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Optional Federal Charter (OFC)—Another Acronym, Another Concern

By Norman E. Hill

Recent Developments and Proposals

At the December, 2007 National Association of Insurance Commissioners (NAIC) meeting, one commissioner said that her Congressman informed her that any Optional Federal Charter (OFC) legislation was strictly on the “back burner.” Since issuance of a U.S. Treasury Department Report this spring, there has been a dramatic resurgence of movement towards OFC for the entire insurance industry, life/health and property/casualty. While the report dealt primarily with banks, financial markets and the sub-prime mortgage lending crisis, it also called for optional federal charters for insurance companies.

The report described the current state regulatory framework for insurers as antiquated and inadequate. It could not point to insurer financial problems with sub-prime mortgages, since none have been publicized. No prominent life insurance failures have occurred since the 1990s. Instead, the Treasury report concentrated on two failings of state regulation:

1. The Interstate Compact for uniform product approvals (ISC) covers life, annuity, disability and long-term care filings. So

far, 33 states have joined the compact, but large states such as New York, Florida and California have not; as a result, only about 54 percent of aggregate premium volume for these products is covered by the Compact.

2. International insurers seeking to be licensed in the United States or desiring accreditation as reinsurers have no single regulator in this country with which to deal.

In addition to bills for OFC directly, a companion bill has also been introduced in the House and even passed out of its subcommittee. Bill 5840 would create a national Office of Insurance Information (OII) to “collect, analyze, advise, and issue reports on domestic and international insurance matters.” Many consider this bill and a new OII organization as the opening wedge to full OFC enabling legislation.

Current Developments

Advocates of OFC have become even more vocal during the current economic crisis. They have pointed to the \$85 billion federal loan/bailout of AIG as a sign of failed state regulation. The NAIC and others have replied that insurance companies

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under the AIG holding company are all (as far as can be reviewed) solvent without surplus strain. The holding company problems—outside the reach of state regulation—stemmed from its credit default swaps, which do not appear to be on insurers' books, and were federally regulated by the U.S. Office of Thrift Supervision. Moreover, their argument is that these types of assets fell under AIG's federal products division.

Historical Developments

There have already been several federal takeovers of insurance regulation, actual and proposed. Medicare Supplement plan design, minimum loss ratios and refund formulas are now based on federal statutes. Agent licensing, reciprocity and uniformity are substantially covered by the Gramm-Leach-Bliley Act (GLB). In 1994, Congressman Dingell proposed a federal takeover of insurance, primarily in response to several prominent bankruptcies shortly before (this was before uniform Risk Based Capital standards from the NAIC came into effect).

Since then, the ISC was proposed and submitted for state approval, in response to widespread complaints about the impossibility of uniform nationwide product offerings. This development came about, partly to correct an obvious failing in state regulation, but also to mitigate future agitation for OFC.

On the property/casualty side, auto insurance companies in particular hoped that federal charters would allow market pricing, rather than pre-approved rates. The former approach has been in effect in certain states such as Illinois for some time, but not in most states.

Opponents and Proponents

The American Council of Life Insurers (ACLI) has come out in favor of OFC. Several large property/casualty companies, as well as some P&C trades, also have favored this approach. However, several trade associations, such as the National Alliance of Life Companies (NALC), representing smaller life insurers, the National Council of Insurance Legislators (NCOIL), and some agent organizations, have remained strongly opposed to the federal approach. Prudential, the largest life insurer in ACLI, State Farm and Allstate have been leading proponents of OFC, while substantial insurers such as AFLAC, are opposed.

Recently, the NAIC surprised many by offering conditional support for OII, while still stating official opposition to OFC. This especially drew the wrath of NCOIL, which claimed a sellout. The current OII proposal would give NAIC a seat on an advisory council, composed of a wide variety of constituents.

The U.S. Treasury Department report was expected to cover recommendations for legislation to deal with the subprime mortgage crisis, but its broad extension to insurance and all financial markets was unexpected. Since then, several congressmen have assured states that their premium tax revenues from companies would not be touched. Since money to fund a new OFC federal agency(ies) would have to come from additional revenue sources, some critics have denounced these statements as untruthful.

In short, there are a wide variety of organizations favoring and opposing OFC. While the majority of small insurers are probably opposed to it, this attitude is not unanimous.

Implications of OFC—General

From either ISC or OFC, the hope among nationwide life and health insurers is that uniform product forms could be achieved, and approvals could be obtained in much shorter time intervals than currently. Today, products may take a year or more before sufficient approvals are obtained before going to market. New York State Insurance Department has apparently decreed that, for domestics, no product can be sold anywhere without its own approval (most states do not seem to require home state approval before they will approve).

One critic of a national approach pointed out that federal agencies such as the Food and Drug Administration are notoriously slow in approving new drugs. While the parallel to insurance products may not be exact, there is no automatic guarantee of insurance products coming to market faster, when federally regulated.

Auto premium levels are enmeshed in political pressures. Some critics have remarked that it is incredibly naïve for property/casualty companies to believe that OFC legislation would automatically allow market rates nationwide. They point to California, where a referendum was passed by voters that actually required blanket reductions in auto rates, regardless of whatever the prevailing market conditions were.

