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RESTRUCTURING THE COST OF LIFE INSURANCE

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	WILFRED J. ROMERO*
Recorder:	MARK A. DAVIS

Can the cost of life insurance be restructured effectively? This session will focus on strategies employed in Canada and the United States to restructure costs. The topics will include:

- Levelized commissions/commission financing
- Joint ventures/reinsurance
- "Sale" of strain/loads
- Statutory liability review
- Effect of tax law changes (deferred acquisition cost, or DAC, tax)

MR. MARK A. DAVIS: Our panelists are Will Romero and Lynn Grenier-Lew. Will is an attorney in the tax practice of Tillinghast in Stamford, Connecticut. Lynn is an actuary in the financial reinsurance division at Crown Life in Toronto.

I thought I'd start out with why we are all here. Chart 1 is supposed to be a typical life insurance profit pattern for many of our products. I've actually designed it so that it corresponds to a 15% ROI, although it may not look it.

We're going to discuss some ways that we can go from the first profit pattern in Chart 1 to the pattern in Chart 2. I can think of a few easy ways to get there. One way would be to enter into a coinsurance agreement with perhaps heaped allowances, and I think we can move in this direction. Another way is to use minimum reserves instead of net level. And perhaps we've also altered our commissions by reducing the first-year commission and increasing the renewal. So we can lessen the first-year strain some. Maybe we can even go as far as in Chart 3 and get to a position that we'd all like to be in where we don't have any strain at all, at least not on paper. I suppose we could get to this position through the use of surplus relief reinsurance and perhaps some type or form of levelized commissions. With that introduction to what we're going to talk about, I'll turn it over to our first panelist, Will Romero.

MR. WILFRED J. ROMERO: How do you restructure or deal with the cost of selling or expenses associated with your life insurance products? My primary focus is going to be with acquisition costs, and I will discuss it in a U.S. context. I will leave it to Lynn to discuss the Canadian aspects of the same problem.

The first thing I want to point out is the tension between statutory and GAAP accounting. Generally accepted accounting principles allow you to capitalize and defer acquisition costs. So in one sense you really don't have a problem as far as your

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PANEL DISCUSSION

CHART 1

Life Insurance Profit Pattern

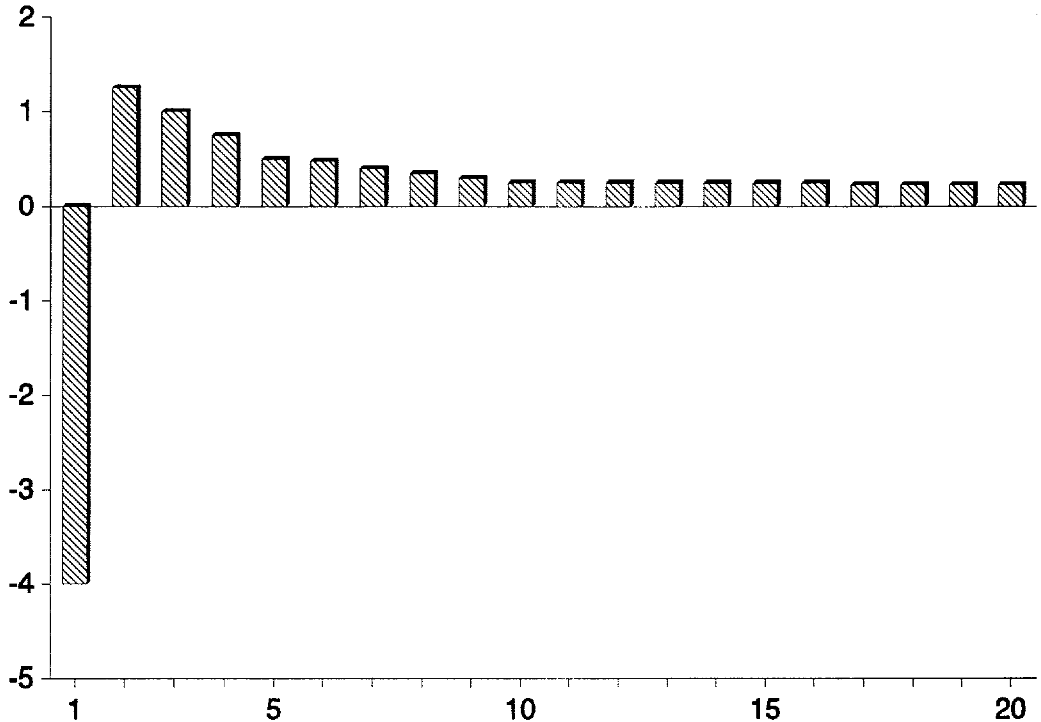
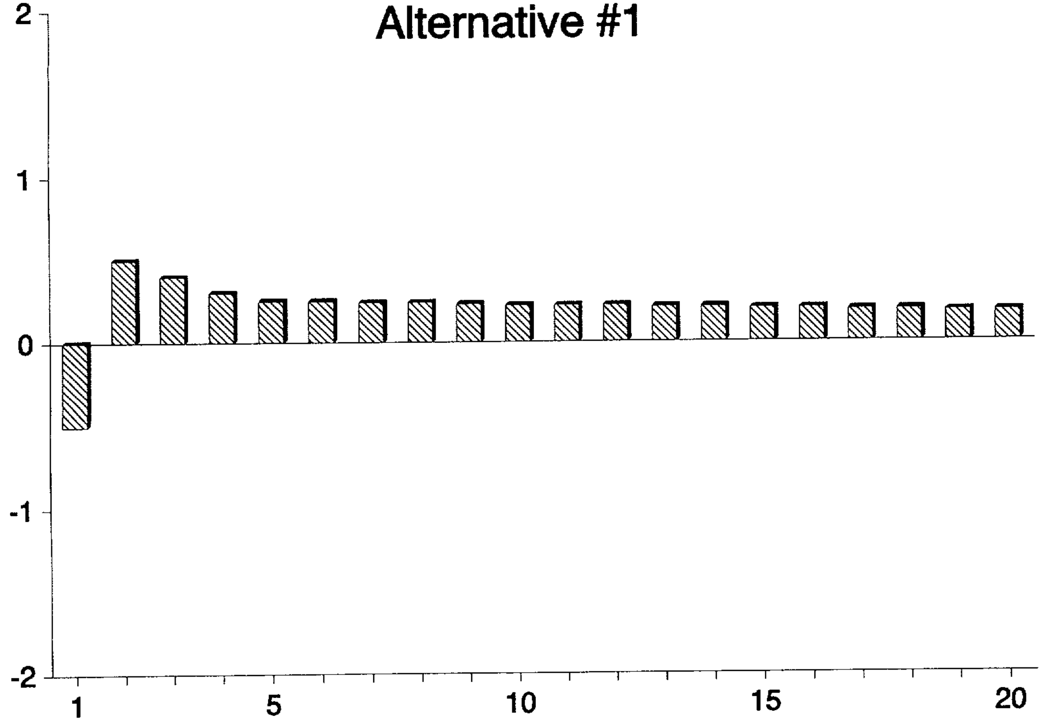


