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Chairperson's Corner

by Angelica Michail

Coming together is a beginning, staying together is progress, and working together is success.
— Anonymous

After each Council Meeting, I confess I am overwhelmed by many emotions. Relief — that in two hours we managed to go through much of what is listed on the agenda. Exhausted — since we don't take any breaks. But most of all, elated because I realized, once again, that I belong to a team that takes seriously the responsibility to serve the interests of the Section and the SOA.

The Section Council has four meetings a year — a face-to-face meeting in October and teleconference for the others. Meeting attendees include nine

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Life Insurance Tax Down Under

by Greg Martin

It is said that death and taxes are the only two certainties in life. However, in Australia one would probably have to add change as a third certainty. So it is inevitable that the life insurance income tax basis in Australia would be undergoing considerable change at present.

The impact of the changes will be significant in both absolute terms, but also relative to the industry's competitors. This article provides a brief overview of the current situation.

What's Happening?

The new regime is expected to apply as from June 30, 2000, but full details are not currently finalized. The following is an indicative summary of the current regime and the changes expected.

The Current Income Tax Regime

- Tax is generally not applied to "profit," but is based on "Investment Income — Expenses," similar to the basis operating in the UK.
- Investment income is all life insurer investment income earned (i.e. both policyholder and company investment income).
- Deductible expenses are those related to generating investment income, or writing and administering investment (savings) type business.
- Different tax rates apply to different business lines:

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- ♦ 0% on Pensions and Annuities in course of payment
- ♦ 15% on "Superannuation" business (pre-retirement pension business)
- ♦ 39% on other "Ordinary" business

The same tax rate applies to both policyholder and shareholder income associated with the particular business line.

- Shareholders receive dividend franking credits ("tax paid" credits) equal to 20% of the total tax paid by the life insurer (policyholders and company taxes).
- Superannuation and Pension policyholder benefits paid are subject to various taxes in the hands of the policy-holder. Ordinary policyholder benefits are tax-free after a policy is held for 10 years, but subject to a concessional tax basis prior to 10 years.

The New Regime

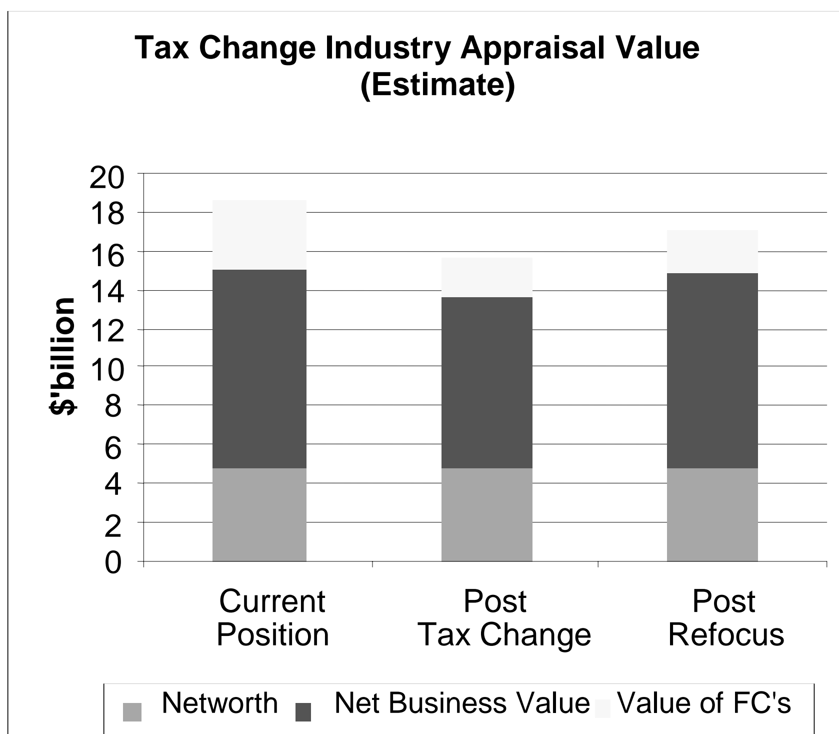
- Life insurers will now pay tax at the standard corporate tax rate of 30% on "profits," where profits comprise underwriting profits on insurance business, "Fees — Expenses" on investment business, and investment income on shareholder capital.
- Shareholders will receive dividend franking credits based on the total corporate tax paid attributable to them.
- Tax on investment policyholders funds will now be based on an "Investment Income — Fees" approach.
- Superannuation and Pension tax rates and benefit treatments remain unchanged.
- The Ordinary business tax rate will reduce to 30%. Ordinary policyholders' benefits will now be fully assessable, but they will receive offsetting "franking credits."

