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EDITORIAL

Remembering the origin of the Bill of Rights, we might remind our Readers that sometimes amendments to a constitution may subsequently carry greater force than the original constitution.

Before the Society Members lies a proposed constitutional amendment, the importance of which should not be underestimated. It is now proposed that the Society's policy of "no comment" on public matters of actuarial interest be abandoned. Mr. Klem's excellent report states clearly the position in which the Society now finds itself. Our knowledge of the practice of other professional bodies is limited, but the provision that "No resolution expressing an opinion shall be entertained at any meeting of the Society of Actuaries" seems unique. As the report states, it was apparently included in the original constitution of the Actuarial Society for a specific reason.

Constitutionalists in American politics are fond of referring to the Founding Fathers as if these gentlemen were the founts of all wisdom now and evermore. Any similar references to the original intent of the founders of the Actuarial Society would ascribe to them a farseeing wisdom which they would probably disclaim were they able to do so. We wonder whether our eminent predecessors would have remained collectively silent on actuarial matters connected, not with individual companies, but with the public interest.

To be objective is not an easy task and may be the more difficult for the Society because of the insurance industry affiliation of most of its Members. There are dangers. If the Society as a body allows its actuarial judgment to be colored by even the slightest tinge of self-interest, then great damage can be done to our standing as a profession.

Nevertheless, as a profession, we owe it to the public and ourselves to jealously guard the areas of our specialized experience and skill. Other professions make their voice heard where the public interest requires and we would be surprised if their recommendations were unanimous. Can we afford to stand by and let matters of great importance to present and future generations remain in the hands of the unqualified? As financial demographers our professional knowledge and skill should be at the service of our fellow citizens.

The wording of the proposed amendment should not divert the reader's attention from the main point which is whether the Society should abandon its policy of silence. We could content ourselves with removing from Article II of the Constitution the sentence already quoted and endeavor to find another way in which the Society could make its views known. The amendment proposes a set of conditions to be met before the Society can take a public stand. These are apparently intended to guarantee that no such action would be lightly undertaken. The manner of speaking and the contents of the speech need careful consideration but surely the duty to speak is all important. The founders of the profession on the North American continent had wisdom for their day: let their successors have equal wisdom for our day.

The columns of *The Actuary* are open to all members for their thoughts on this important topic. —A.C.W.

MORE ON CANADA TAX PROPOSAL

by J. Ross Gray

In its proposals for the reorganizati[on] of taxation in Canada, the Carter Commission recommends that Canadians continue to be encouraged to provide for their old age. The tax credit for the family-unit is limited to the equivalent of a single life annuity of $12,000 at age 65.

Under group life insurance it is proposed that the employee may deduct his portion of the premium from his income, and the employer may take credit for his share as a permissible business expense. This saving is offset by taxing the proceeds as a gain to the family-unit, and again in full if left to some person outside the family-unit.

Immediate annuities give an insight into the thinking of the Commission. Each year the annuitant is to report as income the interest on his decreasing fund; the balance of the payment is a withdrawal of capital. If he lives long enough his fund becomes exhausted, and from there on the full payment is mortality gains subject to tax. If he dies early he has had a loss which his estate can claim as an offset to any other i[n]come, perhaps obtaining a tax refund.

Each year the interest credited to a Canadian life insurance policy is to be reported to the policyholder so that he may pay income tax on it, even though he did not receive it in cash. This interest is to be calculated by all companies at an arbitrary rate at least 4%, on special reserves calculated at the same rate, in complete disregard of cash values.

In addition, dividends paid on a participating policy are also to be regarded as income to the policyholder and he is to pay tax on them. To be sure that he does so, there is to be a 15% withholding tax. Although the Commission recognizes that participating premiums might be reduced to practically eliminate dividends, their attitude seems to be that solvency issues will prevent a company from going too far in this direction.

These two taxes on life insurance policyholders are in violent contrast to the present situation which favors life insurance coverage.

The Commission has something e[lse] in store for the policyholder. Each yea[r] the cost of the mortality risk is to be calculated, and the policyholder may

(*Continued on page 3, col. 1*)

Risk Capital . . .

(*Continued from page* 1)

profit. Ergo, the way to optimize the use of risk capital is to risk it more, right up to the point of eliminating reinsurance altogether.

