SOCIETY OF ACTUARIES Smaller Insurance Company Section

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smalltalk

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Small Life Insurance Company Expenses

By L. Allen Bailey

Walk into any small life insurance company, sit across from the marketing director and ask why sales results are so poor and one will no doubt receive the response that "our rates are too high." Typically this statement would be quickly followed with the comment that "commissions are also too low." Sit across the desk from the CEO and ask why operating results are so poor and one will no doubt receive the response "marketing results are extremely poor and unit expenses are way too high — we just can't compete with the big boys." Go into the actuary's office and ask why rates are so high and one will no doubt receive the response "the numbers don't lie — they are what they are."

What is one to do then? One approach is to make the following assumption. That is, a small life insurance company (SLIC) will remain an ongoing enterprise and will do all it can to grow responsibly out of its current predicament. If SLIC's management team can adopt this concept (and for the moment ignore any surplus constraints), then several new lines of thinking can be implemented (or at least considered) in the pricing of new products. One of the most important assumptions in pricing traditional as well as interest-sensitive life insurance products is that of expenses.

Traditionally, insurance company operating expenses have been divided into acquisition and maintenance expense categories. Though further subdivision of these expenses categories may vary from company to company, representative categorization of these unit expenses is shown in the table on page 4.

In order to accurately price any life insurance product, the pricing actuary must adequately and accurately assess all assumptions impacting rate levels. These assumptions include mortality, persistency, investment income, commissions, expenses, various taxes, and, of course, profits. Though statistical significance levels may impact the credibility of mortality studies in a small company, the actuary certainly should be able to establish credible unit expense values for acquisition and maintenance functions in a small company such as SLIC. For purposes of this discussion, we shall focus our attention on one strategy that will allow a company such as SLIC to take a different view of expenses when it comes to pricing new products for general distribution.

The first thing that must be determined is actual unit expenses being incurred by the company for say the last 12 months. After these unit expenses are determined, the actuary may then calculate what marginal expenses are for SLIC. Marginal expense definition can vary from company to company depending upon the analysis under consider-

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Chairperson's Corner

I Am Just the Zipper

By Joeff Williams

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By the time you read this, the Tour de France will be completed. This is the premier bicycle race in the world. This event has been made more recognizable in recent years due to seven-time winner Lance Armstrong. As an avid cyclist, I have come to appreciate the effort and work that goes into training for an event like this. One aspect that gets lost in the public's understanding of these races is the amount and level of teamwork needed for one individual to gain all the glory. We all know who Lance Armstrong is, but he would be the first to admit that his greatness is directly related to the team he had around him at US Postal/Discovery and now with Radio Shack. In his book, *Every Second Counts*, Armstrong writes, "It takes eight fellow U.S. Postal Service riders to get me to the finish line in one piece, let alone in first place. Cycling is far more of a team sport than spectators realize, and it's an embarrassment worth cringing over that I've stood on the podium of the Tour de France alone, as if I got there by myself. I don't just show up there after almost three thousand miles, and say 'Look what I did.' When I wear the yellow jersey, I figure I only deserve the zipper. The rest of it, each sleeve, the front, the back, belongs to the guys."

I have had the privilege to see this same type of teamwork firsthand during my last three years on the Smaller Insurance Company (SIC) Section Council. The examples of the willingness and volunteering that members and friends of the council have offered have been tremendous. Each member of the team has their unique role, including the all-important *domestiques*[1] who work tirelessly every day without getting any of the glory.

It is difficult to single out every volunteer, but I would like to acknowledge those who have volunteered their support and continued work on the Smaller Insurance Company Council.

Jim Thompson was the editor of *smalltalk* for many years, even beyond his tenure on the SIC Council. The SIC Council presented him with a special service award last fall for his dedicated service to the SIC for the last 10 years. He continues to participate in our activities, and has been a valuable friend to the SIC Council. Thank you, Jim.

We have many former SIC Council members who have continued to support the SIC as friends of the council.

Chris Hause (immediate past chair) was a valuable resource for me. Chris has continued to work with the council as a friend. Chris also initiated the idea of an all-day, face-to-face planning meeting in September, to bring everyone together to talk about ideas for the upcoming year. This past September, the SIC continued that tradition with our third face-to-face planning meeting.

Bill Sayre (past chair) continues to work with the council as a friend, and continues to promote the value of the SIC section.

Terry Long (past chair) has stayed as a meeting representative for the past several years.

Alice Fontaine (LHATF liaison) and Norm Hill (PBA representative) helped start our blast e-mail articles this past year, with timely information regarding PBA issues that impact smaller insurance companies.

Leon Langitz has continued to help with our section metrics.

Rob Hrischenko graciously stepped in to be our *smalltalk* editor, and has worked to transition our newsletter to an electronic format.

Some of our current council members have been very active as well.

Sharon Giffen (incoming chair) was presented a monetary award by the SOA for her paper entitled, "Sustain: An Industry Speech About Success As a Niche Player in 2020." Congratulations Sharon!

Jerry Enoch (secretary/treasurer) jumped right in his first year to take over this role. He also provided valuable insight and leadership for our member survey that was done at the beginning of 2010.

Don Walker (meeting representative), who has served with me for the past three years on the council, was instrumental in helping organize and participate in the council's inaugural financial webinar last winter.

Karen Rudolph (CLIR liaison) has helped with several research projects in the past year. One research project was the recently published "Cost of Implementing a Principle-Based Framework for Determining Reserves and Capital Survey Results" that focused on the potential costs and readiness of life insurance companies to implement a principle-based framework for reserves and capital.

Bob Omdal, a SIC Council member, was also a member of the POG for this survey. SIC is also helping to support a new research project that will look at the challenges and opportunities of reinsurance for smaller insurance companies. Karen Rudolph will be the POG chair.

Bob Omdal and Phil Ferrari (meeting representatives) have helped coordinate our sessions at various meetings over the last several years. Phil initiated the SIC's participation in the SOA's ERM Symposium this past spring with a session focused on ERM for the smaller company.

Dan Durow, along with Jerry Enoch, has worked to help update the SIC website over the last year, and worked to make it more current and up-to-date. I encourage you to visit it at the SOA website on a regular basis. The SIC is working to make this a viable medium by which to communicate with our membership. Dan, the SIC has also enjoyed your pictures of your incredible ice and sand artwork over the past year.

