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Pensions and Tax cont'd.

could not expect to collect another $87 billion in taxes if the law were changed, but only the $59 billion of revenue loss.

2. About $27 billion can be eliminated by taking out the state and local government plans and the federal employees' plan. These plans are not receiving a tax preference by having trust funds, because these plan sponsors could hold the funds themselves and still not pay tax.

3. The remaining $32 billion in revenue loss should be further reduced to about $27 billion to equalize after-tax benefits. Again, if we properly apply "realization" accounting, this tax should not be collected anyway.

Conclusion

The published pension tax expenditure does not represent the tax that the government would receive if employees were taxed on pension contributions and interest income. The numbers vary considerably from year to year because both methodology and assumptions change regularly. Anyone relying on the tax expenditure figures is likely to be misled, and any tax law based on such arbitrary and capricious figures can be good only by accident. Actuaries are uniquely qualified to understand the ramifications of tax expenditures and to check the annual calculations. More actuaries should get a copy of the Special Analyses of the Budget of the U.S. Government (price $8.50 from the U.S. Government Printing Office, Washington, D.C. 20402) and study Special Analysis G. Somebody has to keep the Treasury honest!

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Waterloo/St. Louis Exam Seminars

During the period April 16 – May 5, 1988, the University of Waterloo will offer study seminars for Courses 150, 151, 160, 161, 162, 165 and Parts 6 and 8 in Waterloo and St. Louis.

For more information contact Frank G. Reynolds at his *Yearbook* address.

The Controversy Over Health Insurance Reserves

Features Editor Deborah Poppel spoke with Paul Barnhart, who chairs a subcommittee of the AAA Committee on Health, which has been charged by the NAIC with drafting new health insurance reserve standards.

Poppel: Would you describe the controversial elements of the proposed health reserve standards?

Barnhart: I'll describe three of the several controversial elements. One is what we call the "benefit ratio reserve." This reserve method deals aggregately with policies by assuming that the ratio of the valuation net premium to the gross premium is constant. One can then calculate reserves for a block of business without having to apply separate factors to each individual policy. It's also designed for flexibility — the constant percentage of gross premium can be adjusted if experience calls for it. This adjustability has raised controversy.

Poppel: Why?

Barnhart: Some of those in opposition think it's too subjective. They feel that any statutory reserve standard must be absolutely objective, like the standard for noncancelable disability policies. Whereas that standard uses specific morbidity and mortality tables and interest rates, the standard the Academy subcommittee is proposing is subject to adjustment based on actuarial judgment. Some people say that it is therefore open to manipulation. We think there is no way around having to apply actuarial judgment, since health insurance experience factors can fluctuate so much that an objective tabular standard isn't feasible.

A second, equally controversial feature of our proposal is use of a retrospective reserve formula, enabling one to use actual claim experience rather than expected. Many states have rate regulations that require, for example, that a specific loss ratio be met over the lifetime of a policy, on an actual basis. We felt that to recognize the effect of such regulations our reserve method had to operate retrospectively and account for actual rather than expected results.

Some actuaries feel, however, that you simply can't get appropriate reserves on a retrospective basis, because reserves need to be adequate prospectively. That is, the reserve you're carrying, when combined with future premiums, must be sufficient to pay future claims. Our mathematics show that, provided you have a good estimate of the ratio of net to gross premiums, the retrospective method is equivalent to the prospective method.

Poppel: What is the third element of controversy?

Barnhart: It is the manner of recognizing high first-year expenses. Traditionally, individual health insurance has used a two-year preliminary term reserve method, which in effect creates an allowance for high first-year expenses. We feel that's too arbitrary — sometimes too generous, sometimes not generous enough. Instead, we're proposing a "reserve expense deduction," which is similar in concept to the deferred acquisition cost in GAAP. We determine the actual excess first-year expenses for a block of business and amortize them over ten policy years. Many critics feel that two-year preliminary term is working fine. We say that to make two-year preliminary term work properly with a benefit reserve ratio, you'd need to recalculate a modified loss ratio leaving out the first two years. Besides being complicated, this ignores the experience of the first two policy years, which is a large fraction of the usual cumulative experience. The reserve expense deduction method permits a realistic treatment of actual first-year expenses.

Poppel: Are there other issues concerning the proposed standards?

Barnhart: Federal income tax has become an issue. The IRS has some rather specific rules as to what policy reserves it will allow for tax purposes. The point has been made that this new reserve doesn't fit in with those rules, and therefore the IRS may not recognize it. We know that, but the IRS guidelines were developed around traditional reserving methods; therefore, by definition, any new method

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Reserve Controversy cont'd.

will not fit those guidelines. We think we must first develop a reserve method appropriate for the line of business, and then deal with the IRS.