Consider a hypothetical situation. Imagine that Company X has enough capital and surplus, and is sufficiently unconcerned about the inconveniences of fluctuation in its claim experience to justify, in the judgment of its management, the establishment of a $500,000 limit of retention for individual life insurance policies. The management of Company X however, believes that in the existing market situation, characterized by very competitive underwriting for large size policies, the underwriting profit on policies of over $100,000 will be well below average. They decide therefore, to set a limit of retention of $100,000 on individual policies. They expect that their reinsurer will make a profit on the reinsured business and that the profits will be shared with them by way of an experience refund arrangement. We may now ask: Is this a rational decision?

It could mean that a portion of Company X's risk capital, the portion released by the decision to use $100,000 instead of $500,000 as the limit of retention, is to remain unemployed. If employed, it would have had the prospect of yielding the profits which Company X expects the reinsurer to earn on that portion of the individual policies which fall between the $100,000 and $500,000 limits. To leave it unemployed would be an irrational decision.

But suppose that Company X is considering an expansion in its overall business activity by starting an individual health line or a group insurance line, or by expanding its life insurance sales to military personnel, or by expanding abroad. It intends to employ the risk capital released by a lower individual limit of retention as part of the risk capital assigned to these new ventures and it expects to make bigger and more stable profits on these new ventures than it can make by insuring the portion of large life insurance policies which fall between the $100,000 and $500,000 limits. Under these circumstances, and granting the validity of all of Company X's subjective opinions about the relative sizes and stabilities of the profit potentials of different insurance ventures, its decision to limit its life policy retention to $100,000 is a rational one. It has been made by considering all the elements relevant to a proper decision. The decision may be a wrong one in a practical sense because the company's judgment about relative profitabilities may have been all wrong. All that we wish to assert here is that it is a rational decision.

Now let us consider the rationality of the decision of the reinsurance company which is going to reinsure Company X's business. In the first place, the reinsurance company may well disagree with Company X's estimate as to the profitability of large insurance policies. It may have more confidence in Company X's underwriting ability and in the quality of its agency sources of business than Company X itself has. It may have less concern about the basic soundness of the market situation, about the harmfulness of competitive underwriting, for instance. It may have a lot of confidence in its own ability to underwrite risks submitted facultatively, and its ability to guide Company X in that company's underwriting of risks submitted automatically. Above all it may have a lot more capital than Company X (particularly when its retrocession facilities are taken into account) and hence a lot more capacity to absorb unfavorable fluctuations and a lot more financial support for an optimistic view of the future.

In addition, the reinsurer may not have the prospects for alternative uses of risk capital which are available to Company X. It may be committed by reason of its organizational structure and by reason of the instructions or expectations of its Board of Directors and stockholders to the most intensive use of its risk capital in the reinsurance of business submitted by companies like Company X. To turn up its nose at segments of this business may mean underutilization of its risk capital and a lower than maximum or optimum profit yield. That would be an irrational decision, especially since Company X could well conclude that another reinsurer might give it better overall service.

In the light of these examples it is possible to improve somewhat on our earlier statement and make a more definite one, but one which is still quite vague, about what the optimum use of risk capital means. It involves, certainly, the idea that one strikes a balance, somehow or other, with such help from statistical theory and facts as one has the knowledge and courage to use, between conflicting desires for maximum long term profit and minimum short term loss. Our tantalizing concept also involves the possibility that as the exposure of capital in a given insurance employment increases it may produce some form or other of diminishing returns. This suggests that a skillful rationing of one's risk capital among the available alternative insurance employments is needed to achieve an optimum result.

Gray . . .

(*Continued from page* 2)

claim it as a deduction from his income. However, on his death it will be assumed that his family-unit has had a mortality gain on which income tax must be paid out of his estate. If the proceeds are left to some person outside the unit which paid the premiums, the proceeds are taxable income to such person as well.

Thus we see in the proposals for annuities and insurance a complete refusal to accept the idea of risk sharing by insurance. Each policyholder is to have his own personal profit or loss, and is to be taxed on it.

Actuaries Club Meeting:

June 15-16, Southeast Actuaries Club, New Orleans, Louisiana

June 21, Seattle Actuarial Club, Olympia, Washington

Griffin . . .

(*Continued from page* 1)

ed to become participants after completion of a waiting period; and disclosure of pertinent facts about the plan in footnotes to the company's annual statement. The Opinion also discusses actuarial cost methods and states that the pay-as-you-go and terminal funding approaches are not acceptable for the determination of accounting charges.

The Opinion recognizes that computation of pension costs requires the use of actuarial techniques and judgment and that pension costs should be determined by an actuary. While the Opinion sets forth some actuarial concepts in order to describe accounting for pension costs and for the information of the account-

(*Continued on page 4, col. 3*)