The immediate and longer term impacts of these changes are briefly considered below.

Immediate Shareholder Impact of the Tax Change

At a macro level, it is reasonably clear that the life insurance industry in Australia will suffer an overall considerable increase in tax expense. The industry will be paying a higher rate of tax on its profits and cash flows, and will lose a significant part of its existing franking credit benefits.

One indicative estimate of the immediate total industry shareholder value impact is:



Note that the "Post Refocus" values make some modest allowance for the potential benefits of product re-pricing and capital base restructure. (FC = Franking Credits)

Nonetheless, the impact on any particular company will vary by at least:

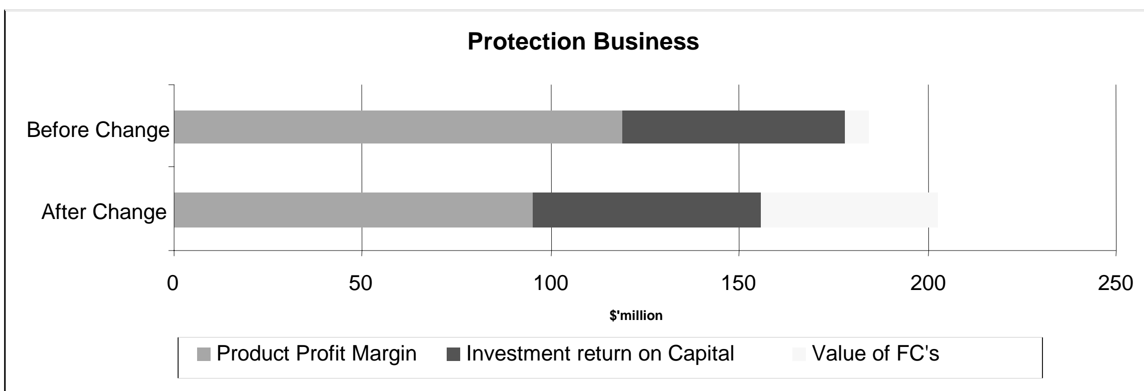
1) Shareholder residency

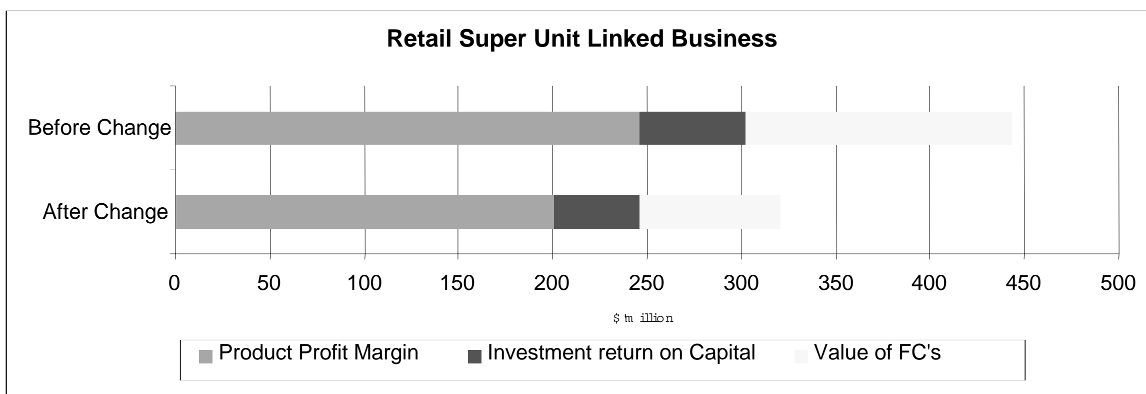
♦ Non-Australia resident shareholders who can make little use of Australian franking credits will be more concerned with the net actual increase in tax payable.

♦ Australian resident shareholders who can make full use of franking credits will be less concerned with the net extra tax (each extra $1 of tax generating an extra $1 of franking credit) , but more with the loss of the existing franking credits.

