SOCIETY OF ACTUARIES

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Use of Embedded Values
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iterated this same general suggestion.

- Do not discontinue the current approach until all technical issues and educational aspects are fully addressed.
- Do develop a set of guidelines. To ensure uniformity in calculation from one period to the next and among business units, as well as to prevent manipulation, each company needs to develop its own guidelines on how the embedded value process will work. These guidelines should address all issues associated with the embedded value process, including defining responsibility for setting assumptions and defining the process for revising assumptions.

Future of Embedded Values

We anticipate increased use of the embedded value approach as more companies recognize its benefits for measuring financial performance. While implementation is not easy, companies that have gone through the effort believe the embedded value concept provides better information for management and thereby improves the actual decisions made by its managers.

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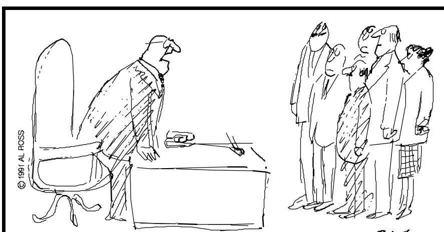
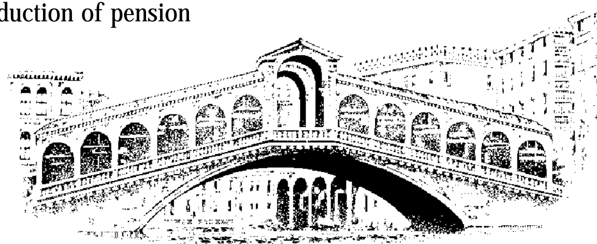


"It has come to my attention that one of you called the profit motive 'a figure of speech'?"

The Italian Life Insurance Market

by Alessandro Corsi

The Italian life insurance sector has been influenced by dramatic and historic changes over the last few years. These changes have stemmed from the creation of the insurance common E.U. market, the strengthening of new competitors into the market such as banks and financial consultants, and the recent modifications in households' savings profile. Also, in the last few years, the social security pension scheme has been reformed through a change in the method of calculating social security pensions and a progressive increase in the retirement age. The introduction of pension funds, which came into effect in 1997, will have to compensate for future lower state pensions, thus creating new opportunities and challenges for life offices, although in the context of a more aggressive environment.



Total life premium income amounted to about 37,100 billion Italian lire in 1997 [roughly $21 billion (U S.) at the December 31 exchange rate of $1 (U.S.) to 1,760 (ITL)], 41.5% over the previous year's figure and representing close to 45% of the total insurance sector. The life market share was only around 25% in 1990. As to the different business lines within the life market, well over 90% is individual business, the remainder being group business which has been quite stagnant over the last few years. As to market concentration, of 127 companies carrying on life business at the end of 1996 (105 pure life, 22 composite offices), the top-ten-ranked companies had a market share of 55%, 72% taking into account the first 20-ranked. It may be of some interest to locate the Italian life market within the European Union: in 1996 Italy was only the fifth-ranked market with premiums of ITL 26,100 billion (5.4% of the total U.E. life market, 1.4% on GNP), behind France with ITL 137,700 billion (6.0% of GNP), the U.K. with ITL 118,400 billion (6.2% of GNP), Germany with ITL 88,900 billion (2.6% of GNP), and The Netherlands with ITL 29,500 billion.

As to distribution channels, trends have been changing dramatically throughout the 1990s. Traditional channels, which are basically career-tied agents and companies' employed sales forces, continue to be the largest channel. However, their market share has fallen rapidly from 82% in 1991 to below 60% in 1997. On the other hand, banks, either through a totally owned life office or through a joint venture with an insurer, gained remarkable market shares at the expense of traditional outlets. Their share grew from 4% in 1991 to nearly 25% in 1997 with more than 50% of new sales. The third major distribution channel consists of financial consultants, which are the captive sales network of mutual fund companies and financial intermediation firms known as the Securities Intermediation Company (SMI). They have maintained a more or less constant share of approximately 15% for the last few years, thanks to this channel offering global advice on all financial needs to their clientele. They have effectively segmented the market and sell tailor-made products to medium and high segments. In life business, brokers play a marginal role, with a marginal market share concentrated in medium- to large-sized group schemes.