CHART 2

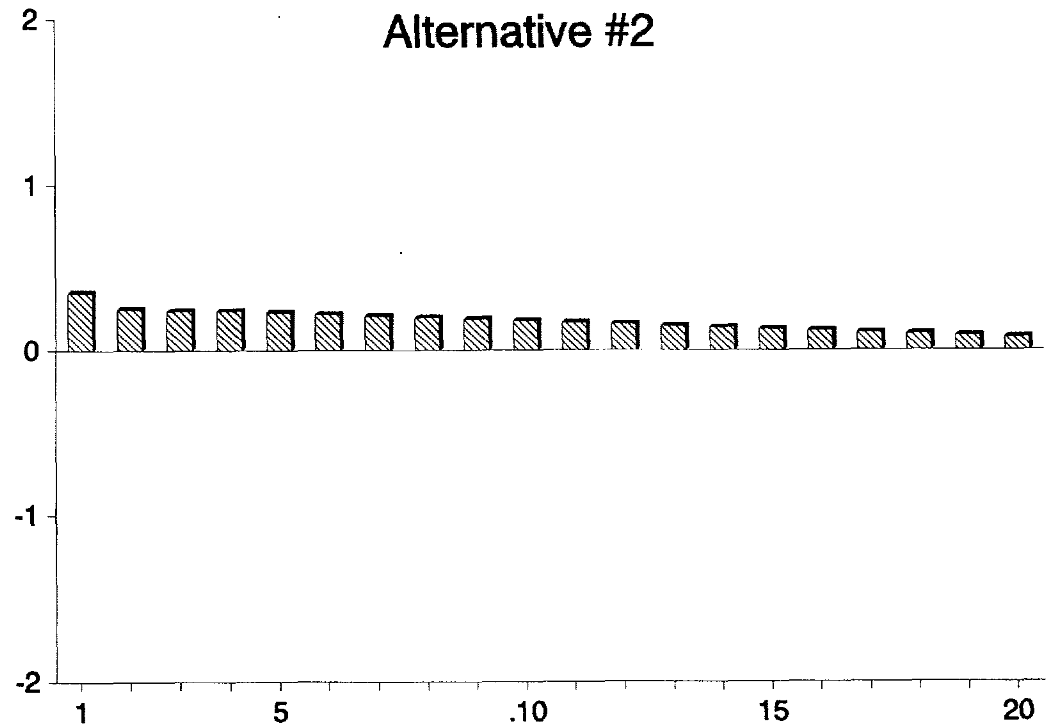
Life Insurance Profit Pattern



PANEL DISCUSSION

CHART 3

Life Insurance Profit Pattern



GAAP books are concerned. However, statutory accounting requires you to expense any expense item as it's paid. It's very rare that you're allowed to capitalize an expense under statutory accounting conventions.

For example, as has been much discussed at this meeting, the DAC tax, which really works like a current premium tax, does not in fact add tax expense on a current or deferred basis under GAAP. You essentially get to take a deferred tax benefit, in most instances, for the future tax deduction that you'll get for those acquisition expenses that you were forced to capitalize under DAC tax provisions. As you can tell by my comments, I will also take a kind of financial approach. I will really focus on the balance sheet and suggest items with which you can essentially dress up your balance sheet or build some kind of asset to offset the acquisition expense that you otherwise have to take on a statutory basis. So most of my comments I hope you take in a statutory/regulatory accounting context.

Generally you can do a few things with your acquisition costs. You can reduce them by lowering the cost of your distribution systems either by going to alternative distribution systems or lowering your commission rate, for example. You can also change your product design so that you include a fairly high surrender charge or lapse charge of some kind, and you can perhaps lower reserves on your product. Those are things I won't discuss in depth, but I'm just pointing them out as things that will reduce acquisition costs.

The things that I will discuss are ways to accelerate income in order to reduce acquisition costs. The typical way of reducing acquisition costs through income acceleration is reinsurance. In essence you sell a product, then you transfer some or all of that block of business to another insurer, which gives you some of the anticipated future income. That offsets some of the cost you incurred in the current period for selling that product.