And what would any section be without the wonderful support we get from the SOA staff? Meg Weber and Jill Leprich have provided invaluable assistance and encouragement in all our endeavors. And Jacque Kirkwood, our SOA staff newsletter editor, has helped *smalltalk* maintain its excellent quality. Thank you all for everything you do!

All of these people and many more have made this an enjoyable experience for the past three years. The SIC truly has an incredible team.

"All of these people and many more have made this an enjoyable experience for the past three years. The SIC truly has an incredible team."

As consultants, we are sometimes encouraged to volunteer for marketing and exposure reasons. These reasons certainly have validity, but in the past three years I have learned that I get so much more out of the volunteering experience. I encourage you to volunteer now. The SIC Council is a great place to get started if you have never volunteered.

I appreciate the opportunity to serve as the chair of the SIC Section for the last year. ●

END NOTES

[1] A road bicycle racer who works for the benefit of the team and its leader. Domestiques help execute team tactics in races like the Tour de France."

ation. For purposes of this discussion, marginal expenses are assumed to be incremental (or additional) expenses associated with the addition of one new policy. Hopefully, the infrastructure of SLIC is such that existing functions such as underwriting, policy issue and administration are in place. Further, it is quite likely that the existing resources are not being utilized at capacity. Marginal expense definition in this scenario then provides a way for a company to determine the marginal cost associated with adding a new policy and can assume (for pricing purposes) that the existing block of business will continue to support fully-allocated expenses.

Though some elements of judgment will be needed to arrive at a measure for marginal expenses, the metrics can be determined generally using a strict analytic approach. Through the years our firm, Allen Bailey & Associates, Inc. (AB&A), has performed this type of analysis for numerous companies. Below is a table summarizing results for a recent study undertaken by AB&A.

SLIC LIFE
Summary Expense Levels

	Acquisition Expense				Maintenance Expense
Line of Business	Sales	Issue	Underwriting		
	% Prem Issued	Per Policy	Per Policy	Per $1000 Issued	Per Policy Inforce
FULLY ALLOCATED Traditional Life	126%	117	332	178%	98
MARGINAL (1 x Current Sales) Traditional Life	37%	34	147	79%	25
MARGINAL (2 x Current Sales) Traditional Life	19%	17	74	40%	25
MARGINAL (3 x Current Sales) Traditional Life	12%	11	49	26%	25

As the reader will clearly discern, marginal expenses will be impacted by the level of assumed future production (obviously the higher the volume of production, the lower the marginal expense). As the reader will also clearly distinguish, any actuary will be able to produce a more competitively priced product using marginal expenses in lieu of fully-allocated expenses. This, in turn, should enhance production.

Some companies' management will not allow a marginal approach to pricing. I have also seen one company where marginal expenses were actually greater than fully-allocated expenses (this is certainly a rare exception to the general rule). Generally, for small insurance companies the approach outlined herein is a valid but temporary approach to pricing products for sale in the market.

The use of marginal expenses in determining rates for new business is an approach that can be applied responsibly as long as company management is aware of overall impact this approach has on unit expenses, including those of fully-allocated expenses. By no means can a marginal approach be used forever. Without some sort of original and responsible thinking when it comes to pricing, SLIC will not have the ability to last in this market. If it cannot be a viable player in sales, then whatever SLIC's unique properties allow it to compete more effectively against larger carriers will never be brought to bear.

Implicit in this discussion is one very important assumption. That is, existing surplus will allow the company to grow out of its current expense dilemma. Most forms of organic growth will require meaningful amounts of invested surplus in order to fund growth that typically is accompanied by meaningful first-year surplus expenditures. A statutory pro forma of company performance in an accelerated growth scenario should be undertaken. Only in this way can management be assured that the company can grow responsibly out of its current expense dilemma scenario. If existing surplus is not sufficient to fund desired growth, there is other "original thinking" that can be applied, responsibly, to temporarily relieve pressure on this limited resource.

Lastly, expenses are but one assumption that can be reviewed originally and responsibly when helping a company like SLIC achieve desired market penetration in targeted lines of business.

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Regulatory Update – 2010 NAIC Summer National Meeting

By Norman E. Hill

Although no drastic changes occurred at the 2010 NAIC Summer National Meeting in Seattle, several areas are worth mentioning and discussing.

Principle-Based Reserves (PBR)

The Life and Health Actuarial Task Force (LHATF) resolved several remaining amendments to VM20, the section on reserve methodology. Most of the amendments had been unresolved due to New York's objections. Some amendments already in place have two alternatives, one with the more conservative approach desired by New York, and the second a less conservative method desired by the American Council of Life Insurers (ACLI) and American Academy of Actuaries (the Academy). Therefore, a "final" exposure draft of VM20 was issued.

So far, the Smaller Insurance Section Council desired approach to valuation for traditional products (Amendment 20 as proposed by Katie Campbell, or the "Campbell" approach) has held up. By passing one reasonable test that does not require undue work, PBR reserves revert to the current National Association of Insurance Commissioners (NAIC) statutory reserves.

The key next step is a full scope field test of the proposed approach to PBR, as agreed to by the ACLI and the LHATF's parent committee. For a wide variety of products, including simplified issue and guaranteed issue (SI/GI) products, gross premium reserves (in some cases, stochastic reserves) will be compared to current statutory reserves. The ACLI's net premium reserves will also be computed. Companies chosen from 60 large insurers, plus a few "small" companies and a few reinsurers, will be asked to perform these reserve tests, not necessarily on every one of their products. A consulting actuarial firm will be chosen by the NAIC to coordinate these tests. Apparently, companies will use their own assumptions for reserves, but broadly corresponding to VM20.

The field tests are still in flux. Therefore, it is not clear whether such unprescribed assumptions will hold up. The goal is completion of the study by year end 2010. The ACLI cautioned that this is not realistic, and completion may well continue into late 2011. This would mean that the new SVL and VM could not be submitted to any legislatures until 2012 or 2013.

With such instability, one risk is that our desired Campbell approach for traditional products could be withdrawn. While preneed is currently exempt from PBR, we can't even take this for granted.

Possibly, the preferences of the chosen consulting firm could affect how the study is conducted. Some firms are more oriented towards stochastic processing than others.

In fairness, LHATF has been living up to its agreement that only a package of SVL and completed VM would be submitted to state legislatures.

Experience Reporting Under the Valuation Manual (VM)

This is covered under VM50 and VM51. A "final" exposure draft of VM has been issued, containing forms, but not the theory, for companies to use in filling out experience data.

