small talk

Newsletter of the Smaller Insurance Company Section

ISSUE 14 SEPTEMBER 1999

Technology Will Level the Playing Field

by Tim Pease

Editor's Note: This article is reprinted with permission by National Underwriter. It ran in the July 12, 1999 issue in the Life & Health/Financial Services Edition.

The third major transformation of the insurance industry has begun, and over the next decade everything will change.

Innovative companies will grow as they adopt new ways to boost service levels at lower costs. The mergers, acquisitions and blending of roles we've already seen will accelerate. By 2010, the business landscape will be very different.

The advent of true network-based computing is driving this transformation. Using all types of networks—the Internet, intranets, extranets, LANs and WANs—network-based computing brings processing power to the point of service, anytime, anyplace.

This ability will level the playing field between all competitors. With the right technology and strategy, any company—whether an independent agency, insurer, reinsurer, direct market or direct writer—can win in the new game.

The industry has been transformed only twice before. First, in the late 1800s, insurance companies hired managing general agencies to support their expansion in the newly opened West. The second transformation was the direct writers' rise to personal line dominance.

After the next transformation, the battle line will be drawn between technologically savvy, efficient players and those with outdated technology.

The following are key issues. First, insurers need network-based computing power at the point of service. The banking industry is ahead of the insurance industry in customer service, because it has long used networked-based computing. ATMs are a prime example. Banks let their customers pay bills and view balances by touch-tone telephone and on the Web. Insurers don't let customers or agents have similar access to policy information—but fairly soon they will.

The advent of client/server networks (LANs and WANs) has brought the insurance industry to the first phase of

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From the Editor

by James R. Thompson

This issue commemorates the 50th Anniversary of the Society of Actuaries. We usually publish in November so that we can get the latest updates from the September NAIC meetings. Regulation has been a significant factor affecting smaller companies, and we endeavor to follow it closely. However, we felt that this issue should be in your hands prior to the annual meeting.

To give broad perspectives on the past and future of our industry and Smaller Insurance Company Section, each past Section chair was invited to submit an article giving his thoughts. To show what we are doing now, we are including our contributions to the annual meeting.

Technology continues to be an important tool for improvement. Large companies have the resources to examine how such improvements as computer technology and the Internet can improve operations and sales. Smaller companies do not have that, but such companies often can benefit the most from expense

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savings. Thus, we have several articles covering online sales and technology improvements. The lead article is on technology leveling the playing field because this may have the largest long-range impact on improving the cost- effectiveness of the smaller companies.

Regulation is another area of concern for the smaller companies. We have followed various regulations in years past. One example is the AOMR (asset adequacy analysis regulation). Attempts to get rid of the smaller company exemptions have been ongoing. As this issue goes to press, there is an NAIC committee discussing this. Possibly when you receive this newsletter, there will be a proposal before the NAIC to eliminate this. Watch this one.

While continuing to follow this and other regulations, it appears that now we are dealing with procedures as well as the particular regulations. Of note is the way the NAIC functions. In dealing with the regulation of GICs (which is a large-company problem), the due process within the NAIC itself is becoming an issue. Because of the fast pace of changes, the regulators are kept busy,

> ***"Regulation is another area of concern for the smaller companies. We have followed various regulations in years past. One example is the AOMR (asset adequacy analysis regulation). Attempts to get rid of the smaller company exemptions have been ongoing."***

and the Life and Health Actuarial Task Force (LHATF) is heavily involved. They report to the NAIC. In this ongoing discussion, LHATF is attempting to circulate a "fact sheet" on GICs before a position has been taken by the NAIC. Several relevant articles on this are enclosed. Please read them and familiarize yourselves with this issue.

Another area is federal-state regulation. This is being precipitated by the ongoing attempts to regulate insurance sales by banks. In a broader sense, the NAIC is becoming proactive partially because the federal government could take over insurance regulation in general if state regulation is perceived as being ineffective. Changing from state to federal regulation would be precedent-setting. Norm Hill gives us some insights on the general situation in this issue. How banks sell insurance products affects marketing in general and the role of smaller companies in particular. Also, it is a specific case of who regulates what. I give an update in this issue on the situation in Congress with bank insurance sales.

All in all, "no one's life or property is safe while the legislature is in session" continues to be a very relevant adage.