Implications of OFC—Accounting

Another possible question about OFC is the future of statutory accounting. In the early 1990s, the proposal from Congressman Dingell for a federal takeover of insurance apparently envisioned only a GAAP accounting framework. With current congressional proponents of OFC, there is no evident reason to assume this approach. If it did, for companies that wished to adopt OFC, but did not yet prepare GAAP financial statements (probably some small insurers), they would face the considerable expense of initial GAAP conversions.

If GAAP ever replaced statutory, what would be the basis for insurer solvency? Possibly, Risk Based Capital standards would be employed. Some of those standards are based today on statutory reserves, which might be modified to include PBR reserves.

Compared to other countries, only the United States has two sets of accounting for most life companies, statutory and GAAP. If OFC was ever adopted, there would be no automatic reason to change this situation. Some have predicted that international accounting standards (IFRS), including reserve standards, will replace US GAAP within a few years. The AICPA reported on 9/30/08 that the SEC has "...outlined a series of steps that could lead to the required use of IFRS by U.S. issuers by 2014." Even so, if that were to happen, there is no automatic reason for statutory accounting in this country to be replaced.

Today, the entire body of statutory accounting is codified and independent of GAAP. If PBR was adopted for statutory reserves, it could easily be integrated into the statutory accounting literature. Further, even if US GAAP were to disappear, statutory accounting, other things being equal, would remain viable.

Suppose the situation became more complicated, and US GAAP replaced statutory under OFC, and then IFRS replaced US GAAP. Current IFRS proposals for reserves have many objectionable elements. A description of such reserves would not match US GAAP, current statutory, or PBR statutory concepts. Dealing with IFRS and opposing its extension to the United States would be the basis for a separate article.

In any event, it is obviously very important to study in detail all aspects of any proposed OFC legislation, and to keep up on United States accounting developments.

General Implications of OFC for Small Insurers

Unlike Principles-Based Reserves (PBR), implications and impacts are much less clear. There should be no substantial start up expenses for OFC, other than analyzing and understanding the legislation. No revisions to reserve systems should be required for OFC as such—unless statutory accounting were ever replaced by US GAAP in some form.

A few years ago, anticipating some form of OFC, the ACLI developed its version of an insurance regulatory code. Basically, this combined all adopted NAIC Model Laws and Regulations, to apply nationwide. It should be remembered that many of these Models had not been widely adopted. Depending on the progress of OFC legislation, companies should make a comprehensive study of these Models, since their prior impact had often been minimal.

As for PBR, if the NAIC adopted a new Standard Valuation Law (SVL) before OFC, that included PBR, it might become effective, regardless of the extent of state legislative passage. If the Valuation Manual for PBR was still incomplete and being debated, it might become effective automatically under OFC.

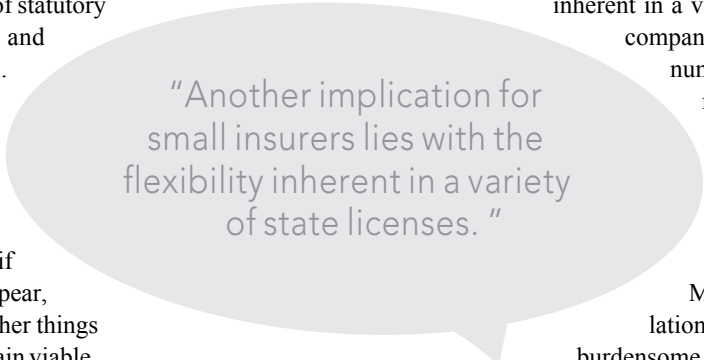
Another implication for small insurers lies with the flexibility inherent in a variety of state licenses. Some companies are admitted in a limited number of states. Sometimes, too much effort would be involved in expanding licensing. In other cases, certain states may impose regulatory burdens that minimize incentives to seek admittance. More to the point, if state regulation in one state becomes overly burdensome, arbitrary or similarly undesirable, companies can always exit the state. In some cases, they can even redomesticate to another state (the "vote with your feet" phenomenon). Obviously, this approach to onerous regulation would be impossible if a company had a federal charter.

Of course, the OFC is still labeled as "optional." Companies could retain the state licensing approach if they chose. Some have complained that the possibility of federal charters would create another version of an unlevel playing field, and give the latter type of companies an unfair advantage.

Legislative Outlook

Many have reported that a full House vote on OII or OFC will not be made until 2009, at the earliest. No Senate action at all on the Treasury report has occurred as yet. Passage of OII does not automatically mean adoption of OFC.

In the meantime, with the OFC resurgence, which has intensified since the recent economic crisis, small life companies should in any event decide on a position pro or con. If a com-



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pany is opposed, ACLI membership should not be helpful, since that organization is solidly behind OFC. Instead, insurers could ally with other trade associations, agency organizations, or rely on their own efforts.

Companies could write to Congress, giving thoughts on OFC legislation. They could also communicate with the NAIC, stating whether they support or oppose the organization's apparent attempt to compromise on the OII question.

Perhaps more important, if opposed, they could render support to NCOIL—through their own state legislatures—to maintain strict public opposition to OFC. If their own state has not yet joined ISC, they could pressure their state legislature to do so. Pointed references to the Treasury report's carping on ISC might help prod legislatures.

Summary

Together with PBR, a host of other NAIC models, the nationwide economic situation and other matters, OFC is now another development that warrants the concern and close attention of small insurers.

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