Small companies have a five-year deferral from reporting requirements. However, with "small" not defined, this is of questionable value. New York's own regulation on experience reporting has an exemption threshold of $10 million premium, a very small limit.

A letter from the North Dakota Commissioner, Adam Hamm, who chairs LHATF's parent (Principle-Based Reserving EX WG) is significant. This memo, still undated, was approved by his WG and LHATF in separate conference calls, and

Continued on **page 6**

submitted to the NAIC's Executive Committee at the 2010 Summer NAIC Meeting. His memo spelled out that "Smaller companies that have less than credible data would not submit their data to the statistical agent, and would in turn use industry data to set their assumptions, and would submit summaries of their experience directly to the requesting regulator. This aspect was a compromise to address concerns of small companies." While "small" and "credible" are not defined further, this could give further support for a company claiming exemption. However, LHATF has not incorporated the above paragraph into VM50 of VM.

New York has proposed that a new VM section 52 is needed for SI/GI product types often sold by small companies. Their hint is that this section would have no deferrals for small companies and immediate requirements for full experience reporting of the above type of products. At the meeting, LHATF ignored a statement from the Academy that many large companies with credible data also write SI/GI.

New York has already sent out a data call for 2010 on experience reporting. I was surprised to hear that the call covers all New York-admitted companies (even accredited reinsurers). The industry will try to move the effective date ahead to 2011.

Life RBC-C3 Phase 3

The current approach for this item is a scope limited to Universal Life with Secondary Guarantees (UL2G) over five years (RBC for variable annuities is already covered as C3 Phase 2). However, New York has finally prepared a letter, outlining some changes they want, such as continuation of current formulas as a floor. Therefore, no discussion at all occurred on this topic.

Obamacare

I was told that several companies selling limited benefit products have plowed through all of the new Health Bill. They are satisfied that for limited benefit products such as cancer, short term disability, and others, the 80 percent and related high loss ratios of the bill do not apply.

Health PBR

The ACLI has stated that final life methodology under VM20 should "set the tone" for eventual health PBR (VM25). However, the latest discussion of long-term care calculations under PBR indicates complete reliance on stochastic processing for reserves. Resolution here probably won't occur until after VM is considered "complete" for submission. This stage would mean completion of VM20, VM50 and VM51 (but probably not VM52 for SI/GI), VM00 which defines PBR scope, including exemption of preneed, VM01 with definitions, and VM21 for variable annuities (formerly Guideline 43). In other words, VM25 for Health would remain unresolved.

Comments

I heard several offhand comments from attendees worth noting. While not conclusive, they may indicate a general industry attitude towards this entire project:

"What will happen if PBR dies?"
"PBR seems to have impossible roadblocks."
"It seems clear that New York will never agree to any half reasonable PBR."

Miscellaneous PBR Items

On Guideline 38, Section 8C, the interim solution for Universal Life with Secondary Guarantees, is due to expire this year-end. After some discussion, the sunset date was extended three years to 2013.

Guideline 38 only allows use of 1 percent lapse rates. New York has always seemed to oppose such lapse assumptions, even though in a different PBR context, they agreed with 1 percent, as developed from a Canadian study.

One change was made to the formula for the Stochastic Exclusion Test (SET). Due to concerns about reinsurance expense allowances, LHATF agreed to modify the SET denominator. Instead of the present value of benefits plus expenses (and commissions), now only the present value of benefits would be included. Since this change would increase the SET ratio, the 4 percent threshold was increased to 4.5 percent.

On reinsurance, one longstanding issue was resolved. New York has long wanted reserves to be computed for the net ceded amount, and separately for the credit on each treaty. After lengthy discussion, it was agreed that in some cases where collateral from the assuming company was involved, separate treaty reserve calculations might be in order. However, the requirement for separate credit calculations and the amendment in general (Amendment 41) were rejected.

Solvency Modernization Initiative Task Force (SMI)

After the 2010 Spring NAIC National meeting, I mentioned my concern with several directions of working groups under SMI. While I couldn't directly attend these Saturday meetings, I reviewed their agendas and handouts. They indicated:

1. Scrapping statutory accounting is becoming more explicit as an objective. No reason is offered other than "certain jurisdictions" want use of international GAAP for regulatory purposes. Even a regulator like Steve Johnson (PA), who defended statutory accounting, mistakenly referred to it as "US GAAP with certain modifications." That may have been true at one time, but statutory accounting has been completely codified for some time.

2. Ed Stephenson of Barnert Associates indicated that a complete exposure draft of IFRS, international GAAP, for insurance contracts including reserves, is now available. He didn't indicate whether its previous terrible flaws are still present.

3. Completely redoing all life RBC formula components to a type of "actuarial projection" basis. This was the approach proposed for C3 Phase 3, which by now is limited to UL2G. Methodology for such a task is elusive, to say the least. No justification or need for such a mammoth project has been offered.

I have to wonder if some commissioners are hoping to impress Congress, in the hope of influencing the 2011 debates on Optional Federal Charter. This seems to be the only explanation for such impractical dubious projects. ●

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NOVEMBER

1

Attestation is Here!

The countdown is on—attestation begins Nov. 1. You must attest compliance with SOA CPD Requirement or be considered non-compliant.

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2. Indicate if you have met the SOA CPD Requirement.

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Go to SOA.org/attestation to learn more about this simple, but important, process.
Attestation for the 2009-2010 cycle opens November 1, 2010 and closes February 28, 2011.

Investing a Few Minutes Now Could Save Hours Later

By Lori A. Newberg

Examiners for State Insurance Departments have moved their attention from a formula reserve review to a risk-based focus examination. Thus, the examiners are paying more attention to the asset adequacy analysis (AAA) and the risk-based capital (RBC) analysis. Each of these analyses requires a supporting memorandum or report as required under the Actuarial Standards of Practice (ASOP). We all know proper documentation is good practice. Further, it will assist a state examiner or auditor in conducting their review. Proper documentation is greatly appreciated by the examiners, and it also helps jog your memory when asked a question. Additionally, when principle-based reserves (PBR) are introduced, documentation will be of the utmost importance.

The Actuarial Opinion Memorandum Regulation (AOMR) states that the AAA memorandum should demonstrate that the analysis has been done in accordance with ASOP, should document each major assumption and strategy used, should cite all material reliances, and should contain other disclosures as specified by the AOMR and ASOP. In my experience, most memorandums seem to contain adequate documentation of major assumptions, strategies employed, and reliances. Where most memorandums fall short is the disclosures for providing why an assumption is appropriate whether by judgment, company experience studies, industry tables, etc. This small but important detail will be even more critical when implementing PBR since assumption setting will have more flexibility.