Another important issue has to do with the timing of recognition of gains and losses. The benefit ratio method can substantially affect this timing.

Poppel: *What would you like to see happen to the reserve standards?*
Barnhart: We've been asking people who aren't satisfied with our proposal to come forth with other proposals. We'd eventually like to see the adoption of an adequate, realistic, and flexible standard that fits the type of coverage we're trying to value, whatever its specific characteristics may be.

Poppel: *Could the issues raised here apply to other lines of business?*
Barnhart: To some extent, yes. For example, the benefit ratio reserve concept of dealing with valuation net premiums in an aggregate, implicit way could apply to other lines of business. The tax issue arising when proposing something that doesn't fall within existing IRS guidelines could also occur in other lines of business. Property and liability insurance is probably subject to the same issues, and coverages like universal life could come to involve similar ones.

Poppel: *How about the issue of balancing rigid standards and actuarial judgment?*
Barnhart: Yes, that could be an issue under any line of business. In that connection, the so-called valuation actuary movement is heading in the direction of placing more responsibility on the actuary's judgment. We think our proposal is consistent with that.

Poppel: *Is this the first time that you have been so closely involved in a professional controversy?*
Barnhart: It's the first one I've been involved in where the positions are so deep and sharply defined, and which has gone on for such a long time at an intense level.

Poppel: *Is it worth putting so much time and effort into making your case and being willing to take a strong stand?*
Barnhart: I think so. There seem to be a number of misunderstandings and misinterpretations of our proposal, and I feel it is important to clarify them so people focus on the real issues and not on erroneously perceived issues. I have always felt a strong obligation to participate in professional discussion and to contribute time and thought to further development of actuarial concepts. This particular controversy very much deserves the effort to place the genuine issues in a true, balanced perspective.

New Zealand Society of Actuaries Conference Speakers Wanted

Would you enjoy freshwater fishing, boating, golf, white water rafting, skiing, hunting, bush walks, deep sea fishing, and visiting an active geothermal field? How would you like to try your public speaking skills on an audience that hasn't yet heard what you have to say? Have we got an opportunity for you!

The New Zealand Society of Actuaries will be holding its biennial conference (we call it a Hui) October 6 and 7, 1988, at Waireki, near Lake Taupo and Rotorua. Our agenda topics include: Solvency Bases for Life Companies, GAAP Accounting for Life Companies, Pension Fund Accounting (FASB) 87, and Risk Management.

We are recruiting speakers to bring us up to date on the situations in the U.K., Australia and New Zealand. We need speakers to do the same for the U.S. and Canada.

If you will be in the area in early October 1988 and would like to speak, please write to Ken Magee FSA, FCIA, Metropolitan Life of New Zealand, P.O. Box 1117, Auckland, New Zealand. We'll need to know who you are, what you do, and why we should choose you over the thousands of others who are certain to respond. Don't miss the experience of a lifetime!

Spring Exam Preparation Seminars

Exam preparation seminars for May 1988 will be held in various locations for Courses 120, 130, 135, 140 and 150. For details please contact Prof. S. Broverman of the University of Toronto at his *Yearbook* address.

TSA Papers Accepted

Four more papers have been accepted for publication in the *TSA* Volume 40. They are:

Christian J. DesRochers, "The Determination of Life Insurance Under Section 7702 of the Internal Revenue Code"

Edward W. Frees, "Net Premiums in Stochastic Life Contingencies"

Richard G. Schreitmueller, "The Federal Employees' Retirement Act of 1986"

Robert W. Stein and Joseph H. Tan, "Source of Earnings Analysis for Flexible Premium and Interest-Sensitive Life and Annuity Products"

Competitive Advantage cont'd.

The life insurance industry, in Europe and elsewhere, has borrowed extensively and built upon the successful agency system of distribution developed mainly in North America. Important changes in that system began to appear 15 years ago. Those changes are now quite profound and quite disturbing. The time has come for those in other countries to look again at the North American experience — this time not as a model to imitate, but as one to avoid. ...

The North American Agency System
The life insurance industry in North America began about 150 years ago. From the earliest years and still today, the prosperity of the industry has depended primarily upon the sale of personal life insurance policies to individuals. From the earliest years and still today, almost all of those sales were made by agents and at least 80% were made by "full-time" agents, those who earned a majority of their livelihood from selling life insurance. It was primarily in North America — in Canada and the United States — that the agency system was developed to its full maturity. In other countries — particularly in Europe, in Japan and in the British Commonwealth — similar systems emerged, sometimes as a parallel development and sometimes by imitation. In several countries, the result represented an improvement on the original model!

It was no accident that the commission based agency system developed mainly in North America.

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