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THE WORLD, THE FLESH AND THE ACTUARY

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IN HONOUR OF JOHN A. MEREU

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THE WORLD, THE FLESH, AND THE ACTUARY

Remarks by Kenneth W. Stewart to the
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INTRODUCTION

Ladies and gentlemen, I am honoured to have been invited to speak to such an distinguished gathering of actuarial researchers and educators. The fact that your conference is dedicated in honour of my long time colleague John A. Mereu is an added pleasure.

John Mereu's career is a prime example of how the roles of researcher, educator and business practitioner can intersect. My association with John goes back to the early 1970's and the start of my own actuarial career. In 1973, at an early meeting of the London Actuarial Club, John Mereu and I presented an analysis of emerging gains by source under a variety of reserving methods, based on Richard G. Horn's 1971 paper (TSA XXIII) on Release From Risk Reserves. In the 1970's, John would from time to time ask me to teach his Life Contingencies class here at The University of Western Ontario. In 1988 at London Life, we collaborated on a study of default costs and provisions for C-1 risk.

In preparing my remarks for this morning, I thought I might best serve your gathering if I attempted to first survey some of the major trends in insurance and related enterprises around the world, then note opportunities arising from these trends, and close by reflecting on implications for actuarial education and practice, and on ways in which actuaries may be of service in the future. Hence the genesis of the title for my remarks, "The World, the Flesh, and The Actuary."

While I would prefer to be more complete, brevity and prudence lead me to focus my personal and perhaps idiosyncratic remarks on the area of insurance which I know best.

GLOBAL TRENDS

In calibrating my remarks against a global background, I cite five trends which are seminal for developments in financial security today. These are:

- population aging
- the spread of affluence
- the rise of technology
- global competition, and,
- (what I choose to call) the fungibility factor

In the West, population aging from lower birthrates, restricted immigration and improved mortality creates new demands for savings and retirement products as people focus on their financial needs through a longer period of retirement. This also places larger burdens on the social security and healthcare delivery systems.

In Europe, social security systems are overextended. We begin to see partial privatizations or limits on national programmes. In North America, we face continuing rises in contribution rates for Social Security and the Canada/Quebec Pension Plans, and crises in healthcare delivery systems and funding.

At the same time, the spread of affluence and the associated rise in expectations in the Newly Industrialized Countries such as Korea and Singapore, and in Taiwan, call for development of new social benefit infrastructures, and a new focus on personal financial security.

As the nuclear family, so well entrenched in the West, begins to displace the multi-generational household, societies such as Taiwan are wrestling with the problems of seniors' housing and eldercare that have challenged us for years.

The rise in technology has allowed us in the West and throughout the emerging nations to move up through Maslow's Hierarchy of Needs to articulate new requirements for our personal comfort and fulfillment, as we become more discerning and demanding in our selections of consumer goods, financial services, healthcare and leisure pursuits.

At the same time, the technologies of communication and computing have empowered a revolution in the manufacturing and delivery of financial security products in new forms that are the financial equivalent of genetic engineering.

The new global competition, both in regional trading blocks and on a world scale, means that British, German, French and Japanese insurers can acquire interests in North American markets at the same time that our insurers look to expand in Europe and the Pacific Rim.

Insurers and banks are fighting to control distribution channels and insurance customers. Banks are already significant players in the insurance markets of Europe and Australia. Bancassurance in France and Allfinanz in Germany suggest that, at least in Europe, bankers are winning over traditional insurers in the battle to control distribution. While a recent Delaware law gives state chartered banks the power to underwrite and sell insurance, regulators express concern that bankers are lusting after new ways to risk federally insured deposits in pursuit of shareholder gain.

A word of caution is in order, lest we fear that, in our brave new future world, a Scottish customer will go to his local bank branch to buy life insurance from his German insurer, or lira-based property insurance for his condominium in Tuscany, as some pundits would claim.

Insurance products have changed enormously in the last twenty years, but are nowhere near as fungible as physical commodities or the products of commercial and investment banking.

While insurance companies or divisions are increasingly fungible, being bought and sold on a national and world scale, the merry dance of mergers and acquisitions steps at a slower pace than for industrial companies because of the sobering constraints imposed by regulators concerned with threats to insurer solvency.

At the individual level, globalization of financial security is less evident. For a host of reasons, including tax laws, product and distribution preferences, insurance products themselves, except for reinsurance and some commercial coverages, do not travel well. Individual insurance continues to be a matter of national markets with their own unique requirements and customs. For insurers, as for environmentalists, the watchword is "Think globally, but act locally."

CONDITION OF THE INSURANCE INDUSTRY

Against this background, what is the condition of the insurance industry? I suggest to you that insurance as an industry is fragmented and often poorly managed and unprofitable.

Insurance margins have shrunk just as the industry faces the cost of financing new technology for new generations of more complex products, greater customer demands, higher levels of taxation, and renewed assaults from self-insurance and from other financial players.

In North America it seems that almost nobody is making an adequate return on Universal Life. Large and small insurers have lost bundles on their annuity and GIC products, or in their real estate, mortgage and junk bond portfolios.

Insurance executives may breathe sighs of relief now that difficulties in the high yield market and various other missteps have thinned the ranks of financial buyers and have raised the cost of leverage for those who remain. If so, this relief is illusory. No one should take comfort that willing sellers of insurance companies outnumber willing purchasers. Strategic buyers with deep pockets are now able to acquire properties with less interference from financial players. Many insurance properties are no longer saleable except to those who would manage them in run-off, merge them with other entities, or, as in the case of banks, buy simply for easy entry into the market. Only for the most attractive properties do willing buyers abound.