When describing the assumptions in the AAA memorandum, be sure to defend the degree of rigor used in setting the various assumptions. Ask yourself, "Where did this assumption come from?" In most cases, it only takes an extra sentence or two to answer this question. A brief checklist of assumptions to be described, including the degree of rigor, in the AOMR is provided here.

Liability derivation of assumptions:

a) Lapse rates (both base and excess)
b) Interest crediting rate strategy
c) Mortality
d) Policyholder dividend strategy
e) Competitor or market interest rate
f) Annuitization rates
g) Commissions and expenses
h) Morbidity

Asset derivation of assumptions:

a) Default costs
b) Bond call function
c) Mortgage prepayment function
d) Determining market value for assets sold due to disinvestment strategy
e) Determining yield on assets acquired through the investment strategy

Another documentation item often lacking in the AAA memorandum is a model validation. The model validation should include such items as:

a) Renewal premium as reported in Exhibit 1 Part I
b) Net investment income
c) Benefits such as death, surrender, annuity benefits, and policyholder dividends
d) Commissions
e) Expenses
f) Investment expenses

If the results from the model assumptions deviate from the annual statement amounts, give a brief explanation of the difference, and why it is appropriate.

The RBC analysis must include a supporting memorandum as stated in the ASOPs similar to what is prepared for the AAA analysis. However, in practice, many actuaries have yet to prepare the required report. The change in examination focus will bring this oversight to light. The supporting report should identify the amounts tested, as they relate to that of the AAA memorandum for the various product lines, as well as all the assumptions and their appropriateness. It may appear as a duplication of effort since the AAA memorandum is quite similar, but it is a requirement, and will be requested by the state insurance department examiners and auditors. The differences in the business subject to testing between the AAA and the RBC analysis may soon be alleviated in 2011. However, in the meantime, a separate RBC report should be prepared.

Having served as both an auditor and an appointed actuary, I have learned a few extra minutes spent on defending and validating assumptions can save hours of discussions when it comes to financial examinations.

Lori A. Newberg, FSA, MAAA, is managing director, consulting actuary at Miller & Newberg, Inc. in Overland Park, Kan. She can be reached at *lori.newberg@miller-newberg.com.*

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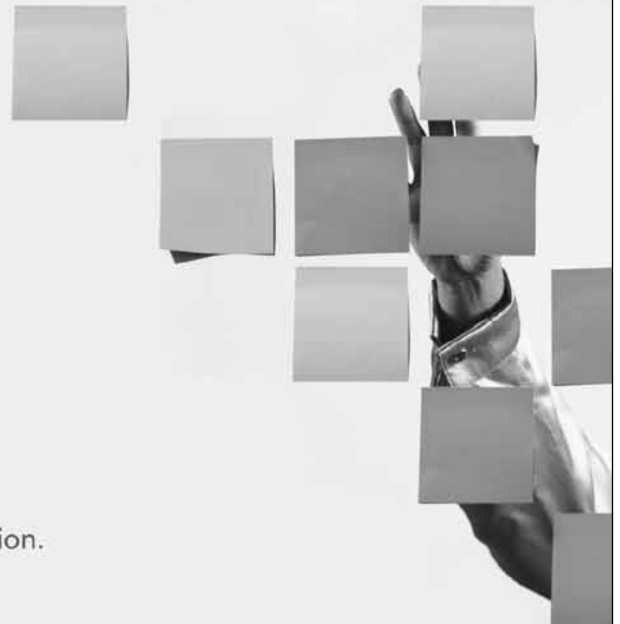

Enterprise Risk Management for Small Insurers—It's Still Three Words

By Norman E. Hill

After the financial meltdown of 2008, there certainly seems to be more interest in risk management than before. This is true on the part of both insurers and banks. A great many articles have been written, stressing that the mistakes of the past must be avoided. This involves greater emphasis on managing risk.

It is true that some articles, usually from insurance and actuarial publications, use the term "ERM." However, there are also many that confine their usage to "risk management." Many of the latter articles points are valid. However, avoidance of the term "enterprise risk management" seems to undercut the validity of the points they make.

So far, my analysis indicates that insurers are somewhat more likely to use the ERM term than banks. This could be tied to the long-term nature of most life insurance contracts. Even here, though, the usage is by no means universal.

Setting the Stage with "Siloing"

As a preliminary note, a complete definition of the term "silos" seems in order. This term is often used when contrasting the beneficial and corrective aspects of ERM. To some, it might be a turnoff or a jargon-like term. But once understood and used on occasion, it can be helpful.

From the business dictionary, Spirit Lexicon, Entry No. 78 for "Siloing": Types 1 and 2 refer to agriculture usage. But Type 3 is on point: "In business, non-communication between departments, incompatible goal-setting, intra-company snobbery or outright hostility … At its most extreme, siloing in the workplace leads to destructive competition among nominal allies. …"

Discussions Involving Risk Management—Banks and Others

A recent issue of the *RMA Journal*, July/August, 2010, (bank-oriented publication) contains several key articles on risk. The first is a summary of a Toronto, Canada chapter meeting of Canadian bank chief risk officers. Some of the quotes are illustrative:

1. "Process is critical to managing risk. ... The challenge is to ensure that the processes yield value-added content that helps us evaluate old risks as well as new ones. …" *Mark R. Chauvin, TD Bank Financial Group*
2. "Risk management needs to work well with our businesses so that we don't get out in front too quickly or lag behind." *Tom Woods, CIBC*
3. "In the past, compensation issues … were resolved without a whole lot of risk management involvement … Now … boards are looking for risk management to be involved." *Morton Friis, Royal Bank of Canada*
4. "Fundamentals matter, the secrets of the risk management business do not change." *Morton Friis, Royal Bank of Canada*

At a meeting of a New York chapter of CROs, more quotes are similar in nature.

"We meet regularly with the audit committee. … Our CEO, our president … and other people … (are) clearly interested in the risk management of the firm. …" *Craig W. Broderick, chief risk officer at Goldman Sachs*

A key point made in the article was that risk managers must understand and support the firm's business strategy. According to David Coleman, Royal Bank of Scotland, "I encourage

people to get out from behind their desks and understand their marketplace, to … be engaged in strategy development."