Another way of reducing acquisition cost is to defer expenses. One mechanism for deferring expenses is through a tax-sharing arrangement with a parent company. The arrangement is one in which you would only pay a tax expense based on your GAAP income. Your GAAP income could be much lower than your taxable income. You've effectively saved the expense at the operating company level. Of course, the expense is being borne upstream, but you've saved the expense at the operating company level by having a smart tax-sharing agreement. There's also a certain amount of freedom in how you can write those tax-sharing agreements.

Tax-sharing agreements are only one category of expense-sharing agreements, and I discuss later how you can use expense-sharing agreements between a regulated operating company and various affiliates to essentially reduce the expense at your operating company level. Remember that the problem here is regulatory accounting. Elsewhere you can capitalize these expenses and put them up as assets on that (nonregulated) balance sheet. So if you can get expenses off of a regulated balance sheet, you can capitalize them.

The other focus area is transferring acquisition costs. Clearly you can transfer costs using reinsurance agreements. You can also transfer acquisition costs through various fronting arrangements. The new fronting regulation has been much discussed and will give a lot of companies problems if they do transfer more than 50% of their business to a reinsurer and that business is considered fronting under the new regulations. Fronting basically means that you use your distribution system to sell a product that's being underwritten by the assuming company.

The other way of transferring acquisition costs is through capital structure. There are certain types of equity or stock arrangements where you can issue a type of preferred stock or debt instrument such that the interest or earnings will be tied to the earnings of the product sold as a result of the capital raised by that particular stock placement. The real economics of the situation are that you've actually transferred the risk or benefit of that acquisition cost to the shareholders or the debtholders. They gave you the capital to underwrite that block of business.

What are the tools and techniques of restructuring the cost of life insurance? Reinsurance is the first and foremost recapitalization technique, and it includes some of the capitalization techniques I just mentioned. There are asset strategies that allow you to accelerate income or accelerate cash flows to better match your acquisition cost string. There are liability strategies that would include possibly reinsurance or restructuring your products to decrease the liability you have to put on the balance sheet. There are joint ventures and expense-sharing agreements. This would include the tax-sharing agreements I mentioned, and also an arrangement with a marketing affiliate that actually bears much of the expense of selling the product. That expense will be capitalized and become an asset on the affiliate's balance sheet, and it would pass to you, the operating company, just a level cost.

Let's turn to reinsurance. When you get into using reinsurance there are several problems and potential applications. First, there is the coinsurance/modified coinsurance problem in California, which deals with the new reinsurance regulation that is about ready to be adopted by California. There is also a new reinsurance model regulation coming out of the NAIC. This new model regulation is quite restrictive in some areas. The new regulation basically would eliminate the reserve credit on any form of reinsurance that takes its surplus relief in the form of a timing difference or a timing game. It would also eliminate the reserve credit if expense reimbursement from the assuming company does not equal or exceed the expense of the ceding company for any particular period in which the agreement is in effect. Also, the model regulation requires you to pass to the assuming company all significant risk in various stipulated sets of categories.

How will insurers lessen the impact of the new reinsurance regulation? I think the best thing I can tell you is, number one, there's fairly favorable treatment for YRT and various forms of nonproportional reinsurance. And it is not clear from the wording of the regulation that you actually have to pass all the risk in every single category. In certain instances the regulation doesn't seem to make any sense. For example, it requires you to pass all of the investment risk, whereas in a regulatory sense in the U.S. you could turn around and swap, through a notional principal swap, that investment risk directly back to the ceding company. Under the reinsurance regulation, you're supposed to pass all the investment performance of the ceding company on to the assuming company, but that assuming company could then write a notional principal swap and swap it right back and everything would be, in essence, kosher. It just doesn't make a lot of sense. I can't at this point really predict how the whole thing will turn out.

There are potential reinsurance venues that might be favorable. Outside the U.S. you don't deal with the problems of statutory accounting. International reinsurance may offer you an avenue of immediate relief. Likewise, what I call "installment reinsurance" is where the assuming company gives you the relief in the form of a promise, but it doesn't necessarily pay you the cash up-front. Because statutory accounting allows you to recognize the full value of that promise, you, in effect, have your surplus and have offset your acquisition cost in that first year. However, from a U.S. tax perspective, if that promise is properly worded, you can take installment tax treatment. One of the major problems with reinsurance for ameliorating acquisition costs is the fact that you have to recognize all that income the day you receive a ceding commission. If you receive that ceding commission in the form of a promise, you can spread that income as the actual cash payments are made under the installment reinsurance agreement providing you with a tax benefit.

Another potential avenue in the reinsurance area is bank finance reinsurance. By bank finance reinsurance I mean a foreign reinsurer that essentially can sell the future profit on the business it's assumed. What I'm making reference to here is all those techniques of sale of future-revenue, levelized-commission financing that essentially cannot be done in the U.S. regulatory environment, but can be done quite easily off-shore.

Finally, let's address affiliate reinsurance. Oftentimes an affiliate has lower acquisition costs, and it might be appropriate to move the business to an affiliate that has lower statutory capital requirements or less concern about its capital level. The point I'm trying to make is that a direct writer needs a fairly high capital or surplus to asset ratio for rating purposes. But as far as a reinsurer is concerned, it may be more willing and able to take the surplus strain. It may make sense to move that block over to an affiliate that doesn't need essentially that same kind of capital support. Now, this whole area will change with the pending reinsurance regulations at the NAIC level where the NAIC is looking to enhance the surplus levels and increase the minimum surplus levels of all reinsurers in the U.S.