Generally speaking, consistent with a trend which can be observed Europe-wide, Italy is experiencing a progressive

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integration between the financial, banking, and life insurance sectors, as well as a radical change in the households saving profile, all of these events again driven by macroeconomic factors.

Until some years ago, it was typical for an average Italian household of a medium- to high-income band to funnel a large part of its traditionally high savings ratio into short-medium term treasury bonds, guaranteeing high real yields within a relatively high inflation scenario. This was much more attractive than the then-asphyxiated stock market. Life insurance could complement the household's portfolio, typically under the form of a traditional, relatively high-loaded, fiscally-driven endowment with profit sharing. Pure risk policies were, and still are, virtually marginal because of a "cultural" lack of awareness of death and disability risks within Latin communities. From the industry's standpoint, main focus points were the little or no contact between life companies and other financial players, the traditional well-commissioned distribution channel dealing with life and nonlife, the high margins stemming from not too innovative and inflexible products, and a certain administrative inefficiency within a relatively self-protected market.

"Reforms of both the social security system and supplementary pensions started in 1993 and received a fresh impetus in 1995 ... social security benefits will be defined in terms of contributions paid throughout employees' working lives, rather than based on final earnings."

In the early 1990s, banks started to enter the life market, normally with pure-saving, low-loaded, fiscally driven products sold on a single-premium basis or on a single-premiums program basis. Thereafter the European directives regarding Free Movement of Capitals and of life insurance specifically, all implying a higher degree of competition and an enhanced consumer's protection, were incorporated into all member countries regulations, including Italy.

Last but not least, the needs of complying with the so-called "Maastricht economic parameters" to qualify for the single currency forced the Italian government to pursue an economic policy aimed at reducing both inflation and the public finance deficit, the result of which was a brutal and rapid decrease of governmental bond yields (incidentally backing most of the life liabilities to date) on new issues.

The households reaction over the last couple of years has been from the one side to switch a significant portion of their savings from treasury bonds to shares or mutual funds, both domestic and foreign, and from the other side to utilize a single provider for all of its saving and sometimes its protection needs (one-stop shopping).

The life insurance industry's reactions have been a move to integrate with other financial players, including joint ventures with banks and acquisitions of mutual funds companies, to convert the traditional sales forces into more global financial consultants, more efficiency, and the reduction in acquisition and maintenance expenses through commissions squeezing and reengineering processes.

On the product side, more innovation has arisen, although with an eye to saving rather than risk products. In the early 1990s, the traditional with-profit endowments marketed by traditional sales forces started to reduce their loadings to face the competition of low-load banking products. Over the last one-and-a-half years, all of these product lines have been partially replaced by new investment products meant to link the life industry to the booming stock markets, especially as to financial consultants and banks' networks. These would typically be either single-premium, index-linked, medium-term products with a return guarantee wrap, or single/singles programs unit-linked products, normally without a return guarantee.

The new laws reforming social security pensions and introducing pension funds have been mentioned at the outset of this article. Because of the impact that they will have on the financial market, as well as on the life industry, it is worthwhile to provide a quick overview on the subject. Interested readers can find a more thorough treatment in the April and October 1997 issues of *Benefits & Compensation International*.

The Italian pensions environment is dominated by a variety of State and other compulsory, collectively bargained arrangements, varying by business sector and category of employee. These provided benefits that were generous salary-wise by international standards, with the exception of higher-paid employees. Before 1993 no coordinated legislation governed supplementary pension schemes. Therefore, employers who established pension funds, normally for highly paid employees only, were able to set up the benefit structures and the funding means almost as they wished, in the context of a generous tax environment.

Reforms of both the social security system and supplementary pensions started in 1993 and received a fresh impetus in 1995. In particular, future social security benefits will be defined in terms of contributions paid throughout employees' working lives, rather than based on final earnings. Moreover, restrictions have been imposed on early retirement. It is widely recognized that further benefit cuts and more restrictions will be necessary in the future. In turn, private pension funds, meant to supplement lower social security pensions, have finally been regulated from a statutory and tax standpoint after a long bureaucratic process which almost ended in 1997.