Discussions Using ERM—Insurance Related Organizations

The above discussions in the New York Chapter seem closer to what is normally thought of as ERM. But they never quite make the leap in using the term in its broadest, most complete meaning.

Several articles in a recent *National Underwriter, Property & Casualty*, April 26, 2010, seemed tied in with ERM, as advocated by the actuarial profession.

The first article is by Mark Anquillare, CFO of Verisk Analytics, parent of ISO. His key points are:

1. "Effectively managing corporate risk today requires the adoption of enterprise risk management—a holistic, dynamic and operations-oriented that encompasses broad areas of responsibility across the entire organization."
2. "ERM offers risk managers the ability to manage risk across the enterprise … (and) contributes to the optimization of risk-related decision-making and alignment of the ERM strategy with the organization's overall risk tolerance and goals."
3. "When implementing an ERM strategy, companies should augment the use of traditional risk data with advanced operational-risk analytics and scoring. …"

On a less positive note, another article in that issue describes key hurdles facing ERM today. According to a recent Aon study, "2010 Global Enterprise Risk Management Risk Survey," only a very small percentage of risk managers (7 percent) rated themselves as advanced in terms of implementing ERM programs. Perhaps more significantly, over one-third of risk managers taking part in the survey stated they were only "getting started" in ERM.

The same Aon survey provides three recommendations for boosting ERM within a firm:

- Appoint an executive level leader to be responsible for driving ERM strategy and implementation.
- Consider having the risk function report directly to the Board.
- The title of the ERM leader is less important than recognition of that person's position within the organization.

Finally, the study cited the primary barriers to ERM within organizations:

- "Lack of tangible benefits (40 percent).
- Lack of skills to imbed a program (34 percent).
- Lack of senior management sponsorship (31 percent).
- Lack of a clear implementation plan (28 percent).
- Failure to communicate the case for change (27 percent)."

Analysis of Aspects of Aon Study

In a previous *smalltalk* article on ERM ("Enterprise Risk Management for Small Insurers (ERM)—An Evolving Concept"), I recommended that, especially in a small company, the chief actuary was the logical choice to be chief risk officer. This would mean that, in the above terms, he would be the "executive level leader to be responsible for driving ERM strategy. …" My own preference would be that he still report to the CEO. I believe this would aid his perception as part of top management, rather than akin to external or internal auditors.

"Insurance and actuarial organizations seem more likely than banks to use the term ERM enterprise risk management. …"

Conclusions

Insurance and actuarial organizations seem more likely than banks to use the term ERM, even when all discussions really pertain to the functions and responsibilities of enterprise risk management. Banks seem sensitive today to the critical need for better management of risks they undertake. But at least some insurance-related organizations see the broader, firm-wide nature of ERM. To them, traditional silos must be overturned so that the entire organization is committed. Emphasis on "risk management," as such, runs the danger of being much too narrowly focused. In other words, ERM is indeed still three words. ●

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Check Out the Section's Website

By Jerry Enoch

There is one place on the Web that is devoted to actuaries at small insurance companies—the section's Web page on the SOA website. We've worked to make it better, and with increased usage and involvement, we can make it better still.

To find the site, go to *www.soa.org* and locate the "Find a Section" box at the lower left. Click "Smaller Insurance Company" in the drop down box, and you're there. The SOA staff puts a lot of content on section Web pages, and we are working to make our Web page more section-specific.

We've focused especially hard on the "Latest News" area, posting updates about the latest National Association of Insurance Commissioners' meeting and the Solvency Modernization Initiative, among other things. I suggest checking the website once a week. The more people that check out the information, the harder we'll need to work to keep it fresh. It's a challenge to keep up with everything, and these news postings can be a great help.

I also recommend the "Resources" area, where you might find a link to the latest version of VM-20 or the American Academy of Actuaries' website about PBA. Of course, you can link to issues of *smalltalk* or research articles, and you can see upcoming events.

Our website has one other feature that excites me— it's the first to allow members to contact us. Near the top, immediately above "Latest News," is a link that allows you to contact me. You can ask a question or make a comment. You can suggest that we make a change to the website. If you know something that other section members might want to know, you can notify me so that it can be added to the site. If we get to the point where members are frequently suggesting content, our section website could become one of your favorite places for news. Everything is in place.

We are all very busy, and keeping up with the latest news can be very time consuming. Our section Web page can become your friend—a great source of news in one convenient place. I encourage you to visit it frequently and use the link to contact me freely. I'll stop writing so you can check out the site now!

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Smaller Life Insurance Companies and Smaller Life Reinsurers: The Partnership Solution

By Jay M. Jaffe

Editor's Note: *Volunteer editors of Society of Actuaries' section newsletters are always happy to receive quality articles to fill their respective publications. While topics usually vary, there are times when articles cover the same subject, but take a somewhat different approach. We received two articles on access to reinsurance for smaller insurance companies—both are published in this issue. Jay Jaffe's article outlines multiple possible solutions at a high level, while Clark Himmelberger's article drills down into one possible solution in detail. Jaffe also suggests that the Smaller Insurance Company Section facilitate a think tank to further develop solutions to limited reinsurance opportunities. We hope these two articles provide you with solid information on the reinsurance topic. I'd also like to note that currently, Karen Rudolph, FSA, MAAA, of Milliman Inc., is chairing a project oversight group to perform a research project examining current problems and potential solutions regarding access to reinsurance for smaller insurance companies. This research is sponsored by the Reinsurance Section and the Committee of Life Insurance Research. Results of that research should be available in the near future. We'll keep you posted.*

—Robert Hrischenko

The most recent listing of recurring reinsurance premiums published in *Reinsurance News* shows that in 2009 about 85 percent of the U.S. life reinsurance market was controlled by just five reinsurance companies.[1] The situation in Canada is even more limited with just three reinsurers having about 95 percent of the life reinsurance market.[2]

The concentration of the life reinsurance business reported in the *Reinsurance News* report should not be startling to anyone who has been involved with life or health reinsurance during the past several decades. There have been numerous consolidations of life reinsurers over the years and more are likely to occur in the near future.

For small life insurance companies (direct writers) the impact of fewer life reinsurance companies (reinsurers) is significant for many reasons. Unlike their larger sized brethren, smaller direct writers need reinsurance to make many of their products possible. They usually don't have the capital and number of insureds to cover larger amounts of life insurance; they may not have the underwriting expertise needed to evaluate larger risks; and they may need surplus relief when production is good, etc.