The next tool you have is recapitalization. Recapitalization basically involves acquiring some kind of capital to offset the acquisition costs or the expense that you've just paid out. This could involve what I call "tracking" preferred stock. Another typical way is to use surplus notes. In other words, find an investor who will put in capital and then take a rate of return over time based on the performance of the underlying block of business that was just sold with that capital. I should mention here the pending surplus note regulations that would not allow surplus notes to be considered equity for statutory reporting. Currently, surplus notes are considered debt under GAAP but equity under statutory. This would severely constrain the use of surplus notes for any purpose in the U.S. regulatory environment.

Another way to add capital would be through stacking. You can stack various non-insurer companies underneath your life insurance company and add capital. Remember that you carry your subsidiaries at GAAP book value. That means that various capitalized expenses in your noninsurer subsidiaries will be real assets in the insurer parent.

The final technique is the use of intercompany debt. There are several financing techniques that allow you to create assets on your life insurance company balance sheet by using intercompany debt, where the debt, in fact, is incurred upstream at the parent company level. If the debt is a promise to pay the insurer subsidiary, then the insurer subsidiary actually gets capital out of the deal. For example, most people don't realize that a pure promise from your parent to pay you, the insurance company, is a good asset in the U.S. statutory environment, as long as there is a sufficient assurance that particular note will get paid. In other words, if it's guaranteed by a bank, then that should be a good statutory asset.

As to asset strategies, one strategy that is overlooked is the sale of nonadmitted assets. In fact, one of your major nonadmitted assets in a statutory sense would be your deferred acquisition costs and I'll get into that later. There are various kinds of asset swaps where you swap appreciated assets and recognize the book gain yet essentially you don't give up the asset. You swap it back into like assets and recognize the book gain without really selling them. I think this is an excellent technique.

Another investment strategy is to invest in tax-favored assets. What most people don't realize is that market discount bonds, although they are book income for statutory, are not book income for tax, so they make a nice tax-favored asset. Securitization allows you to package up your mortgages and bonds and basically sell them. This could allow you to accelerate some income. It allows you to also do certain amounts of coupon stripping. There are notional principal contracts, which allow you to hedge out liabilities. One popular technique is to do uneven swaps, that's where the insurance company promises to pay fixed at say 7% and the other party promises to pay you the London Interbank Offered Rate. There is a market value difference on day one and one party pays the other for that difference, saying, "Okay, you're really promising to pay at the outset higher than what I'm promising to pay, so I'm going to give you a lump sum today." Generally the amount that's prepaid there goes directly to the surplus. And if it's done in the right hedging environment, it should be kosher.

I think Mark briefly touched on the reserve review which is a liability strategy. What that essentially means is you go through all your products and you review the reserves and your reserving techniques. And oftentimes you'll find that you could save some surplus or some acquisition costs by that reserve review. Likewise, and this is a subcategory of reinsurance, you might be able to engage in a liability swap and swap into a liability which better performs vis-a-vis your asset portfolio and save some cost or some strain.

The final tool that I want to mention is joint ventures or certain expense-sharing arrangements. Since statutory accounting treats a life insurance company as a stand-alone, separate entity without consolidation, you can oftentimes achieve expense savings through various sharing arrangements with noninsurance company subsidiaries or affiliates. For example, you could have a tax-sharing agreement or a levelized commission agreement with a real marketing company affiliate. Finally, you can also achieve some real cost savings by sharing various operating systems with other companies and by certain pooling arrangements. We've seen all these things happening in the U.S. marketplace.

I would like to point out some of the regulatory constraints on reducing your acquisition costs. Some of the techniques I've mentioned involve the sale of future revenue. As we all know, in September 1989 the NAIC essentially outlawed that as being surplus enhancing. However, it didn't say that you could not engage in those agreements. One of the points that I'd like to make is that the sale of future loads or future revenue may be a good technique for adding to liquidity. It may not add to statutory surplus, but it will add to liquidity. In other words if you need cash, you could go out and sell future loads and get that cash.

The second item is levelized commissions. In 1990, the NAIC outlawed various levelized commission agreements. What the NAIC basically said is any commission arrangement that is not linked to traditional elements such as premium and policy persistency will not be recognized. If you in fact have a real marketing company affiliate and have a levelized commission agreement, that should still be a valid arrangement under that regulation.

Inherent in all of my discussion is the fact that statutory accounting in the U.S. does not recognize prepaid expenses. There are exceptions to that and I hope that the NAIC will recognize that the prepaid tax expense due to the DAC tax should probably be an admitted statutory asset.

MR. DAVIS: I want to talk about many of the things that Will was discussing, but perhaps from a different perspective. Let us now put on the hat of our local state regulator. I would say that the regulatory climate right now is a little cold and conservative at best. The reason for that is obviously the states are under a lot of pressure right now to regulate more effectively. There is pressure from the federal government. The states also have political concerns and budgetary constraints. So it's a tough time right now for state regulators of insurance.

I can't think of too many favorable rulings recently or approvals for things that were new or novel. All of the recent original ideas such as selling policy loads for cash and the levelized commission financing agreement have been disapproved ultimately at the NAIC level, or at least the surplus enhancement was disallowed. So I think that it's safe to say that the state is going to look very closely at it anything you're doing that is, let's just call it clever. I would always recommend that with anything you're considering that you're not too sure about, you always try to get advance approval from the state of domicile or at least find out in advance what its reaction is going to be. I would never recommend that you try an end run, so to speak, around the state.

First let's discuss the sale of future revenue. I believe this first happened in 1989 with Washington National. I think General American in St. Louis did a very similar thing. Washington National took policy loadings, that is, the difference between gross and net valuation premiums, and sold them for cash. The reason they did that was, I think, to enhance surplus, but another possibility is that it would increase liquidity. Liquidity increased because they exchanged some revenue in the future for cash now.