As to fund legal structures and apart from the detailed regulations such as the separation between the Fund and the different operational parties involved (that is, administration, investment and asset custody, tax treatment, investment restrictions), it is useful to recall that pension schemes will have to be defined-contribution. Defined-benefit arrangements are possible—albeit unlikely—for the self-employed only. There would basically be two classes of new pension funds, "open" and "closed." Closed pension funds could be established by an employer or other "affinity group" with membership limited to that group. Membership of open

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pension funds would initially be restricted to those who are not covered by a collectively agreed pension fund, but it will be possible for a closed pension fund member to transfer one's rights to an open fund after five years of membership.

Likely developments of the new market will be that new pension funds will be established along a number of different lines. First, there will be a number of national industry schemes, applying to certain employment sectors which will be largely influenced by the national trade unions. Second, several large employers will establish closed pension funds to cover their employees, contracting out of the relevant industry-wide arrangement. Third, the main financial services providers, such as banks, life companies, mutual fund companies, and SMI, apart from offering investment, administration, custody, and consultancy services to the closed-pension funds, will establish their own open funds.

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Insurance Regulation in Spain—Changes and Challenges

by Daniel A. DeKeizer

The European insurance market has been rapidly changing in the last five years. Adoption and implementation of the life and nonlife directives, the converging economies required by the monetary union, privatizations, mergers, and acquisitions have all helped reshape the insurance landscape.

Spain has not been exempt from these changes. In response to the 1995 Ordinance on the Supervision of Private Insurers, the Direccion General de Seguros (DGS) has proposed a sweeping new set of regulations. These regulations replace the 1985 and 1986 regulations and their amendments and are intended to bring Spanish regulation and practice into line with the European Community (EC) directives.

This article reviews some key aspects of the new Spanish regulation and discusses possible responses by the insurance market.

Technical Note

Much of Spanish regulation builds on the concept of the "Technical Note," which is a formal statement of the pricing basis for a given contract form. This concept is carried forward from the 1985 regulations. The Technical Note must include a guaranteed mortality table and interest rate, benefit descriptions, the calculation of the net premium, and the expense loads used to convert the net premium to a gross premium. It also describes the basis for participation, if any. This note must be certified by a qualified actuary.

Reserves

Articles 32–38 of the proposed legislation deal with the calculation method, the interest rate, mortality tables, and expenses. Previously, the reserves were determined on a valuation premium basis, which provided for maintenance expenses but not the amortization of acquisition expenses. The interest rate and mortality table were the same as those used to determine the premium in the Technical Note. Under the new regulations, products of up to one year duration require an unearned premium reserve, while longer term products require a seriatim, prospective, gross-premium-type reserve.

Interest

The interest rate can be no more than 60% of the weighted average of long term (five or more years) government bond yields during the last quarter of the last three years. The weighting is 50% of the most recent year's rate, 30% of the next prior year's rate, and 20% of the yield from three years ago. The government will publish the rate on an annual basis. If the actual investment returns of the insurer are less than this benchmark rate, then the actual returns are to be used. For certain contracts, the interest rate used in determining the premium—if lower than either of the above rates—is used in reserves as well. Previously, actual returns were allowed to be below the reserve interest rate for up to two years before reserve strengthening was required (Article 71 of the 1985 regulation).

For policies denominated in non-Spanish currencies, a similar formula, applied to the appropriate governments' bond yields, is required for foreign currency contracts.

Currently, this formula would result in a statutory interest rate of approximately 3.4%, which by itself will require substantially higher reserves than many companies are now holding. However, for "unit-linked" contracts, in which the insured is bearing the interest-rate risk, the company can simply hold the market value of the assets. These contracts are reported as part of the general account. No separate accounting treatment is currently required for such products.

This provision should encourage companies to move more aggressively into variable products or products with market value adjustments.

Mortality

There is no explicitly specified mortality table, such as the U.S. Commissioner's Standard Ordinary table. Instead, the table must satisfy certain criteria:

- It must be based on national or foreign experience and determined using generally accepted actuarial methods.
- It must be within certain confidence intervals specified by the government.