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Reconstruction of the Insurance Industry in Jamaica — An Enhanced Role for the Jamaican Actuary

by John W. Robinson

Introduction

Policyholders of the Jamaica Mutual Life Assurance Society awoke on the morning of August 2, 1999, to find the company closed for business.

Mutual Life, founded in 1855, was one of the most stable companies in the English-speaking Caribbean. Its failure was part of a general failure of the financial services sector. All locally owned banks and insurance companies were seriously affected.

In this article, I will recap the causes of the failure, discuss the response of the government of Jamaica and end with an explanation of the appointed actuary's new role.

Causes of the Failure

In the early 1990s, the government of Jamaica pursued a policy of liberalization of the financial sector. This included:

(a) Relaxation of controls over entry into the sector;
(b) Elimination of foreign exchange controls and
(c) Deregulation of interest rates on savings.

The government strengthened the regulatory framework for monitoring and enforcing new banking rules, but there were no changes to the supervision of insurance.

With liberalization came a major expansion of bank credit. However, loans were made without proper risk assessment. Moreover, loans were primarily consumption-oriented rather than production-oriented. Inflation eroded borrowers' ability to repay loans; interest rates increased dramatically, which in turn further eroded borrowers' ability to repay loans. Consequently, the banks suffered a high proportion of nonperforming loans.

In the insurance company arena, there were three relevant developments:

(a) Financial sector groups;
(b) The extensive use of real estate to back liabilities and
(c) The impact of inflation on internal expenses.

Financial sector groups emerged during the late 1980s. Typically, a group included a life insurance company, a commercial bank, a building society and a general (property-casualty) insurance company. Their goal was to minimize the overall impact of regulation, supervision and taxation on the enterprise. They typically had interlocking boards of directors and extensive inter-group transactions. This made it impossible to tell the true financial position of any one member of the group.

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For life insurance companies, real estate was the main asset class used to back policy liabilities. There were two main reasons for this:

(1) The country had a dire need to generate foreign exchange. A company that had the ability to help meet this need and failed to do so could be seen as socially irresponsible.
(2) There was no other asset class in abundant supply.

So, life insurance companies invested heavily in tourism-related real estate, agricultural ventures and office buildings.

One of management's responses to inflation was to increase salaries beyond the level that could be accommodated within their price structure. In order to generate cash, they sold large amounts of deposit-like contracts that offered high interest rates and liberal withdrawal provisions. Many of these contracts were equity-linked (i.e., variable). With the economy in decline, the stock market plummeted, and policyholders exercised their withdrawal rights. This run on the bank could not be financed by normal cash flows, so the life insurance companies turned to their bank affiliates for loan support.

Real estate also suffered a major decline as fewer tenants could afford to pay increasing rents, and this, combined with the normal illiquidity of real estate, created two major adverse effects:

(1) The life insurance companies became insolvent, due to the decline in the value of their assets; and
(2) They were unable to repay the loans from their bank affiliates.

A severe asset-liability mismatch, combined with a decline in asset values, led to the demise of all the locally-owned life insurance companies, and consequently spread to further

cause the demise of their affiliated banks. Ironically, foreign-owned banks, such as the Bank of Nova Scotia, became favored. They avoided a similar fate by not becoming part of a group, and by having superior internal controls.

Economists have identified other contributing factors:

(1) CEOs of the life insurance companies were too prone to bend prudential norms and regulations
(2) Deficient management
(3) Lack of a credit-reporting entity
(4) A deficient regulatory environment, particularly for insurance
(5) Increased risk-taking and reduced managerial prudence that resulted from liberalization
(6) Within the financial sector groups: lack of transparency of relations and lack of accuracy of information on the individual companies

The Jamaican Government's Response

The government responded on two levels: financial and regulatory.

Financial

The precedent for the financial response was set in 1994, when problems with Blaise Trust were uncovered. The government's response was to:

(1) Guarantee depositors' funds;
(2) Shut down Blaise Trust, liquidate its assets and recover what it could; and
(3) Take legal action against its owners, where warranted.

In 1995, Century National Bank had similar problems, and the government took the same steps.

In mid-1996, CEOs of the troubled life insurance companies approached the government for assistance. What appeared to be liquidity problems were also revealed to be solvency problems. In 1997, following a study by local and international experts, the government formed the Financial Sector Adjustment Company (FINSAC) and announced that it would again guarantee depositors' funds.