In circumstances when the number of providers of a needed service to a market is limited, the availability and cost of the services is inevitably going to increase if for no other reason than larger service providers generally don't have the cost structure and mentality to deal with smaller production sources.

But finding a solution or solutions to the vanishing reinsurance market isn't only a problem for smaller direct writers. Virtually the same problem is also being faced by the smaller reinsurers. The direct writing life insurance industry is also concentrated with the top 25 groups having about 80 percent of the life insurance in force in the United States and it can be difficult for smaller life reinsurers to get their feet in the door of the larger direct writers.[3] Thus, smaller life reinsurers also need to find a way to compete against the five (and possibly in the near future just four) major life reinsurance carriers.

If the life reinsurance market continues to contract, smaller direct writers are going to face a hard decision: ***if they want to operate independently, can they continue to afford to offer products that require reinsurance?*** The smaller life reinsur-

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ers face a similar question: ***what do we have to do to compete against the major life reinsurers?***

If the smaller direct writers conclude that under current conditions they can't afford to offer products which require reinsurance, then they are going to have to consider alternative survival strategies including:

- Restricting their portfolios to products with limited face amounts (e.g., the senior market);
- Limiting their products to those that fit smoothly into a standard reinsurance system offered by reinsurers;
- Accepting larger retentions and the experience fluctuations that follow;
- Paying higher reinsurance premiums which may lead to lower profit margins; and/or
- Developing creative solutions to expand life reinsurance capacity.

The best strategy from the above options depends on each company's circumstances and may even involve combining multiple solutions as needed in a situation. There may be other solutions that emerge over time which also should be considered.

"But the most obvious conclusion that any smaller direct writer should reach is that a "take no action" approach is not going to be a long-term solution."

But the most obvious conclusion that any smaller direct writer should reach is that a "take no action" approach is not going to be a long-term solution.

At the same time, the smaller reinsurers still remaining are going to have to decide whether they can exist in a market without smaller direct writers. If they conclude that the future for both smaller direct writers and reinsurers is interdependent, then they, too, will have to develop strategies for preserving the universe of smaller direct writers.

Given the common interests between smaller direct writers and smaller reinsurers, it is logical to expect that some relationships or partnerships between these two groups will form. But what will these arrangements look like? Here are some possibilities:

a. Small life reinsurers become active solicitors of major distribution sources on behalf of a consortium of smaller direct writers.
b. Reinsurance pools led by and guaranteed by smaller reinsures become available.
c. Smaller direct writers become shareholders of smaller reinsurance companies.
d. Smaller reinsurers and direct writers completely consolidate operations to achieve expense efficiencies but without surrendering their independence.
e. Smaller life reinsurers create new forms of reinsurance and services specifically geared to the needs of smaller direct writers.

None of the above or any other solutions will happen overnight. One way to get started would be for the Smaller Insurance Company Section to sponsor a "think tank" conference call attended by members from both direct writers and reinsurers. Write to your SOA Section chairperson or newsletter editor with your ideas.

But if something isn't done to find ways to develop strong symbiotic relationships between smaller direct writers and smaller reinsurers, the probable end result is that both of these types of entities will vanish or become even more immaterial to the life insurance market. While there are laws to save endangered species, there will likely not be a campaign to save either small life insurance or reinsurance companies so something better start to happen soon to increase the likelihood that both breeds of smaller insurance entities will survive.

END NOTES

[1] *Reinsurance News,* Society of Actuaries Reinsurance Section, July, 2010, p.7.
[2] *Ibid,* p.8.
[3] Best's Statistical Study "U.S. Ordinary Life—2009 In Force.' As a further indicator of the concentration of the U.S. life insurance industry, the top 50 groups control 90 percent of the market and the top 100 groups control almost 100 percent of the U.S life insurance market.

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The Smaller Company Reinsurance Issue

By Clark F. Himmelberger

It is a competitive disadvantage when professional reinsurers don't provide reinsurance to smaller insurance companies at the same prices they provide reinsurance to larger insurance companies (or don't provide reinsurance at all). This is especially true for products like level term insurance, where reinsurance is a valuable tool for building a viable product. Sometimes, the unfortunate answer for many smaller insurance companies is to forego developing a product when they cannot attract a competitive reinsurance solution.

As Carl Spackler once said about gophers, "My enemy, my foe, is an animal. In order to conquer the animal, I have to learn to think like an animal. And, whenever possible, to look like one."

Looking at the reinsurance transaction from a reinsurer's perspective helps shed some light on the difficulties of developing a reinsurance solution for the smaller insurance company. Hopefully, some insight into the reinsurer's operational issues will help smaller insurance companies increase their opportunities to transact successful reinsurance deals.

The Reinsurer's Perspective

From the reinsurer's perspective, it's a costly investment to develop a reinsurance treaty. It takes time to underwrite the insurance company, price the product and negotiate the allowances and then negotiate the reinsurance treaty. Twenty years ago it was more common for a reinsurer to develop a "one size fits all" mortality assumption, but in today's competitive reinsurance environment it is almost universal to customize a mortality and persistency assumption for each product line within each insured's product portfolio. For developing the terms of a reinsurance treaty, the reinsurance underwriters, actuaries and lawyers don't come cheap. About $40,000 is not an unreasonable estimate of what it costs a reinsurer to underwrite and establish a typical term coinsurance treaty.

It is the allocation of this upfront reinsurer cost of doing business that prevents a smaller insurance company from achieving the same successful reinsurance transaction as a larger insurance company. Applying a $40,000 upfront cost to a reinsurance treaty with a two-year shelf life for an insurer writing $200,000 of reinsurance premiums per year amounts to 10 percent of premium expense. Compare that to a larger insurance company annually writing $5,000,000 of reinsurance premium, where that expense becomes less than 0.5 percent of premium.

There aren't many insurance product opportunities out there in the market that can withstand a 10 percent expense disadvantage and still result in a successful insurance product. On the one hand, it's kind of rude for a professional reinsurer to decline to even quote on a company's reinsurance proposal; but on the other hand, it's frustrating for a reinsurer to put together a competitively priced quote (from their end) that fails to gain acceptance because the fixed expense cost imbedded in the reinsurance quote results in a noncompetitive underlying insurance product for the insurer.

Economies of scale are critical to a reinsurance transaction, and a targeted minimum treaty size is just as important to a reinsurer as it is for a direct insurer to maintain a minimum policy size on the policies it sells to its policyholders. Nobody benefits from losing money reinsuring or selling policies that can't produce the revenue necessary to cover the costs of maintaining them.

