another important issue is codification. We have two articles on this. One by Rick Browne deals with reinsurance in codification in particular. The NALC also points out the potential dangers of it.

There is lots going on in the world of regulation. XXX was recently passed. This will affect the pricing, reserving, and product design of term insurance. Through the end of 1999, there will be a "fire sale" on for the selectivity underwritten reentry term insurance with fairly long guaranteed periods (20-30 years). Next year will be a new ball

(continued on page 5, column 3)

The Year 2000 Clock Is Ticking

by Mike Lombardi



R U Y2K OK? If you're not, you're not alone. With less than eight months before the year 2000 arrives, many businesses, large and small, continue to put off or struggle with their Y2K projects. The insurance industry is no exception.

Jokes may be made about planes grounded because they are 99 years overdue for maintenance, long distance phone calls that get charged for millions of minutes, and credit card bills with a century of overdue interest charges. However, it is indeed a serious problem. In this article, we'll look at the recent developments in the year 2000 issue from the perspective of the insurance industry and some special issues faced by smaller insurance companies.

The Problem Is Real

A RECENT STUDY conducted by A.M. Best revealed that the level of readiness to meet the new year is below expectation. According to a similar survey of Canadian companies by TRAC Insurance Services, it is more than likely that a significant minority of insurance companies will experience serious operational difficulties in the first few months of next year.

For major companies with heavily customized software systems, much of the corrective work has been done by the companies themselves. It's estimated that the insurance industry will spend between $6 and $8 billion to address, disclose and remediate the Y2K problem. Although the costs of corrective action vary from company to company, a common rule of thumb is $1.50 -$2.00 per line of source code to correct the date field problem. Especially for a smaller company, that's a lot of investment, with

(continued on page 2, column 1)

In this Issue

The Year 2000 Clock is Ticking
continued from page 1

zero additional profit, just to stay in business! And these costs exclude considerable additional amounts for project management, communication, routine supervision, analytic support, and training.

A major factor in the complexity of the issue is that we're dealing with many systems that have effectively been on autopilot for perhaps decades. How these systems work is often unknown to the current users. These systems were created many years ago in COBOL, FORTRAN, or ASSEMBLER languages, which few modern programmers understand very well. In general, users may know what inputs are required and what reports or information is generated but they do not understand the detailed code behind these systems. Also, users may not understand how different systems (administration, commission, financial reporting, reinsurance) interact with each other.

Expecting that a third party contractor or consultant can be hired to fix everything while company staff continue with business as usual is not realistic. The reality is that no outsourcing firm can be expected to do it all. Internal staff need to identify all the customized approaches used by a sophisticated insurer and to validate all changes during the testing phase. As the deadline approaches, the cost of corrections will increase due to the shortage of experts and the anticipated increase in demand for their skills. Small companies with little time, resources or money to spend on the Y2K issue may be challenged to find solutions at a reasonable price.

It's not just software, either. Hardware controls critical environmental systems such as elevators, lighting, heating, telephones, voice mail systems, air conditioning, electricity, and security. These need to function, too. Insurance companies will also need to make sure their PCs, operating systems, and peripheral equipment don't have hardware date overrides that invalidate the software changes.

If a company can't get its system running properly, there is the real risk of a traditional liquidity crisis or run on the bank, as policyholders get wind of a troubled company and decide to pull money out fast before the regulator steps in.

Solutions

THE A.M. BEST survey results show that many respondents will not have completed their remediation work until the third quarter of 1999. It shows the life and health industry being only 40% finished with remediation by the end of 1998. A.M. Best predicts that many companies will adopt a "triage" approach, with shortcuts taken and substantive testing plans scrapped. Mergers and joint ventures may also be expected as a solution to the problem.

The use of outside consultants rose considerably in 1998 as compliance efforts became more urgent. While many companies have outsourced some part of their Y2K work, many are using only in-house resources. In any case, testing and verification must be done in-house by employees.

Solutions to software issues follow three broad approaches: upgrade, repair, or replace. In many cases, repairing existing systems is the prudent choice, although software vendors offering Y2K compliant products may see record sales as legacy systems are abandoned.

A large part of the challenge is effective communication. It is very useful to

SMALL TALK

Issue Number 13 May 1999

Published by the Smaller Insurance Company Section Council
of the Society of Actuaries
475 N. Martingale Road, Suite 800
Schaumburg, IL 60173
Phone: 847-706-3500 Fax: 847-706-3599
World Wide Web: http://www.soa.org

This newsletter is free to Section members. A subscription is $10.00 for nonmembers.

Back issues of Section newsletters have been placed in the Society library and are on the SOA Web Site. Photocopies of back issues may be requested for a nominal fee.