FINSAC's mission was in three phases:

Phase 1: Intervention

Phase 2: Rehabilitation

Phase 3: Divestment

The mission was to be completed in five to seven years. As a result of FINSAC's work, the 13 locally owned life insurance companies have been merged into two, both foreign-owned.

FINSAC has provided J$65-70 billion of financing to the troubled institutions in the form of Government-guaranteed bonds. When this is compared to the 2002 GDP of J$364 billion, the magnitude of this is apparent.

In effect, the government has created money. The impact of this will unfold over many years, as the bonds come due.

The rationale behind the government's method of resolving the problem was to restore public confidence in the financial sector. This is in contrast to the "shut-it-down" approach adopted in other Third World countries with similar problems, such as Indonesia. The shutdown of Mutual Life was a major loss to the corporate community. Its reincarnation, Guardian Life, began operations a few weeks later.

Regulatory

The need for comprehensive regulatory reform was clearly understood. The Insurance Act of 2001 was drafted to replace the Insurance Act of 1971. The new law (94 pages) is accompanied by a substantial set of regulations (1,038 pages) and a separate set of actuarial regulations (57 pages).

The drafters of the new law recognized the need for regulatory convergence — to ensure that the regulation of the different sub-sectors was synchronized. The new Insurance Act was one of five new pieces of legislation.

The other set of driving principles was the Insurance Core Principles (ICP) developed by the International Association of Insurance Supervisors (IAIS). As of October 2003, there were 28 of them, with more to come.

I will now outline nine of these principles, which I consider particularly relevant to the Jamaican situation.

(1) *ICP 1 Conditions for effective insurance supervision*
Insurance supervision relies upon
- A policy, institutional and legal framework for financial sector supervision;
- A well-developed and effective financial market infrastructure;
- Efficient financial markets.

Not only is this applicable to successful supervision; it is a prerequisite for a successful insurance industry.

continued on page 12

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(2) *ICP 3 Supervisory authority*
The supervisory authority
- Has adequate powers, legal protection and financial resources to exercise its functions and powers;
- Is operationally independent and accountable in the exercise of its functions and powers;
- Hires, trains and maintains sufficient staff with high professional standards.

(3) *ICP 5 Supervisory cooperation and information sharing*
The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.

This is particularly applicable because the two continuing life insurance companies are foreign-owned.

(4) *ICP 7 Suitability of persons*
The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfill their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.

The right of ownership is normally conferred on the basis of ability to pay. This ICP suggests that this criterion is not enough. Also, it implies an increased level of accountability for boards of directors.

(5) *ICP 9 Corporate governance*
The supervisory authority requires compliance with all corporate governance standards.

(6) *ICP 10 Internal control*
The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.

This ICP bears comparison to the principles and objectives underlying Sarbanes-Oxley.

(7) *ICP 18 Risk assessment and management*
The supervisory authority requires insurers to recognize the range of risks that they face and to assess and manage them effectively.

Management should not simply "bury its head in the sand" regarding risk.

(8) *ICP 21 Investments*
The supervisory authority requires insurers to comply with standards on investment activities.

The old law had no restrictions on investment policy.

(9) *ICP 26 Information, disclosure and transparency toward the market*
The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.

Recall that the financial sector groups routinely violated this principle, by design.

Some Provisions of the New Law, And Resulting Changes

(A) INVESTMENT REGULATIONS
The new law has restrictions on the asset classes that are suitable for backing life insurance liabilities. To be eligible for purchase by an insurance company, a security must be:
- Interest-bearing; or
- Interest-accruing, or
- Dividend-paying;
  AND
- Not in default.
- Real estate is admitted
- For the head office and branch offices,
  AND
- Only up to 10 percent of assets.

Not more than 5 percent of assets may be in any one security. Bonds issued by the government of Jamaica, municipalities and government agencies are admitted.

Obligations of certain (named) regional financial institutions are admitted. Preferred or guaranteed stocks are admitted, up to 15 percent of assets. Ordinary shares (common stock) are not admitted.

First mortgages are admitted,
≤ 80 percent LTV for residential mortgages up to 30 years;
≤ 75 percent LTV otherwise.