The reinsurer spends the bulk of its developmental cost on pricing (actuarial), risk selection (underwriting) and treaty negotiation (legal, executive and other managerial disciplines). This repetitive process undertaken with each reinsurance opportunity is time-consuming and expensive. But as the reinsurer spends its money, the big question is whether it is possible for an insurer to provide shortcuts that reduce the expense burden of the upfront cost, and in turn increase the potential for a reinsurance transaction to take place between a professional reinsurer and a smaller insurance company.

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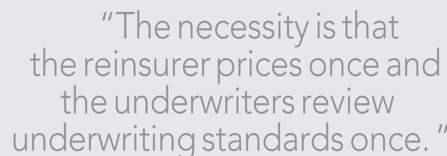
Potential Reinsurance Solutions for the Smaller Insurance Company

How can you respond to a reinsurer's insistence that reinsurance isn't available due to the small size of the transaction? With many reinsurance reps, a good dialogue can help identify hurdles that can be overcome as well as, equally important, the hurdles that can't be overcome. With most reinsurers, the subject matter that's going to help advance your case is the one where you can identify what reinsurer costs you can reduce or eliminate to make the transaction feasible.

Unfortunately, utilizing reinsurance is often a trade-off in sovereignty versus conformity. Accessing affordable reinsurance for smaller insurance companies may at times feel like a painful process of complying with reinsurer ideologies, particularly when those reinsurer requirements are not as efficient as the process your company has sensibly and confidently gravitated to through the years of experience of knowing your business.

The first thought that comes to my mind as I listen to many smaller insurance companies discuss reinsurance issues is that conglomeration seems the most logical solution to attracting reinsurer interest. If a small volume of reinsured business is unattractive, then a pooled volume of multiple insurance companies totaling a large volume of reinsured business would then of course be more attractive.



"The necessity is that the reinsurer prices once and the underwriters review underwriting standards once."

Conglomeration

If like-minded life insurance companies can present a significant amount of reinsurance volume and a method for overcoming the reinsurer's overhead expenses, capitalism has a good chance of prevailing. For sure, there would be a significant loss of autonomy in conforming to a reinsurance "standard." I think it all comes down to the value of a potential reinsurance transaction versus the value of independence to customize your products for the benefit of your policyholders. But regardless, the obstacles for smaller insurance company reinsurance programs continue to face an uphill battle unless companies find a way to overcome reinsurer fixed-cost expense issues. Below is my pipe dream of a conglomeration methodology that could overcome reinsurer costs related to pricing, underwriting and treaty compilation.

Pricing

Excluding the cost of providing premium guarantees, a reinsurer's profit depends only on the net reinsurance premium (premiums less reinsurance allowances). Becoming part of a reinsurance conglomeration does not necessarily mean all companies would have to charge the same premiums. An insurer charging higher premiums would get higher reinsurance allowances (that is, more money available for expense coverage and/or profits) and an insurer charging lower premiums would get lower reinsurance allowances. The reinsurer would price once with a single scale of net reinsurance premiums, and assure itself that each insurer product portfolio meets the reinsurer's profit criteria.

This would unfortunately still require insurers in the conglomeration to all conform to certain underwriting class criteria to assure consistency across all underwriting classes.

Underwriting

Similarly to premiums, uniformity of underwriting standards wouldn't necessarily be required, but in all likelihood a set of *minimum* underwriting requirements would be. The necessity is that the reinsurer prices once and the underwriters review underwriting standards once. Although companies can achieve similar underwriting results by being stricter on some requirements and looser on others, in order to achieve a single review of underwriting standards, a single set of minimum requirements would lead to the desired expense savings.

Treaty Negotiation

Lawyers are expensive. Identical treaty terms mean identical administrative processes, claims processes, company protections, etc. It should be conceivable that insurers interests are similarly aligned and that a single treaty could provide sufficient protections for all insurers, and accepting a $4,000 communal treaty might be more advantageous than negotiating a $40,000 gem of an individually negotiated treaty. No, the $4,000 agreement won't contain the exact protections each life insurance company desires, but if the benefits of reinsuring under uniform terms are not worth the missing reinsurance treaty protections, then declining to participate in such an agreement is the right choice for that particular insurance company.

Conglomeration Summary

A good question to ask is why there isn't a history of successful conglomerations already in existence? It seems obvious that if a reinsurer can't afford to price smaller individual reinsurance transactions, that it would benefit from aggregating those potential revenue sources. Certainly, the sacrifices a company would have to make to participate probably have a lot to do with it. But maybe the starting point of a motivated insurer willing to invest the time to organize and solicit a reinsurance conglomeration is the missing ingredient.

Although conglomeration seems the most logical method to achieving economies of scale, there are potential single-insurer actions that can also chip away at the cost of providing reinsurance transactions. These "nonconglomeration" efforts merit a mention here to give the smaller insurance company additional ideas of how to make themselves more attractive to a potential reinsurer.

Non-Conglomeration

The sections that follow outline a few steps that I think can make a difference in how a smaller company is perceived by a professional reinsurer, and potentially can make a smaller insurance company more attractive to do business with.

Pricing

If you don't know how your claims translate to a particular level of mortality, it's difficult for a reinsurer to justify using a competitive mortality assumption. For most small insurance companies, there is always going to be the issue of credibility in the mortality results, but that shouldn't preclude the company from making the efforts to quantify. Quantifying does two things: it shows the reinsurer you manage claims, and it provides valuable feedback on how well the company's mortality results stack up to past mortality assumptions used in pricing. There are low-cost options out there to analyze mortality results in a cost-effective manner, and the small efforts to compile a mortality study are well worth it.

Underwriting

This is potentially the most difficult aspect of the reinsurance quoting process. Many insurance companies pride themselves on their flexibility and ease of doing business with, and judiciously choose when to enforce stricter underwriting requirements and when to waive standard underwriting requirements. The problem here is that a reinsurer may be left with no security of knowing whether your flexibility is prudent underwriting process management or simply a lack of underwriting control. Developing an underwriting process where there is consistency (conformity) in the risks that would be eligible for reinsurance is an excellent step towards simplifying the reinsurance underwriting review process. Reinsurers want to see evidence that the risks they assume will be underwritten in a consistent manner. Providing documentation of clear unwavering underwriting guidelines for reinsurance risks will improve how a reinsurer views your risk selection process.

