1989 VALUATION ACTUARY SYMPOSIUM PROCEEDINGS

TRANSITIONAL SOLVENCY PROVISION

MR. ROBERT C.W. HOWARD: This is the third time that I have addressed an actuarial gathering on the Transitional Solvency Provision, which I will usually refer to as TSP. This being the third time reminds me of publishing the banns of marriage. If any of you can show just cause why the standard of practice on Transitional Solvency Provision should not be implemented, speak now, or forever hold your peace.

Seriously though, we do wish to receive your input. We have not received any to date other than from the committees that have been working on one aspect or another of it. We want to go to an exposure draft very soon, with adoption by the end of this year.

My remarks today are divided into four sections:

- I will outline the history of TSP.
- I will go through the text of our present draft of TSP.
- There are some issues yet to be resolved of which I think you should be aware.
- Finally I will comment on where we are headed after TSP becomes obsolete.

History

We have said for a number of years now that one of the conditions for the acceptance of the policy premium method (PPM) has been some solvency provision or a minimum continuing capital and surplus requirement (MCCSR).

We would prefer to have an actuarial determination of the solvency provision so that we could take into account the specifics of each company and allow for the actuary to exercise his judgment. Although our committee has been working for a number of years, we are not yet at the stage where we can recommend a basis for a solvency provision with a sound actuarial foundation.

(Incidentally, when I say "solvency provision," I am referring to an item on the balance sheet calculated as of the statement date. "Solvency provision" is not to be confused with Dynamic Solvency Testing (DST) which does not produce a figure for the balance sheet.)

The old statutory basis has been around for many years, in spite of whatever defects it may have, it has the advantage of standing the test of time. Many people, and the Office of the Superintendent of Financial Institutions (OSFI) in particular, have become comfortable with it and understand how strong or shaky a company may be from reading the financial statements.

OSFI was concerned that when the new GAAP basis is implemented, free surplus would increase substantially and that the additional free surplus might be paid out as dividends or used up in acquisitions.

The TSP was proposed by the GAAP implementation Task Force to OSFI as a means of addressing these concerns. The idea is simply to keep free surplus unchanged as a result of the change in reporting basis. Of course, there is no guarantee that the amount of free surplus that a company had on the old reporting basis is the right amount of free surplus. If nothing else, this will buy us time to come up with a sound measure of solvency without running the risk of free surplus being depleted only to find out later that it ought rather to have been increased.

Text

Now let's review the text.

Unless there are some meaningful objections raised to this draft at this session, we will be seeking Council's approval to send it out as an exposure draft. In a sense you are the final review body before TSP goes to the full membership.

STANDARD OF PRACTICE
TRANSITIONAL SOLVENCY PROVISION
UNDER COMBINED GAAP AND STATUTORY REPORTING

1. DEFINITIONS

1. Old - A determination made using standard actuarial practice prior to combined statutory and GAAP reporting.

2. New - A determination made under combined statutory and GAAP reporting, including this standard of practice.

2. INITIAL DETERMINATION

The purpose of TSP is to ensure that free surplus does not increase as a result of moving from the old to the new basis for valuing the insurance obligations of a life insurance company. Accordingly TSP is determined on the date that the new basis is implemented as the excess, if any, of unappropriated surplus (before considering TSP) on the new basis over unappropriated surplus on the old basis.

3. SUBSEQUENT ADJUSTMENT FOR FUTURE CONDITIONS

TSP, being temporary, is normally used without adjustment. However, if some event occurs which makes the original TSP no longer appropriate for its purpose, TSP is to be adjusted by the Valuation Actuary. The new TSP approximates the value that would have been obtained if the implementation date of the new reporting basis had been the date on which the adjustment is to be made.

Examples of events that might require adjustment to TSP are:

1. Acquiring a significant block of business from another company.

2. Disposing of a significant block of business.

3. A major shift in the mix of business.

4. Rapid growth in business.

5. A significant change in valuation basis.

TSP is not to be adjusted for experience gains or losses relative to the valuation assumptions or for changes in valuation basis which are justified by emerging experience alone.

I will use the definitions of "old" and "new" as shown in the draft. Old refers to the current basis. New refers to the new GAAP basis to which we all think we are heading.

The focus of TSP is on free surplus. One might think that we would be comparing liabilities on the old and new bases, but that is not sufficient. Because of the appropriation of surplus, a policy with a negative reserve on both bases already will have the same effect on free surplus even if the two bases give substantially different liabilities.

Because TSP is concerned about solvency, we don't want to see free surplus increase. In most cases free surplus will be identical on the two bases because of TSP. I suppose theoretically free surplus might decrease on the change to the new basis, but I don't expect that to happen.

It is the moving to the new basis which is the critical event. There may be some changes to the financial statements which would have been made even if the basis had not changed. If free surplus changes as a result of these things, that's fine.

The TSP calculation is done on the date that the new basis is implemented. TSP is determined once from the balance sheet. It is a very simple calculation. So what's the big

deal? Why does an actuary need to be involved? The actuary is needed more for dealing with TSP subsequently, as we shall see in a moment.

The section on subsequent adjustments says that TSP is normally used without adjustment. The last thing that we want is to have to maintain the old basis, valuing on both bases each year. For the vast majority of companies, there will be no need to change TSP for the few years that it is in force. If free surplus changes a little, it should not upset anyone. We expect that no more than a handful of companies will ever have to make an adjustment to TSP.

The condition for adjustment is some event occurring. We are talking about unusual events, not the mere passage of time or the usual fluctuation in experience that companies are subject to.