The NAIC came out and ruled that this will not be permitted in the future to the extent that you get surplus enhancement. The NAIC didn't say you couldn't sell policy loadings, but the NAIC said you won't get the surplus enhancement that you want. Instead of increasing surplus, you are required to set up a liability and reduce that over time, so you really won't get the balance sheet effect that you were looking for. But as Will said, you could still get the cash up-front, perhaps for some special investment that you want to make or just to improve your liquidity.

It's interesting that the reason given by the NAIC for not approving these types of arrangements was that they are inconsistent with statutory accounting principles. The NAIC seems to say that a lot and that's it. There's no explanation of where the arrangement is inconsistent or a statement that it's inconsistent in the following ways. It's just inconsistent and that's final. I think these pronouncements are evidence of the fact that state regulation is under a lot of pressure and by approving "deals" or whatever we want to call these, the states are essentially sticking their neck out if something bad were to happen. Then you may have the federal government coming and saying, I told you so. I think this pressure is driving a lot of the states' reactions right now.

Next we have levelized commission financing. The key word here is financing. This involved the Massachusetts Indemnity and Life Insurance Company (MILICO), which is the company that the A.L. Williams General Agency writes business for. It did not simply switch to a levelized commission arrangement with its agents. MILICO set up a type of financing arrangement. Essentially, an independent third party was established, and MILICO paid level fees to this third party which was called Mapleleaf. Mapleleaf was a limited partnership of which MILICO was the only partner.

Mapleleaf paid commissions on the regular basis to the agents. Mapleleaf borrowed money from banks to get started. This arrangement was structured so that the agents had absolutely no recourse back to the insurance company. For a company writing large amounts of new business, the arrangement was quite a surplus enhancer.

The company was very smart in the way it went about seeking approval for the arrangement. It had various legal opinions. It was very up-front with the Massachusetts Insurance Department, which is MILICO's state of domicile. The Massachusetts Department also had legal opinions, actuarial opinions, and everything like that, and Massachusetts approved this transaction. Subsequently, however, the NAIC looked at the transaction, and in spite of all these favorable opinions from actuaries and attorneys, the NAIC decided that this type of commission financing would not be permitted. So although the original agreement did get grandfathered in, levelized commission financing of this type would not be permitted. It's not that the arrangement isn't permitted, but that the surplus enhancing features of the level commission payment could not be recognized -- commission expense would be that paid to the agents.

This was not really a typical levelized commission structure resulting from switching your agency force over to a level commission structure. This was a little bit different. The agents still received the money the way they normally did, however, the company was paying it out a bit differently. And for that particular company, since it does write a lot of new business as you all know, the commission structure was quite a surplus enhancer in that first year, because MILICO was paying out perhaps a 20% of premium commission to Mapleleaf, whereas normally for new business it must pay something like five times that amount considering all the overrides contained in the A.L. Williams structure.

Will talked about reinsurance and surplus relief reinsurance. I'd just like to say a few words about surplus relief. I think in years past some regulators weren't very concerned with surplus relief reinsurance or didn't know about it or weren't aware of it. Well, I'd say they are keenly aware of it now. The state of California, by an insurance department pronouncement, essentially has disallowed all surplus relief reinsurance. I understand that is not a law but a department position. It is not a law in California, at least not yet. Will discussed briefly how California is considering that and it's pending now, isn't it?

MR. ROMERO: Yes.

MR. DAVIS: If California disallows all surplus-relief-type transactions, I wonder what the other states are going to do?

You may or may not be aware that there is a new model regulation at the NAIC level entitled, "Life and Health Reinsurance Agreements." It essentially says that you will not be permitted to take reserve credits unless your treaty conforms to nine specifications stated in the model regulation. And they're quite restrictive. Will mentioned one of them, which is that you have to pass on the investment risk for the business that's reinsured. I can talk more about those during the question and answer period if somebody wants to know all nine provisions. I have them written down. But it's really going to change the reinsurance structure.

Another thing about the way the model regulation is worded now is that for all existing treaties, a window of time will be given, perhaps six months or something like that, where the treaties must be restructured to conform to the new regulations, or you will not be permitted to take the reserve credits. If that model regulation ultimately is enacted by state legislatures, I think it would change the reinsurance game significantly.

Surplus debentures or surplus notes, unlike some of the other things we've been talking about, seem to be a friend of the regulators. They seem to like these arrangements. Surplus debentures are interesting because, in my opinion, they get favorable and perhaps inconsistent treatment with the way that other things are considered for statutory purposes. Essentially, the way a surplus debenture works is that a parent company passes money down to a life company in exchange for the surplus note. The life company augments its surplus by that payment, but there's also an agreement at that point that the life company will pay back the note out of surplus as surplus exceeds a stated amount. So if you start out with $200 million in surplus, and you have a $20 million surplus note, you may have it in the agreement that the life company will pay back the $20 million when its surplus exceeds $200 million. So if the surplus never goes above $200 million in this case, the surplus note does not pay down. But if surplus does go above $200 million, it's required to pay back the note.

Now for statutory purposes, the liability is considered contingent: you don't have to pay back the surplus note unless your surplus exceeds a certain amount. You don't have to establish a liability. If you think about it, you see that surplus is created out of thin air through the use of surplus debentures or surplus notes. The parent company will hold the note as an asset on its books. Surplus debentures have been very popular in many acquisition situations. Some of the big acquisition organizations that have large holding company structures and use the ladder approach to pyramiding their companies often use surplus debentures.

It's interesting that for GAAP purposes surplus notes are considered debt and for statutory purposes surplus notes are considered equity. That doesn't seem to make a lot of sense to me. But regulatory approval has been given for surplus notes, and I think they're still permitted, although there is some action at the NAIC right now that may produce a new regulation concerning surplus notes.