Treaty Negotiation

Treaties outline the rights and obligations of the reinsurer and insurer. Negotiation of those rights is extremely important; however, if a reinsurer's boilerplate treaty effectively manages the reinsurance transaction, and costs the reinsurer relatively little to produce. There may be some justification for simplifying the reinsurance treaty negotiation into a simpler "in totality" accept/reject process instead of a hotly (line-by-line, word-by-word) contested reinsurance treaty negotiation. Yes a smaller insurance company deserves the same consideration in customizing their reinsurance treaties as a larger insurance company, but affording the cost of that customization contributes to the overall obstacle of creating a cost-effective reinsurance transaction. If a reinsurer includes the cost of developing a treaty as an impediment to reinsuring your business, try requesting a boilerplate treaty and agreeing to accept or reject it as a whole prior to advancing to the reinsurance pricing and underwriting process.

Can Reinsurance Work for the Smaller Insurance Company?

The repetitive process that a reinsurer undertakes with each reinsurance quoting opportunity is a time-consuming and expensive process. When it comes down to it, though, the reinsurer is basically ensuring that each deal it puts on its books meets its profit, expense and risk objectives. Theoretically, each deal is priced to the same profit, expense and risk objectives, and each negotiated treaty merely specifies the accounting, administration and actuarial details that result in that theoretical level of profit, expense and risk. Aggregating insurer business would reduce reinsurer expense but otherwise leave the profit and risk objectives unchanged. Additionally, providing a reinsurer with information or structure that reduces their quoting expense creates opportunity for reducing the expense burden of your potential reinsurance opportunity as well. Increasing economies of scale or reducing quote-associated reinsurer expense both seem like win-win situations for all parties involved, and can work to increase the opportunities for reinsurance solutions. ●

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Developing Professional Development

By Jennie McGinnis

As you are no doubt aware, the SOA's Continuing Professional Development (CPD) Requirement went into effect in 2009 and at the end of this year all SOA members will be required to attest to their compliance. You may not be aware, however, that in 2009 another significant change was made to the oversight of PD with the establishment of the Professional Development Committee (PDC). The PDC has been charged with the following responsibilities:

- Meeting the diverse development needs of the profession,
- Providing the highest quality learning experiences,
- Ensuring that the program is focused on both current and forward-looking technical and nontechnical content, and
- Making appropriate use of technologies to ensure timely access to relevant and engaging programming.

While numerous volunteers serve to ensure that individual PD events provide meaningful development opportunities, the PDC oversees planning at a higher level to minimize potential gaps in membership needs and the SOA's offerings. The PDC is chaired by Dale Hall, as the Board of Directors' representative, and is comprised of section representatives and liaisons from the Education Committee and SOA staff. Each year the PDC will set out a plan (e.g., number and types of opportunities to be offered) and evaluate the fulfillment of that plan. In addition, the PDC gave focus to the following five areas of interest this year:

Marketing the Competency Framework

The SOA Competency Framework (CF) was developed by and for actuaries to give focus to the key skills that drive success in the field. Beginning with this year's spring meetings, each learning opportunity has been mapped to one of the eight competencies. The competencies have been organized around business and technical competence and are often interrelated. Session evaluations have been used to gauge the participants' awareness of the CF category when selecting the session and how well the category applied. In the works is a CF self-assessment, which will help provide actuaries with a more informed perspective when selecting PD opportunities.

Piloting a Blended Learning Opportunity

Blended learning utilizes various teaching and learning techniques to increase the retention and comprehension of the material. Science class comes to mind when thinking about blended learning—you read a chapter in advance, attend a lecture and then put what you have learned to work in a lab setting with some measure to validate that learning occurred. These techniques have been used in other SOA sessions before. At this year's Annual Meeting, we are not only using the technique but will assess the effectiveness of this blended learning opportunity with attendees. Participants will be debriefed in order to evaluate how well the structure worked and if/how it should be utilized going forward.

Evaluating the Implementation of a Leadership Institute

The team involved in this project has faced many questions and, upon surveying members and employers, continue to search for answers. Should the SOA offer a Leadership/Executive Development program? Would it be developed in-house or in partnership with an already established program? Will employers support a program geared toward actuaries or is a multidisciplinary approach preferred? Will such a program be cost effective given the number of employers who have training programs of their own? How can technology be used to minimize costs while ensuring engaging programming? Stay tuned!

Piloting the Conversion of an Education e-Learning Module for PD Purposes

A key tenant of PD development is the repurposing and repackaging of material where appropriate. With an increased

desire in “anytime” access to learning opportunities and recognizing the availability of e-Learning modules used in basic education, it made sense to determine if this material could be of value to those already credentialed. After review, and with a resounding “yes,” the subcommittee has set forth on a pilot conversion. Up first is a module focused on modern corporate finance.

Developing a Speaker Database

Those who have volunteered on a PD planning committee know how difficult it can be to find speakers. Finding subject matter experts and ensuring that they are effective presenters (and available!) can take a significant amount of effort, especially when considering that most panels have more than one speaker and that session coordinators typically work on multiple sessions for any given meeting. The desire and need to ease this process is clear and thus the development of a speaker database was born. Once in effect, it will assist not only those looking for speakers, but will also provide those thinking about presenting a place to post their interest and credentials.

To learn more about PD opportunities, the CPD Requirement and the Competency Framework visit the Professional Development area on the SOA’s website (*http://www.soa.org/professional-development/landing.aspx*). A current list of PDC members can be found at *http://www.soa.org/pdcmembers*. ●

Note: This article first appeared in the November 2010 issue of *Actuary of the Future*, the newsletter of the Actuary of the Future Section.

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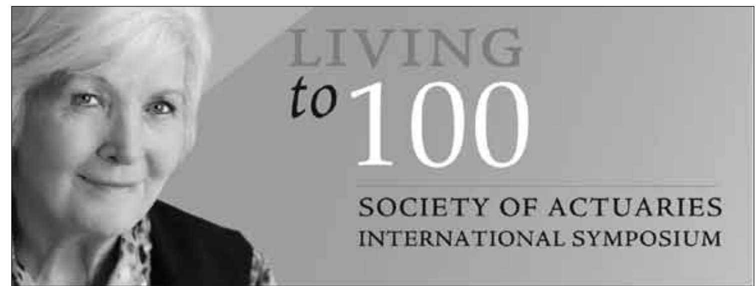

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