Article from:

# The Financial Reporter

February 2000 – Issue 41

# Caribbean Seminar Co-Sponsored by Financial Reporting Section

*by Michelle Chong Tai-Bell*

A seminar on Financial Reporting in the Caribbean in December 1998 — who came up with that great idea? Credit goes to Shirley Shao (then chairperson of the Financial Reporting Section) who might be accused of having an ulterior motive were it not for the fact that she was unable to make the trip to the Caribbean due to conflicts in her schedule. Shirley also initiated the original seminar that was run in Asia earlier in 1998, then followed by one in Argentina.

In response to Shirley's letter offering to put on the seminar, I made contact with her in my capacities as then President of the Caribbean Actuarial Association (CAA), chairperson of the International Section and member of the organizing committee of the 1998 CAA Conference. A few more telephone calls and many e-mails later — the seminar entitled "Facing up to the Risks" became a reality at the Trinidad Hilton hotel on December 2, 1998. The Caribbean seminar, the third in the series, was jointly sponsored by the Financial Reporting Section, the International Section of the Society of Actuaries, and the CAA.

## Caribbean Environment

This initiative by the Financial Reporting Section was seen by the CAA as a welcome opportunity to create a forum for discussion by Caribbean professionals about the risks that we face, approaches to quantifying these risks, the role of reserves, capital and surplus in funding for these risks, and the professional responsibility of the actuary. Furthermore, against the backdrop of the turmoil in the Jamaican banking and insurance sectors, the need became obvious for debate among actuarial professionals about what framework needs to be put in place to make for a stronger Caribbean industry and to safeguard the reputation of our profession.

We Caribbean actuaries practice in an environment characterized by volatile economic conditions, increasing competition from outside players, relatively unsophisticated financial markets, out-dated financial regulation, ineffective enforcement, and a typical corporate culture of *laissez faire* governance. It is my belief that this state of affairs calls for us to take up the challenge and be proactive in seeking necessary changes to our systems of risk management and statutory financial reporting.

These changes must recognize the interests of the policyholders, the shareholders, and the responsibilities of the regulators, the actuaries, and the auditors. It is for this reason that we made a special attempt to encourage the attendance of persons within the accounting profession and of our regulators. We felt that exposure of these interest groups to the regulatory environment in North America, particularly the evolution of the various approaches to measuring solvency and the role of the actuary, would be invaluable in our efforts to influence the change process.

Having briefed Shirley about some of our objectives, she put together a fine slate of speakers in John Castellino, Jeffrey Harper, Carl Harris, Richard Labelle, Phillip Whittaker and Bob Wilcox.

The one-day seminar was organized as the kickoff session of the Caribbean Actuarial Association's 1998 conference.

## Risks Faced by Insurers

Jeff Harper began by giving an excellent review of the C-1 to C-4 risks faced by insurers. He also gave a brief overview of how cash flow testing is used to measure and analyze some of these risks. He outlined how the U.S. economic and insurance environments changed over the last three decades and how the regulators, industry, and actuarial profession dealt with these changes. Of particular in-terest to me was the discussion about the evolution of required Actuarial Opinions and the role of Actuarial Standards of Practice and Practice Notes in the effective operation of such a system based on actuarial judgement.

John Castellino, drawing on his decades of experience with the primary reinsurer in the market, then gave an overview of the Caribbean environment. His provocative presentation discussed the key risk exposures of insurers in the Caribbean and his view of the inadequacies of the current management and regulatory processes to identify the risks and manage them in a prudent manner. He pointed to the fact that like in North America, not withstanding the youthful age profile of the Caribbean, Caribbean insurers have changed their main role from a provider of insurance protection to that of a financial intermediary. Equity linked and interest sensitive products are the norm. In this new role, the C-1 and C-3 risks predominate particularly given that:

- Many Caribbean insurers have substantial holdings of real estate and equities in their general account.
- Capital markets are small with little opportunity for diversification.
- Local economies are driven by one or more major industries; e.g., tourism in Barbados, tourism and bauxite in Jamaica, and petrochemicals in Trinidad. This creates a highly volatile market environment for investments.
- Inadequate supply of sound investments that not only can provide attractive returns to compete effectively with other financial institutions but also can

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provide necessary liquidity if policyholders rush to cash out.