Every investment must have the approval of the Investment and Loan Committee.

The following table compares the asset portfolio of Life of Jamaica at year-ends 1990 and 2003.

Investments	1990	2003
Leased assets	0.0%	0.0%
Real estate	33.6%	5.5%
Quoted equities	7.8%	4.5%
Gov't. of Jamaica & other fixed-income securities	8.2%	55.8%
Unit trust	9.9%	1.3%
Term loans and deposits	6.7%	0.3%
Mortgage loans	7.3%	4.2%
Policy loans	5.6%	1.9%
Other	0.0%	0.1%
Investment in subsidiaries	8.6%	7.8%
Investment in associated company	0.8%	0.0%
Fixed assets	3.6%	3.0%
Goodwill	0.0%	5.2%
Other assets	8.0%	10.3%

Notice the great decrease in real estate assets and the corresponding increase in fixed-income assets, consisting mainly of government bonds.

(B) SOLVENCY REQUIREMENTS, LIFE INSURANCE

The new law set out, for the first time, minimum continuing capital and surplus requirements (MCCSR), similar to those in Canada:

Available capital ≥ minimum capital, where minimum capital = the sum of components for

- Asset default risk
- Changes in interest rate environment risk
- Foreign exchange risk
- Interest margin pricing risk
- Mortality / morbidity / lapse risk

MCCSR percentage = Available capital ÷ Minimum capital

The minimum MCCSR percentage is scheduled to increase each year to 150 percent by 2010, and remain there.

(C) SOLVENCY REQUIREMENTS, GENERAL INSURANCE

The new law set out, for the first time, solvency requirements for general insurance companies.

Admitted Assets ≥ Required Assets

Required Assets = Total Liabilities
+ Reserves for reinsurance ceded to unlicensed reinsurers
+ margins for unearned premiums and claims

(D) CORPORATE GOVERNANCE

A 1988 study of bank failures in the United States found the following primary causes:

- Uninformed or inattentive board of directors;
- CEO lacked capability, experience and/or integrity;
- Inappropriate transactions with affiliates.

Risk-based supervision requires strong corporate governance and less emphasis on compliance. The new regulatory approach stresses sound business and financial management.

Requirements include:
The board of directors must appoint

- An Audit Committee;
- An Investment and Loan Committee; and
- A Conduct Review Committee.

The board of directors must have a written policy for each of the risks faced by the company.

(E) APPOINTED ACTUARY

Prior to new law, the life insurance actuary's responsibility was limited to the calculation of reserves and the pricing of insurance products. There was no requirement or authority related to the companies' investment policies.
General insurance companies had no actuaries; senior management considered them unnecessary.

The new law provides that every insurance company must appoint an actuary.

Under the new law and regulations, the actuary shall:

- Value reserves and other policy liabilities

continued on page 14

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- Submit a report at the annual general meeting of shareholders and policyholders;
- At least once a year, meet with the board of directors to report on the company's financial position;
- Submit a written report to the CEO and CFO on matters adversely affecting the company, *with a copy to the regulator*. If management fails to act, the actuary must notify the board of directors *and the regulator*.

Upon termination, the actuary must communicate in writing the reasons, to the regulator, the board of directors and his/her successor.

The appointed actuary must carry out Dynamic Capital Adequacy Testing (DCAT) annually. The objective of this exercise is to identify threats to future solvency and mitigate those threats.

Finally, the actuary is expected to play a key role in risk management.

In effect, the actuary's role now includes the role of whistleblower, with built-in protection from arbitrary termination.

CONCLUSIONS

Jamaica provides a prime example to the Third World of how to handle a financial crisis without IMF assistance. However, the impact will evolve over many years.

In Jamaica, the appointed actuary, and the profession in general, now has a much more demanding, more respected and more public role, as well as the independence needed to act as a quasi-regulator.

While the situation for life insurance companies is much improved, this author is concerned about two ongoing issues:

1. While the asset side of the balance sheet seems much more appropriate to the purpose, the issue of whether there is a proper asset-liability match also depends on the nature of the liabilities.

2. The government of Jamaica is currently the primary provider of the fixed-income assets used to back the life insurance liabilities. The motivation for the government to issue bonds is not necessarily aligned with the needs of the life insurance companies. This author believes that companies should do what they can to foster a private-sector bond market. □

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