The insurance industry is late maturing to the cycle of consolidation and fundamental restructuring that has already swept through the industrial and banking sectors, but that time is now here. Many of today's mid-sized and smaller insurers will disappear well before the Year 2000. They will fail, or be liquidated by private sector purchasers or regulators, or simply be swallowed up by larger and healthier entities. Even large insurers will not be immune, as some who have frittered away their surplus and who lack the vision and financial competence to rebuild it will accept the humiliation of fresh capital from new owners.

SUCCESSES AND OPPORTUNITIES

Amid this litany of misery, bright spots for the insurance industry remain. The decline or transformation of the traditional mortality and morbidity franchises has not been entirely bad news.

A significant minority of insurers have successfully adapted to and thrived in a new environment as their franchise has shifted from the liability to the asset side of their balance sheets.

This minority of successful insurers exhibits some or all of the following characteristics:

- carefully focused customer and market strategies
- fanatical attention to customer service at the levels and costs required in their target markets
- disciplined and comprehensive financial management systems
- rigorous expense controls
- sophisticated investment strategies and comprehensive asset/liability management processes
- a clarity of purpose and vision
- the moral fibre and common sense not to rush in as the proverbial fools where angels fear to tread

As I look around the world, it appears to me that the best and brightest insurers adopt one or more of the following strategies:

- they build critical mass and strategic capability in a few core products, whether healthcare, pensions, disability income or individual insurance

- they supplement core products with a broader range of ancillary products without losing focus or sacrificing control of distribution channels

- they stabilize and diversify their revenue streams by developing new sources of fee-based income, whether from ASO business, funds management, manufacturing product for other distributors, or providing administrative services

- they de-commoditize their markets by developing non-standard products for delivery through non-traditional channels

Among a polyglot mix of dullards and incompetents, these insurers stand out as having the brightest prospects for the future. These companies will be best positioned to capitalize on emerging opportunities.

NEW PRODUCTS AND MARKETS

Although the broad insurance market strikes me as singularly unimpressive, I see a bright future for adaptive, disciplined and well-managed companies. The global trends and industry conditions I have cited give rise to an impressive array of opportunities.

- Population aging, public sector restraint and other global forces imply continued explosive growth in pensions and other forms of private sector savings.

- The rise of affluence is fueling new demands for insurance in the emerging economies.

- Consolidation of the industry will have winners as well as losers - the winners being the new global giants and the insurance equivalent of the super-regional banks.

- There are enormous opportunities for improved financial management, even among the successful companies.

- These is a need to develop improved financing and delivery mechanisms for healthcare and eldercare, and supplements to restrained or contracting social security systems.

- New forms of reinsurance will facilitate risk management and financial restructuring.

- New products will be required as we collectively shift some of the emphasis of financial security from protecting childhood dependency to safeguarding old age dependency.

ROLE OF THE ACTUARY

It seems to me that we are now at a crossroads in the evolution of actuarial practice. As a profession, we have stepped irrevocably beyond the former limits of liability-oriented practice. The nexus of demographic and competitive forces suggests that we will have fresh and continuing opportunities to:

- develop new and better tools and techniques for financial management

- create new products for new markets and emerging needs

- apply actuarial techniques to a broader range of financial and social problems

Actuaries by their training and experience are ideally suited to expand their traditional role of financial analysis and stewardship for insurance and pensions. I see new challenges for actuaries in fields as diverse as the following:

- more general financial problems arising from the forced renegotiation of certain inter-generational compacts in social insurance and healthcare

- the asset side of non-insurance financial institutions such as banks and trust companies

- new frameworks for the evaluation and management of risk-adjusted capital

- a greater role in investments

- an expanded role in the strategic growth and development of insurance enterprises

- perhaps even a role in certain environmental and resource management problems

These visions of the future role of the actuary arise from my own view of what we are and have become.

- First of all, we are mathematically trained technical experts in the evaluation and management of financial risks.

- We are a highly ethical profession, trained to consider questions of equity and fair-sharing even when we do not entirely control the distribution or assessment process.

- We are trained to balance short term needs with longer term considerations.

- We have become accustomed to working with shorter windows for action and less certain data.

. At our best, we excel at strategic thinking in an uncertain environment.

ACTUARIAL EDUCATION

Our growth as a profession and the opportunities I have cited carry implications for actuarial education. It seems to me that actuaries of the future will require:

. a broader range and a higher order of technical competence

. much greater knowledge of investment vehicles and practices

. an enhanced interpretive vision - the ability to interpret, extend and adapt

. improved communication skills to translate complex technical problems into human and understandable terms

. enhanced political and social interaction skills in order to function more effectively in cooperation with other disciplines and in the arena of public debate

You who are attending this conference have an important role in strengthening the technical infrastructure of our profession, extending its frontiers, and providing academic training for its new entrants. You too will be shaped by the global and competitive forces affecting actuaries in financial institutions, public practice and government service. You will also be challenged to frame and communicate your work so that it can be more widely used by other practitioners to the ultimate benefit of the society we all serve.

Thank you for listening to my remarks. In our remaining time, I would be happy to attempt to answer any questions you may have.