- Available investments in real estate, mortgages and unquoted private companies tend to be illiquid.
- Many insurers see themselves in the role of investment management companies setting up holding companies or other similar structures that acquire major stakes in many sectors of the economy. The life insurance company that forms part of such conglomerates is often used as a major funding vehicle for these acquisitions. This often results in some life insurers having a significant portion of their assets in a single investment holding in a company mainly to exercise control over that company.
- Some major insurers are using funds generated under interest sensitive products with attractive rates and liberal cashing-out provisions, to finance acquisitions or take large equity positions in companies — as well as make long-term investments in real estate.
- Some major insurers have taken on foreign currency loans, as these borrowings have been at interest rates much lower than is available in the domestic market. While these funds are typically intended to finance investments in projects that generate foreign currency earnings, there is the danger these earnings will not meet the level necessary to service the borrowings.

Castellino was of the view that liquidity, or lack of it, is probably the biggest future threat facing Caribbean insurers. He questioned whether Caribbean regulators have adequate resources and access to proper advice or skill sets necessary to cope with the diverse business interests and complex corporate structures of Caribbean insurers. He also advised that the fiduciary role and responsibilities of the board of directors, external auditors and actuary of the company needs to be defined under law and their powers enhanced to ensure that the proper framework exists for the prudent management of insurance companies. In addition, the regulators need to ensure that acceptable investment guidelines exist for every company and monitor them for compliance.

## Valuation Systems

The various valuation systems were discussed next. Richard Labelle gave an overview of the three elements of the Canadian system: the Policy Premium Reserve (PPM) method, Minimum Continuing Capital and Surplus Requirements (MCCSR) and Dynamic Capital Adequacy Testing.

Bob Wilcox reviewed the U.S. valuation system by describing the role of the various elements: Formula Reserves, Risk Based Capital and the Appointed Actuary. He also gave us an insight into the possible future direction of the NAIC toward expanding the role of the Appointed Actuary.

*"Caribbean actuaries have considerable freedom in the choice of valuation methods and assumptions used....Given that regulatory supervision of companies may not be timely or sufficiently detailed to detect weak companies, the risk of insolvencies could be high."*

John Castellino commented on the valuation systems in use in the Caribbean. The point was made that in the absence of regulatory guidance, a diversity of valuation approaches are in use. Most companies either use a modified net premium valuation method or have adopted the Canadian Policy Premium Method for valuing their liabilities. Caribbean actuaries have considerable freedom in the choice of valuation methods and assumptions used. He argued the point that this freedom available to life insurers in their financial reporting is ultimately not in the best interest of the policyholders as there is no common benchmark for computing policy liabilities or solvency standards that companies have to meet. Given that regulatory supervision of companies may not be timely or sufficiently detailed to detect weak companies, the risk of insolvencies could be high.

## Urgent Need for Standards

In his opinion, there is a need to organize an industry body in the Caribbean that can access the best minds to tackle the problems, including the development of common standards for valuing policy liabilities that will reflect the unique risks and conditions encountered in the region. These standards should also incorporate:

- Capital and surplus requirements
- Method of valuation of assets
- Cash flow testing of reserves
- Dynamic solvency testing

He echoed the thinking of the CAA that the establishment of standards is urgent and pointed to the need for coordination and consensus between the actuaries, accountants and regulators.

## Capital and Solvency

The topic of capital and solvency was handled by Jeff Harper, Richard Labelle and Phillip Whittaker. Following from his earlier presentation on the risks facing insurance companies, Jeff Harper discussed the following consequences if these risks are not recognized and adequately measured:

- Insurance company performance is depressed.
- Product performance is substandard.

- Industry reputation is damaged.
- Regulatory intervention can occur — after the cows are loose.
- Management, employees, investors and especially policyholders are disenchanted and damaged.