I'd like to speculate a little about what impact the valuation actuary concept, the appointed actuary, and cash-flow testing will have on the standard valuation law. Right now the only impact is the requirement that you must assess whether the assets backing the reserves are adequate. But I'm wondering if certain reserves, such as deficiency reserves, for example, could be eliminated if you can prove through cash-flow testing that you really don't need these reserves. Other miscellaneous reserves in Section G of Exhibit 8 on the Annual Statement would also be candidates. I'm also wondering whether, in the future, prescribed minimum reserves can be abolished or done away with allowing the valuation actuary to set reserves as he or she feels appropriate. This is the way it is done in Canada and in Great Britain and in most other countries of the world where there are no prescribed minimums. I'm just speculating here that, should our reserving change in that manner, I think that could have a tremendous impact on the structure and the cost of life insurance.

I don't think changes to the Standard Valuation Law are likely in the near future, say up to five years, because we move ahead very slowly as an industry and we've just now got the concept of the valuation actuary in place. It would be expecting quite a lot to see the reserving basis for minimums change that quickly. But I think ultimately there will be some change.

Now we move on to a favorite topic of mine, the Standard Nonforfeiture Law. I think if the nonforfeiture law was changed or repealed, it would certainly have a tremendous impact on the cost of life insurance, and it could also lead to a product revolution. It's interesting that the U.S. is the only major insurance market that has mandated minimum values for certain types of products. Canada does not have minimum cash-value requirements. Neither does the U.K. I think both of those countries have a very healthy life insurance industry.

I think that by having minimum cash values, the Standard Nonforfeiture Law forces agents and policyholders to make short-term comparisons when looking at different products. I really think that, if any policyholder is looking at what the fifth-year cash value is for a permanent life product, he's really buying the wrong product. If you're even looking at what the fifth-year cash value is, at that point in time you're contemplating doing something with that policy other than continuing it. If a policyholder is even thinking about that, I think he's buying the wrong product. But I believe that mentality is forced by having the minimum cash values. In the absence of minimum cash values, perhaps policyholders buying permanent insurance would focus more on long-term values, because those are the key values that should impact the decision-making.

What kind of products could we have if we didn't have a nonforfeiture law? I'm going to tell you about a product similar to some of the products that I've seen in the United Kingdom. There they have a variable life product, which is called "unit linked." It tends to work like our universal life product, except that in the absence of a nonforfeiture law, it often has a very heavy front-end load. Some of the products in the U.K. can have 100% front-end loads for three or four years and then they break even.

For an article that I wrote a couple of years ago, I developed three products, a back-end-, and a front-end-load, U.S.-style universal life, and a universal life product more similar in design to the U.K. unit-linked products (Table 1). What I did in developing these products was equate the present value of profits, that's the constant between the three products. The U.S.-style UL products are plain vanilla as much as possible. For the U.K.-style product, I solved for the front-end load, which provided the same present value of profits as for the U.S. product. It turned out to be a 100% of premium load for the first two years and about 66% of premium in the third year. After that, the U.K.-style product operates on a break-even basis, so it makes all of its profits in the second and third years. It's interesting to have such a high internal rate of return, but as I just said, all the profit is returned in years two and three, so you're really up-fronting the profit compared to U.S. products.

TABLE 1
UL Product Comparison

	U.S.-style Design		
	Front Load	Back Load	U.K. Style
Profit Margin	9%	9%	9%
IRR	18%	16%	94%
Breakeven Year	13	13	2
Account Values			
Year 10	7,997	8,731	6,808
Year 20	22,880	23,238	24,696
Year 30	47,343	47,006	65,515
Year 40	99,592	98,480	171,915

With that heavy front-end load, you can see that, initially, policyholder account values are reduced. If we take a longer view, the U.K. product account value passes the U.S. products in about year 18.

Now let's look even longer. Because the U.K. product is on a break-even basis after the front-end load expires, by year 30 the account value is some 40% higher than for typical U.S. products. If we go way out to 40 years -- that's a long time to make a comparison -- the account value is now 70% higher. This is a vivid example of how we can provide policyholders with long-term value, if with no minimum values. We get a break early on, and we're not on the hook for 10 years or so before we get a return on our investment.

Here's the profit pattern for the U.K.-style product (Chart 4). We still have a big loss in the first year. But in the second and third year, we have this big gain and that's it. Essentially, it's just break-even after that. I think this profit pattern is certainly more acceptable to us than the traditional one where relatively small annual profits are returned to us over 20 or more years.

It would be interesting to consider the changes such products would bring to our industry if they flourished. For instance, I think it would have interesting implications for appraisal values. Actuarial appraisal values consist of statutory capital and surplus, value of in force, and the value of new business or existing structure value. The latter is also known as goodwill, and it represents an insurer's ability to profitably produce new business. The value of in force is usually the biggest component of an appraisal value. But if we all had these U.K.-style products, the present value of future profits on the in force wouldn't be that great since all the profit is returned in the first few years. However, the existing structure value, the third component, would be impacted tremendously assuming you had good marketing and distribution. Once business is sold, all the profit is only a few years away. Another change would be the capital structure. I think the industry would be able to attract capital much easier than it can today.

I'll leave with one interesting thought. With a product such as this, if you were to GAAP it under SFAS 97, you would capitalize those front-end charges and then amortize them over the course of the contract. This actually came up in a job that I was working on for a U.S. subsidiary located in England that has this kind of product. The strange thing is that strict application of SFAS 97 to this type of product produces GAAP results that are more conservative than statutory.