It is at this point that the actuary needs to be involved. The valuation actuary has to make a judgment that the TSP is no longer appropriate. Of course, this implies that the valuation actuary should form a judgment on TSP each year in all companies. If the degree of solvency of the company is much the same as it would have been had the company still been on the old reporting basis, then the original TSP is still appropriate to its purpose, and

no adjustment is required. Only the valuation actuary can come to that conclusion because only the valuation actuary will have access to all the facts necessary to form that judgment.

When the adjustment is required, the valuation actuary makes the adjustment. It is an actuarial calculation. Unlike the original determination of TSP, this will not be a matter of simple arithmetic. In practice it may involve more art than science.

We are not asking that the new TSP be calculated to the nearest dollar; in larger companies it would not even need to be accurate to the nearest million dollars. In particular, an accurate valuation on the old basis is not required. The valuation actuary should rely on his judgment, gather all relevant data, and then wing it.

The value that the actuary is trying to determine is what would have been had the original calculation been done at that later date. This description of the value gives the target, but it also gives the mindset. If I were doing the adjustment, I would be asking myself, "How much would free surplus be likely to have changed if we had stayed on the old basis?"

The draft gives a number of examples of events that might require adjustment to TSP. The list isn't intended to be exhaustive.

The first two items, acquiring or disposing of a block of business, would call for an adjustment to TSP because they would represent a quantum leap in the company's portfolio. Of course, if the block of business is a small one, or if the valuation actuary thinks that there would be very little free surplus associated with that block, it may be that no adjustment is required.

To deal with a major shift in the mix of business, you would need to think of TSP as being split by line of business. The TSP for the shrinking line may be too large, and TSP for the expanding line may be too small. Of course, the two effects might net each other out so that no adjustment is required.

A rapid growth in business can be treated in a manner similar to a shift in the mix. If the amount of new business strain, allowing for necessary appropriation of surplus, would be markedly different between the old and new basis, then an adjustment to TSP may be required.

When GAAP is implemented, an actuary may choose to take a fairly conservative stance but over time conclude that it would be more proper to have a weaker valuation basis. In this case the TSP would have started out smaller than it ought to have been. When the valuation basis is weakened, TSP should be increased to compensate. Of course, this

requirement will also keep people from following this approach in an attempt to beat the system. Unlike the other reasons for adjusting the TSP, this is one for which there has not been a real event take place.

If the real event, emerging experience, shows that the valuation basis should be changed, then no adjustment to TSP is required. Similarly if free surplus goes up because there have been experience gains, that is a normal occurrence and TSP is not adjusted.

Unresolved Issues

We think that if the actuary's judgment is required for anything related to TSP, then this fact should be mentioned in the opinion of the valuation actuary both in the government statement and the public statement. At present this is not the case. We understand that Ken Clark has been given responsibility to draft the text of the new opinion. We will be watching developments closely.

Even if the draft standard of practice had already been adopted by Council, it would exist in a rather odd form of legal limbo. The law does not require appropriation of surplus for a solvency provision. The draft, however, says how it is to be calculated if one is required. Some would like the standard to require the actuary to recommend an appropriation of surplus for TSP, but this hardly seems an improvement if companies do not have to accept

the recommendation. We could have some messy power struggles. Let's hope that the governments don't let this happen.

Some people think that the T of TSP should stand for "temporary." Some suggested it should last only for one year. Initially our committee thought it might last as long as five years to give us time to come up with a sound actuarial determination of a solvency provision. The two years is a compromise. It is a short enough period that very few companies will need to make an adjustment to TSP. It is long enough that we may be able to come up with a significant improvement in a solvency provision, but two years may prove to be too short to do the whole job.

As far as we are aware OSFI wants TSP. Quebec, on the other hand, wants no part of TSP. Quebec would prefer to wait until we have an actuarially determined solvency provision. Our standard should reflect our professional judgment, but I would hate to see us caught in the middle.

Future Direction

With regard to where we are going from here, first we recognize that TSP is arbitrary. It should not be considered an actuarial determination in any regard. There is no real justification for it other than that we were comfortable with the old reporting basis. No one

on the committee really likes it. However, most would admit that something is necessary. It also reserves a slot in the new statement for an actuarially determined solvency provision. We want to replace TSP as soon as possible. In fact what I think TSP should really stand for is "Temporary! Supersede Please."

One of the issues that we are coming to grips with is the fact that there does not seem to be stated anywhere any principle for determining how strong a solvency basis should be. We know that a solvency basis is more stringent than an income reporting basis, but how much stronger? In some respects we would like a basis so strong that no company will ever fail. But if we force too much capital to be tied up, we may hurt our consumers and make us uncompetitive with others in the financial services sector. Obviously this will not be an easy matter to resolve, but it is a very important one. We need to have at least some qualitative answers before we can proceed with the next step.

And that next step is an actuarial solvency provision. This is very likely to involve a second valuation like GAAP but with a larger provision for adverse deviations. There may need to be an explicit determination of the mismatch risk between asset and liability cash flows. We have considered requiring some provision for a lack of diversification in assets. We may need to draw on risk theory to provide for the risk of statistical fluctuations about the mean.

I am sure that the last thing you want to hear is that the amount of work required of the valuation actuary is likely to increase, but this is almost certain to be the case. It is incumbent on us to ensure that there is value received for the time spent.

It will take several years to do the full job. I think our minimum intermediate objective should be to establish, within two years, procedures for determining the most significant elements of the solvency provision and fill in the missing pieces with an arbitrary formula.

Please do not consider TSP to be representative of what we are capable of doing. Expect better things to come from us soon. There is a lot of work yet to be done. I assure you that we will be working hard to serve you by expanding your areas of competence and enhancing the security of the consumers in the life insurance industry.