2) Business mix and capital base. Many Ordinary and pure insurance business lines will experience reduced effective tax costs. The main driver of the increased tax is Pension and Superannuation business lines, and increased tax on investment earnings on shareholder capital and retained earnings.

The difference in immediate impact on Ordinary protection and Superannuation savings business, estimated for the overall industry, is illustrated below:





3) The ability to pass on some of the increased burden via price increases (see further comments on competitive position and impact on policyholders).

One interesting general point that can be noted from a closer look at the above graphs is the very important impact of the change in the franking credit rules. For example, the overall industry value impact (after "refocus") principally comprises just the loss of the existing franking credits value.

Longer Term Industry Impact of Tax Change

The longer term impact of the tax basis change on the industry (and individual companies) will reflect a number of factors, including the impacts of the tax changes on:

- Policyholder benefits.
- Product pricing and the competitive position of the industry.
- Life Insurer capital requirements.
- Net investment returns on capital reserves.

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Impact on Policyholders

The vast majority of policyholders do not appear to be materially affected by the change in tax regime (setting aside potential industry pricing responses).

However, one group that is affected is Ordinary savings policyholders, via the reduction in the funding tax rate (39% to 30%) and the change in end benefit taxation rules. While Ordinary savings has not been a significant new business area in recent years, these changes may provide some potential market positives on this product line.

Product Pricing and Competitive Position

Two broad product categories need to be considered:

- Those where the industry has little outside competition.
- Those with significant outside competition.

Interestingly, the first category above is generally the less impacted by the tax basis change, while the second the more affected.

Protection Business

The first product group above, mostly contains protection business including term life, disability income, and long term annuities (including lifetime annuities). This is a mixed group with some wins and some losses, but for those able to realize reasonable value for franking credits, the overall impact may neutral to marginally positive (see Protection Business graph).

Superannuation Savings Business

The second group mostly contains the superannuation savings business line, which is the current main business line of much of the industry. As indicated by the Retail Super graph, this is significantly adversely affected by the tax change.

This business line has considerable competition from the wider funds management sector (superannuation unit trusts /mutual funds), but at present the life industry has a direct advantage in pricing in terms of its current favorable tax position. The life industry also has a perception benefit in terms of being able to quote policy charges on an effective net of tax basis, versus other sector participants that must quote charges gross of tax.

Under the new tax basis these advantages will be lost as the life industry tax basis essentially moves into line with the wider funds management industry.

The competitive position of the life industry will now focus more on issues such as:

- Brand, reputation and "community trust/faith" in the life industry versus its competitors.
- The potential disadvantage in terms of its higher capital requirements relative to the rest of the fund management sector (and relative to the above point).
- The potential advantage of greater product design and administration flexibility, and some access to cash flow and reporting flexibility advantages over its competitors.
- Some perceived life insurance regulatory, sales and disclosure disadvantages (although current regulator review in this area is also relevant).
- The negative impact of legacy products and systems, which affect a number of long established life insurers more than more recent funds management industry entrants.

Success going forward will depend on the ability to capitalize on the positives above and minimize the negatives. It will also be important to properly distinguish between reality and perception. Capital requirements are a case in point. A lack of regulated capital requirements for some market segments does not mean there is no market or corporate need for adequate capital reserves. The difference between visible and invisible capital reserves is also important. A life insurer holding capital against a DAC asset is not disadvantaged against a unit trust manager who does not hold a DAC asset in the first place.

Life Insurer Capital Requirements

The solvency and capital adequacy requirements of Australian life insurers are based on a modern risk based capital assessment approach involving, inter alia, various present value calculations and asset value change scenarios.

Under the current tax basis the present values need to be assessed on net of tax discount rates, and tax relief on adverse asset value scenarios is limited to the associated policyholder tax rates. The change in tax basis will mean the use of gross of tax discount rates in at least some cases, and generally an increase in the tax relief benefits potentially available.

Both these effects are likely to result in some reduction in capital requirements for the industry, although the quantum of this is currently unclear.

Net Investment Returns on Capital Reserves

An associated issue is the net investment returns on the capital reserves held by life insurers.