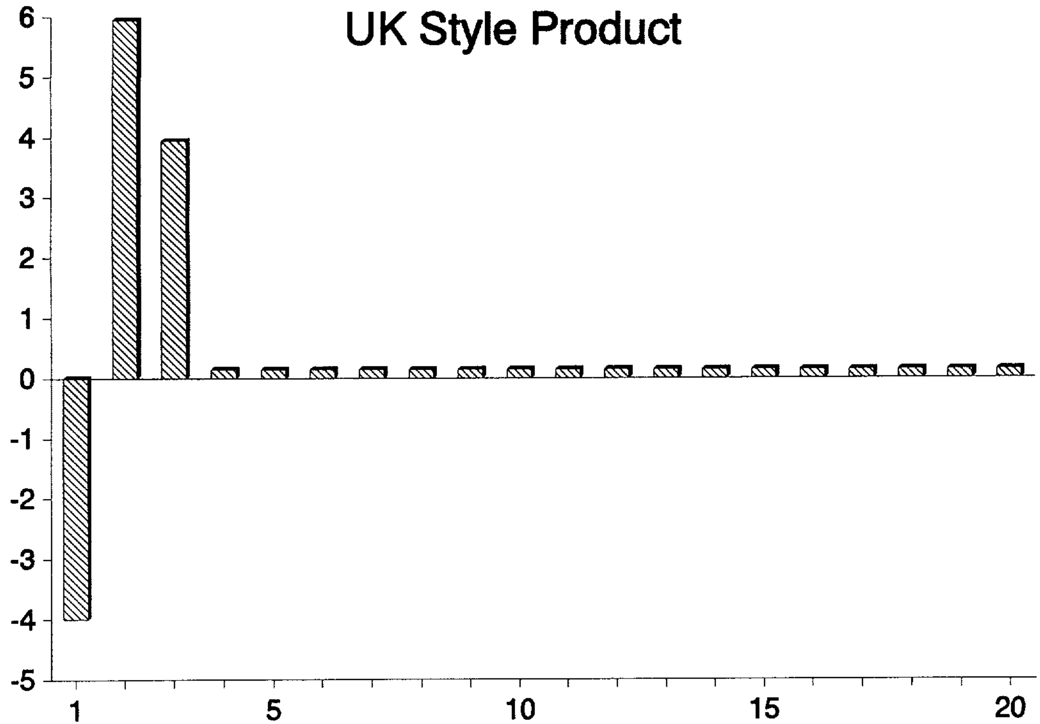
MS. LYNN C. M. GRENIER-LEW: I am here to talk to you about what's happening in Canada. I'm going to begin by pointing out some important differences between Canada and the United States. All of you are familiar with statutory or NAIC reserves and the Annual Statement used in the United States. Reserves and the Annual Statement in Canada are different in many ways. Many companies in the United States file two sets of statements, a statutory statement and a GAAP statement. In Canada we only have one set of statements. They are called our statutory statements, and they're probably more similar to GAAP than anything else.

In the United States, high acquisition costs produce surplus strain. Current Canadian valuation requirements permit partial deferral of acquisition costs. The limit on the amount we're allowed to defer is 150% of the net valuation premium. The result is some surplus strain, although quite a bit less than what you would get under an NAIC valuation.

This method of valuation in Canada is on the way out. Last June 1991, Bill C28, a new insurance Act, was tabled in the House of Commons. Bill C28 states that insurance must be valued using GAAP principles, and the artificial deferral limit of 150% of net premium is no longer there. The Canadian Institute of Chartered Accountants, with the help of the Canadian Institute of Actuaries, defined GAAP to

CHART 4

Life Insurance Profit Pattern



be the policy premium method, referred to as PPM. Companies expect to use this method of valuation effective January 1, 1992.

The PPM is a method whereby the policy benefit liability is set equal to the present value of policy payments after the valuation date less the present value of policy premiums, if any, payable after the valuation date. Policy payments are defined to be guaranteed benefits, policyholder dividends, and nonguaranteed nonforfeiture benefits. I'd like to point out here as Mark mentioned that we don't have guaranteed cash values, which is why they're called nonguaranteed nonforfeiture benefits. Policy payments also include benefits that have become established concessions, issue, administrative and investment expenses, and all cash flows resulting from any reinsurance agreement in effect for the policy.

Now I want to emphasize here that only policy payments after the valuation date are included in the valuation. Acquisition expenses that make up what we call the DAC are not part of the PPM valuation calculation. Policy premiums are premiums or other revenues payable under a policy. Assumptions should be appropriate to the total circumstances of the company as assessed at the valuation date and should be determined prospectively at each valuation date in the context of current experience. Provision for adverse deviations should define a margin for adverse deviation in each assumption to add a provision to the liabilities. The provision is for misestimation of the mean and deterioration of the mean. It is not meant to cover statistical fluctuation, catastrophic or similar major, unexpected events.

So what does this produce in reality? Well, let me ignore reality for a moment. If you assume the product is adequately priced, i.e., the premiums are sufficient to pay for expected policy payments, and if actual equals expected for the entire duration of the policy and if the provisions for adverse deviations are set to zero, then the first-year reserve will be negative, income in the first year will equal expected profit, and income in renewal years should equal zero. I'd like to go back to the negative reserve for a moment and point out that, under U.S. GAAP, the DAC is an asset. In Canada it ends up being a negative reserve, not an asset.

Now, in reality this will never happen, and what I've just described is not by any means the complete story. There are many issues to resolve before PPM can be put into use and practice. The major points I'm trying to illustrate are that the PPM valuation method does take into account all future cash flows, including reinsurance. It does give relief to surplus strain, provided that strain is recoverable and expected profits or something close to them emerge at issue.