He cited the experiences of Mutual Benefit Life, Guarantee Security Life, Executive Life, First Capital Corporation, Summit Life, and Andrew Jackson Life.

Richard Labelle discussed the importance of having risk-based capital requirements (at minimum, internally, but hopefully externally, too).

Jeff and Richard's warnings could be said to be too late in the case of the Jamaican industry as described by Phillip Whittaker. At the time of the seminar, the Jamaican insurance and banking sectors were suffering the ultimate consequence of poor risk management practices in an environment of high inflation and tight monetary policy. Virtually all of the indigenous insurance companies and banks became insolvent due in large part to asset/liability mismatch. In January 1997, the government established the Financial Sector Adjustment Company (FINSAC) to rehabilitate the financial sector. As of October 1999, the cost of the bailout has been US$2.3 billion, more than 50% of GDP.

## Standard Valuation Law

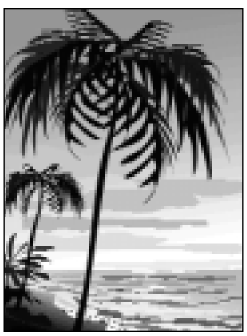
Carl Harris then followed with an excellent overview of the Actuarial Opinion and Memorandum Regulation in the context of the Standard Valuation Law applicable in the U.S. Of particular relevance in the context of the Caribbean situation, was the use of cash flow testing in determining asset adequacy and the importance of Actuarial Standards of Practice to the effective operation of the Appointed Actuary concept embodied by this regulation.

## Professionalism

The final presenter, Bob Wilcox, did a tremendous job of involving the audience through his use of case studies to illustrate the critical role of the actuary in serving the public interest. The issue of the non-applicability of the Actuarial Standards of Practice to SOA members practicing outside of the United States who are not members of the American Academy of Actuaries was discussed. Many within the audience saw a possible role for the CAA in standard setting and in the promotion of professionalism within the Caribbean. There was lively discussion about the topics of discipline, peer review, mentoring and standard setting.

## The Progress in the Caribbean

The issues of risk and risk management, for the most part, know no geographic boundaries. The risks faced are no less significant in the Caribbean; the very fact of our small size magnifies some of the risks. The seminar successfully highlighted the fact that a lot of work needs to be done within the Caribbean to ensure that a system of proper checks and balances is put in place to protect the public interest.



At the time of this writing, Jamaica, having learned the hard way, is the furthest along toward implementing a statutory valuation and minimum capital and surplus standard to be modeled on the Canadian system.

The council of the Caribbean Actuarial Association has developed an action plan to address the issues of professionalism and standard setting in the Caribbean context.

Over the past few years, we have had the privilege of hosting the presidents of the Society, the U.K. Institute and Scottish Faculty at our annual conferences. I believe that in some measure, the seminar served to drive home to the international leadership the true nature of the issues facing their international membership that impact actuarial practice and the reputation of the global profession. There is tremendous goodwill between the CAA and our "parent" organizations, who have been equally generous in their offers of assistance in the task at hand.

At our recent 1999 conference in Jamaica, in the light of the interest generated by the Financial Reporting seminar on the topic, we ran two Professionalism seminars co-sponsored with the SOA, Institute and Faculty. Speakers included Chris Daykin, chairman of the International Actuarial Association's Professionalism Committee; Paul Thornton, president of the U.K. Institute of Actuaries; Frazer Low, president of the Scottish Faculty of Actuaries; and Jack Turnquist, Chairman of the Society of Actuaries' Professionalism Committee and joint chair of the Committee on the Code of Professional Conduct.

These subsequent events are some of the spin-off benefits of the Financial Reporting seminar. I am hopeful that the insights gained and the advice given will influence positive action by the regulators and by the profession within the Caribbean. Many thanks to John Castellino, Jeffrey Harper, Carl Harris, Richard Labelle, Phillip Whittaker and Bob Wilcox, to the International Section, to the Financial Reporting Section, and in particular Shirley Shao, without whom the seminar would not have happened.

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