Prima facie, the increase in tax rate to 30%, from an average rate probably around 15% for most companies, should have a negative impact. However, the change in the franking credit rules and the value of these to the shareholders can be critical. The change from the current 20% rule to full future franking credit for taxes paid on investment income on capital reserves can mean for those able to

The SOA President Visits Georgia

by A. Norman Crowder, III

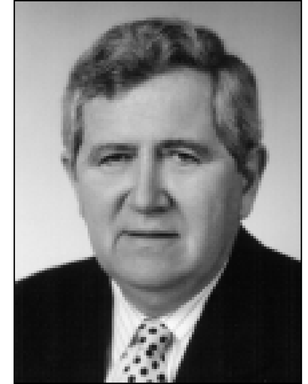
It took two overnights and nine time zones to reach Tbilisi, Georgia. The Association of Actuaries and Financial Analysts (AAFA) had asked me to participate in and speak at their first meeting. It was early November in Georgia — near freezing with snow in the mountains. Georgia is a poor country struggling to remain independent from Russia and to build a market-based economy. Most public institutions don't work well — the police haven't been paid in recent months.

The AAFA meeting was held in an unheated room in the Institute of Mathematics. Guram Mirzashvili is their enthusiastic leader, a statistician whose academic appointment earns him $15 per month (and is five months overdue). He and his wife each work two private sector jobs to make ends meet. The 20-plus founding members of the association are almost all mathematicians of some sort: statisticians, demographers.

There is now an emerging private insurance industry — 17 companies writing an unusual mix of products. These companies, which have been getting modest actuarial help from their reinsurers, now want to have their own actuaries for pricing and meeting emerging financial reporting requirements.

The meeting had about 40-70 attendees, depending on the topic under discussion. One fascinating paper by a Georgian, who is currently a visiting professor at Stanford, explored the mortality of emperors and how it correlated to the rise and fall of the Roman Empire. Two English actuaries made presentations. One was Hugh Sutherland of the Institute of Actuaries educational staff in London. He discussed how the Institute might help the Georgians get started on their educational activities. He described a diploma program that the Institute has run in several Eastern European countries to get an actuarial profession started locally. Initially, it involves a two-part training program. Each part is a series of week-long lectures on actuarial matters presented by UK actuaries to a starter group of 20-30 students, done monthly. Course materials are supplied for interim study. At the end of 16 months, the student writes a thesis on a local insurance matter and defends it in a brief process. At the end, the Institute awards a diploma, marking the accomplishment. Thereafter, the intent is that the local academics will pick up the training, with further help from the UK. This is the route that the AAFA will probably take to start their educational activities.

Their president, Mr. Mirzashvili, is an avid reader of SOA materials, which he receives regularly. He was so taken with the Big Tent ideas that he insisted that their name include "and Financial Analysts." I doubt there are many financial analysts in the Georgian market as yet. I did a presentation on the state of actuarial practice and the profession in North America today. In retrospect, it may have been a lot to throw at them, but it did make them aware of what they can aspire to over time.



A. Norman Crowder, III

My hosts were cordial and warm. They wanted me to learn a bit about Georgia during my brief visit. Theirs is an old, Christian culture interwoven with Turkish, Arab, Mongol, and Russian flavors. They have been overrun by many over the centuries. Their dinners were formal affairs with lots of vodka, wine, exotic foods and toasts. They like to enjoy life. Georgians do not have much money and have to struggle to build a new world. But, they are optimistic and seem happy. It's a different world from ours.

I offered whatever help I personally can provide, as well as the resources of the SOA, as they begin to develop an actuarial society in Georgia. We wish them good fortune.

A. Norman Crowder, III, FSA, MAAA, FCA, EA, is retired. He is president of the Society of Actuaries, and can be reached at: nrmcrowder@aol.com.

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realize even 60% of the value of the franking credits provided, that the net tax impact may be lower under the new basis than under the old.

Conclusion

The change being made to the tax basis of Australian life insurers is significant. It will have a material impact on the industry, and it raises a number of pricing, competition, capital management and shareholder value issues. While the overall increase in tax payable is a clear negative for the industry, there are some actual and potential positives hidden in the detail, and the negatives principally remove one of the industry's current competitive advantages rather than imposing a net disadvantage. One of the main challenges for the industry going forward will be to successfully market and leverage off its many other strengths and advantages.

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