PPM gives relief from surplus strain, but there are still very real constraints on growth. Cash flows and surplus appropriations are realities we still have to live with. The difference between the cash value and the reserve must be appropriated on our balance sheet. One result is that any negative reserves result in surplus appropriations. For somewhat obvious reasons, if your capital plus free surplus is negative, you do have a problem. Surplus appropriations, capital, and free surplus all have an important effect on the minimum continuing capital and surplus requirements calculation, which is something that I'm not going to discuss here, but it is another requirement that Canadian companies are going to have to live with.

Now that I have briefly discussed Canadian valuation, I'd like to get on to some of the topics that you were expecting to hear more about. There are basically two ways of helping your acquisition expense problem. One is by delaying the expense and the other is by reducing the expense. There is reduced strain under the current valuation method and potentially no strain under PPM, so methods such as sale of strain, commission financing, surplus relief, and securitization that have been used in the United States are pretty scarce in Canada. Most typical U.S. surplus-relief-type transactions would be ineffective under this type of valuation.

Level commissions do have some advantages. Assuming their present values are equal, a high first-year commission pattern versus level commissions would have the same income pattern under PPM. Level commissions, however, would help reduce the surplus appropriations and improve cash flows. I know of one Canadian company that has converted to level commissions and some others are now offering the choice of level commissions or the traditional structure. Only well-established salespeople really have the option of choosing level commissions.

Other than commissions there isn't a lot of opportunity for levelizing expenses, and for most companies the problems associated with the high cost of growth have to be solved the hard way, by reducing expenses. The introduction of saliva tests in Canada by Crown Life in May 1991 did away with many blood and urine tests. The saliva test is administered by the agent and it tests for HIV, nicotine, and cocaine. The number of tests available for saliva will increase in the future. This change is significantly decreasing our underwriting costs. Unfortunately, the saliva test is having problems with the FDA in the United States, and this could jeopardize or slow down its use in North America.

Reinsurance and joint ventures can also be used to reduce expenses. Companies can take advantage of other companies' strengths and efficiencies in areas such as field force, product design, system design, and underwriting. One example I always like to use is universal life. Systems needed to administer universal life are a lot more complicated and costly than ever needed before. You may think you are large enough to have your own system. For traditional life, you probably are. For universal life, you probably aren't.

Breaking from traditional distribution systems can also reduce expenses. Direct marketing in Canada has been growing in the last few years. There are two major new types of programs. First, joint arrangements between a bank and an insurance company are currently popular. In 1990, Crown Life and the Toronto Dominion Bank joined forces, and they have been very happy so far with the results. The second new type of program is to direct market to all of your existing policyholders. The product is typically an add-on rider like accidental death. The original agent receives a commission, but much less than if he had sold the rider himself.

Those are just a few of the things that I've chosen to talk about in terms of reducing expenses. The Canadian valuation methods do give us a lot of advantages in these areas over what you must do in the United States. When PPM does come in, we will no longer have a strain problem on the income statement. As far as the balance sheet is concerned, I guess there is still some strain there, and reducing expenses is probably where most of the emphasis is going to be in Canada.

PANEL DISCUSSION

MR. DAVIS: Now, we have some time for comments or questions.

FROM THE FLOOR: I just want to comment on the items mentioned with respect to reinsurance. A comment was made that regulators may not have been aware of surplus relief reinsurance. I think it's safe to say they were. New York had adopted its surplus relief reinsurance regulation back in 1984. The NAIC had a model regulation that was adopted in 1985. That is part of the package for model regulations that states must adopt or substantially adopt as part of their accreditation process. So the regulators as well as the industry are keenly aware of that.

The second item mentioned was that California outlawed surplus relief earlier this year. The notice that was sent out dated April 15, 1991 was a notice to outlaw one form of surplus relief reinsurance. That's coinsurance/modified coinsurance which unfortunately was the only form that administratively California had approved in the previous years. So technically California hasn't disapproved surplus relief, although administratively it has. Therefore, when the NAIC came out with this draft model regulation two or three weeks ago, we kind of looked at it as a victory. At least we know what the rules are that you can play along with. The industry advisory committee met in Washington, and we have since spoken with a representative from the California Insurance Department and pointed out certain weaknesses in California's position. We seemed to have some understanding that California would perhaps consider delaying the enactment of the California regulation. There's no guarantee what will happen, but at least we made contact. We pointed out some of the deficiencies. The advisory committee is working on a response, with comments to be received by the end of October or early November 1991, so that by the NAIC meeting in Houston in December we would have something in writing responding to the regulators.

MR. ROLF H. RUNNING: Mr. Romero mentioned there was some latitude in tax-sharing agreements between subsidiaries. Could you comment a little bit further on that?

MR. ROMERO: Generally the rule of thumb, and each state has its own rule, is that the tax-sharing agreement cannot be any more onerous on the operating company than charging it an expense equal to its statutory income. In other words, if you, in fact, under your tax-sharing agreement, charge your subsidiary a current tax expense equal to its GAAP income, that's a much lower expense, and that's permitted. What you're essentially doing is taking out the timing difference, the timing difference being your deferred acquisition costs. So, in essence, you can use tax-sharing agreements to inject surplus into your operating company, because you've reduced its tax expense.

You can get a little bit more sophisticated, and I've seen fairly sophisticated agreements that take into account various consolidation benefits. What I mean by consolidation benefits is the tax benefits from filing a consolidated return. The net tax expense of the operating company would be its net current tax expense on a GAAP basis, net of various consolidation benefits. So, in fact, you radically reduce the tax expense of the operating company and essentially give a benefit equal to 34% of the timing difference represented by the DAC.