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Editorial

Now it's the actuary's turn

by R. Stephen Radcliffe

As we enter the 1990s, actuaries stand at the threshold of more opportunity than at any time in our profession's history. Someone has to clean up the mess left by the excesses of the 1980s. No one is better prepared for that job than the actuaries. Our skills are a perfect match for the problems that now exist in the industry.

There is tremendous concern about the future solvency of the insurance industry. Some go so far as to predict that we could face problems similar to the current problems of the S&Ls. During the 1980s, the capital base has been disappearing at an alarming rate. Several companies now have failed or are on the verge of failure.

The marketing promises of the 1980s are now bankrupt. This is the promise that by driving the revenue line, everything else would fall into place. Actuaries have consistently maintained that profitability is the key to a company's success and not just sales. It's the bottom line that's really important and not the top line.

To deliver on marketing's promise of more revenues, the price per unit had to be lowered because the marketplace was so crowded. It was a marketplace threatened by overcapacity and underdemand. As Rick Kischuk pointed out in a previous editorial, the overcapacity was not created by new capital but by the willingness of most companies to leverage existing capital, some unwittingly. It now seems that this leverage has been increased so much that the industry may now be undercapitalized.

The underdemand emerged as a problem because our distribution systems switched from needs selling to replacement selling. Our penetration into households steadily decreased through the 1980s because the public's need for insurance, especially life insurance, dropped in priority compared to the other more pressing needs of the household budget.

The pressure of oversupply and underdemand forced the unit price to go so low that it crossed the line to where the marginal units sold actually depleted the value of the company. Once that line is crossed, there is actually negative leverage. This is a twilight zone where all of the usual rules are turned upside down. When this line is crossed (with the poor information developed in many insurance companies it's hard to tell when it's crossed), the more a company sells, the sicker it becomes. The traditional idea of being able to grow out of a problem becomes invalid. The phrase "you can make it up in volume" always sounded a little silly, but now there is ample proof that for companies with negative leverage it doesn't work.

When the price per unit is not fundamentally sound, adding the underpriced units is the source of the deterioration of the capital base. So, where was the actuary while all of these underpriced units were being added to the inventory? Pricing – isn't that the job of the actuary?

I submit that it's a little unfair to blame the actuary for all of the problems we face today. Look at the marketplace of the 1980s. It went berserk with great force. No one had control of the market forces, not the CEOs, not the regulators and least of all the actuaries. It was not a fair fight. The power of the forces of oversupply and underdemand was no match for the managers of the financial security institutions that were dealing with this problem.

Of course, the actuary should share some of the blame for the problem – for not paying close enough attention to the assumptions used in actuarial models; for not understanding the impact of the assumptions used; and for being tempted to rationalize assumptions that were obviously incongruent with reality.

As we enter the 1990s, a new day is dawning. The failures of weak companies and consolidation in the industry should correct the oversupply problem. A return to needs selling has some chance of helping the underdemand problem. We are moving from an age of excess to an age of reality and reason. Now there are plenty of opportunities for actuaries to make meaningful contributions. The term "marketing actuary" has emerged as a new oxymoron. The really important contributions will not come from the flashy and clever marketing actuaries but from those who will reapply the sound fundamental principles of our profession.

The main responsibility of actuaries of the future will be to make sure that our principles are advanced far enough and fast enough to accommodate explanations of persistent volatility in our economy. Of course, it will be important to make sure these ideas are communicated and managed well. That is a basic prerequisite of advancing ideas into the public domain, but the most important and useful job is to rationalize the process of providing insurance through financial security systems in dynamic economies. Our failures as actuaries in the 1980s, if there were any, were not necessarily caused by our failure to communicate or manage. Instead, it was because our ideas were not prepared for the marketplace and the marketplace was not prepared for our ideas. Ideas are at the core of our profession. They're all we really have to sell.

As the disappearing capital of our industry reaches new levels of scarcity, our ideas will become more relevant. There won't be any excuses the next time around. Actuaries must participate in the process. If we don't make more forceful and meaningful contributions in the next decade, then we should share some of the blame.

How can actuaries contribute? We must stand firm on our principles. No room is allowed for compromise when fundamentals are at stake. There is no room for rationalization when others are counting on our advice.

Now it's the actuary's turn. The marketing promise of bigger is better should be replaced with an actuarial promise that stronger is better – a promise that is built on sound principles and a return to the basic concepts adapted for the new volatile economies. We have some of the answers and we have a good reputation – so let's seize the opportunity and begin to rebuild our financial security systems while the time is right. It's our turn at bat so let's step up to the plate and take a good swing.