Chairperson
Christian J. DesRochers, FSA
Vice-Chairperson
Rodney A. Keefer, FSA
Secretary/Treasurer
Paul J. Sulek, FSA

Council Members:
Norman E. Hill, FSA
E. Perry Kupferman, FSA
Stephen L. Marco, FSA
Edward J. Slaby, FSA
James R. Thompson, FSA
Lori A. Truelove, FSA

Editor of *Small Talk*
James R. Thompson, FSA
Central Actuarial Associates
P.O. Box 1361
Crystal Lake, IL 60039-1361
Phone: (815) 459-2083
Fax: (815) 459-2092
E-mail: jrthompson@ameritech.net

Staff Liaison, Lois Chinnock
Phone: (847) 706-3524
Email: lchinnock@soa.org

DTP Coordinator, Joe Adduci
Phone: (847) 706-3548
Email: jadduci@soa.org

Facts and opinions contained herein are the sole responsibility of the persons expressing them and should not be attributed to the Society of Actuaries, its Committees, the Smaller Insurance Company Section, or the employers of the authors. We will promptly correct errors brought to our attention.

Copyright 1999 Society of Actuaries. All rights reserved.
Printed in the United States of America.

have a documented conversion plan and to understand how it interacts with other business priorities. Impact analysis should identify the most critical areas that require attention. This can help identify business critical issues. PC based systems, such as sales or illustration spreadsheets with many macros, may give rise to big headaches.

"However, companies will not be able to hide their Year 2000 problems, because disclosure is now required under various accounting standards, securities laws and regulatory policies."

Smaller companies that have put off addressing Y2K issues until the last minute may be facing the challenge of coming up with cost-effective solutions. With fewer integrated systems, lower tech or manual procedures, and smaller volumes of business than their larger counterparts, a smaller company might be ready to accept solutions that fix 95% of cases and to work manually with the rest. A larger company with more rigid job descriptions and specialized capabilities might feel compelled to aim for 100% completion, a goal that may cost multiples more.

The development of formal contingency plans for the most critical systems is essential. Even with the best-laid plans, there is a possibility that Y2K problems will not be resolved in time, or that an unexpected system failure may occur. Business continuation and disaster recovery plans need to be established.

Compliance

IT'S INTERESTING TO note that a significant number of smaller insurers did not respond to the various industry surveys on Y2K readiness.

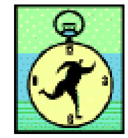
Companies with significant Year 2000 problems may be reluctant to talk about the magnitude of their Year 2000 corrective work, for fear of providing damaging information to future plaintiffs in the event the Year 2000 problems are not corrected in time. However, companies will not be able to hide their Year 2000 problems, because disclosure is now required under various accounting standards, securities laws and regulatory policies.

New York insurers are required to file a readiness report by April 1, 1999. The filing, modeled after the Securities and Exchange Commission's guidelines for publicly traded companies, must address the insurer's current state of preparedness for Y2K, how much it will cost to address the Y2K problem, the risks associated with their Y2K issues, and the company's contingency plans.

Canadian federally regulated insurers are required to notify the Office of the Superintendent of Financial Institutions (OSFI) if renovations to critical internal systems, as well as a review of critical external systems and interfaces, have not been completed by March 31, 1999. OSFI also requires that company actuaries, in their annual Appointed Actuary reports, address the issue of how the actuary's work is affected by the Year 2000 problem. Any problem areas need to be highlighted and a plan of action should be recommended.

One of the GAAP principles promulgated by both the Financial Accounting Standards Board (FASB) in the USA and the Canadian Institute of Chartered Accountants (CICA) in Canada provides that contingencies that are reasonably possible, whether or not the amount can be calculated or estimated, must be disclosed in a note to the financial statements.

The financial impact of the problem is exacerbated by the recommendation of the Emerging Issues Task Force of the Financial Accounting Standards Board. It recommends treating Year 2000 expenditures as current year expenses rather than amortized costs. This hotly argued recommendation will have a direct impact on the bottom line and give rise to additional volatility in company ratings or stock prices.



The possibility of personal liability is usually very effective in moving management away from any inaction or attitude of serene complacency. Corporate law typically imposes standards of care on the company's managers and directors which could be breached if they are negligent in dealing with the Year 2000 problem, resulting in potential personal liability for the directors. If a company fails to adequately disclose its Year 2000 problem in its annual report and subsequently has to shut down its business due to the problem or otherwise experiences substantial operational difficulties, shareholder and policyholder suits are likely to follow.

Policyholders may launch class action suits alleging fraud, breaches of contract, or failure to perform services. In the event of liquidation, other suits will follow from creditors, employees, other investors, reinsurers, or consumer protection plans. One defense can be reliance on the reports of the company's officers and third party experts in the course of making corporate decisions. It would be useful to be able to produce detailed documentation as to the company's Year 2000 corrective plan and the diligence with which it was pursued.

Conclusion

THE Y2K DEADLINE approaches fast and not all is well! The Year 2000 issue is real and it is no joke. Insurance companies that are going to make the headlines are the ones that aren't paying attention. The clock is ticking, 'the stakes are high,' the time to act is now!

Mike Lombardi, FSA, is consulting actuary at Tillinghast-Towers Perrin in Toronto, Ontario.