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SMALL TALK

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Price, Ease of Use Are Keys to Online Selling

by Kevin Keegan

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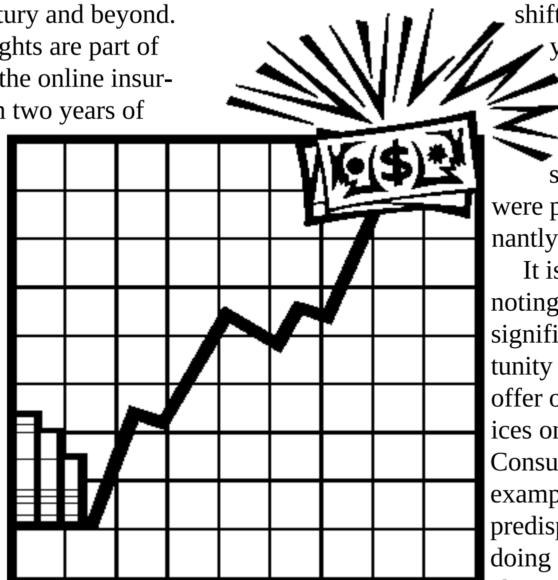
The possibility of getting a lower price for insurance is the most frequent reason online consumers comparison shop for insurance—more so than poor service, disenchantment with a claim, or anything else.

Online consumers also say the Internet has become a more valuable information tool for making an insurance-related decision compared to television, radio, newspapers and magazines—a finding likely to have a far-reaching impact on the industry in the next century and beyond.

These intriguing insights are part of the emerging profile of the online insurance consumer based on two years of extensive market research and analysis of consumer behavior by InsWeb. With almost 400 million online users expected by 2003, a keen understanding of the online consumer is critical to carriers' success as they rethink their distribution strategies in the Internet age.



In the process of helping consumers obtain quotes and select property-casualty and life-health products from 35 leading carriers, we have identified a number of consumer trends.

First, price remains the top reason consumers shop for insurance. When asked what will prompt them to comparison shop, rather than simply renew a policy, 51% of consumers said a better price was the primary motivator. Quality of customer service ranked a distant second at 23%.

We also found that online consumers are discriminating about their online experience. When getting quotes over the Internet, for example, an overwhelming 82% prefer a handful of accurate quotes produced by a single, easy-to-use form, rather than dozens of quote estimates, which are likely to change later if they qualify for that price and policy.

Online insurance shoppers are an increasingly appealing demographic. Sixty-two percent are college educated, and more than four in ten have annual household incomes of $60,000 or greater. Moreover, the age profile of the online consumer falls squarely in the sweet spot of the personal lines market: 57% are ages 25 to 45. And, interestingly, the number of women shopping for insurance online is now the same as men—a remarkable shift from two years ago, when online insurance shoppers were predominantly men.

It is also worth noting that a significant opportunity exists to offer other services online. Consumers, for example, are predisposed to doing simple claims online because they believe they will be able to state their case more accurately if it is written in their own words.

The consumer's willingness to conduct online transactions follows a predictable pattern of behavior.

The typical online consumer first approaches the Internet to collect information or do research. Once he or she feels comfortable doing that, they venture on to small purchases, such as books or CDs. Overtime, these individuals proceed to more sophisticated transactions, such as online banking, online trading and insurance.

That dynamic was clearly evident in the first half of 1999, when online Christmas shoppers and first-time computer owners accounted for a substantial increase in InsWeb's traffic. Many of these consumers had a positive shopping experience over the Internet, as gifts arrived safely and on time, and there were no problems with credit card security or fraud. The ease and convenience of these purchases inspired these customers to try a more complex financial transaction. It's likely that the brief migration from Web novice to sophisticated Web user will repeat itself over and over again, as the Internet becomes a more mainstream tool.

As consumer behavior evolves, it's clear that the Internet's interactivity will likely be its enduring strength. Unlike traditional media such as newspapers or televisions, the Internet empowers online users to drill down to their own level of knowledge and educate themselves at their own pace. Equally important is the Internet's ability to provide personalized and accurate quotes and information that simply can't be recreated in a one-dimensional media. Those carriers who understand the game is to empower consumers are likely to craft the most effective Internet strategies.

The expectations of the online consumer will continue to evolve quickly, challenging carriers to execute effective distribution and sales strategies. The good news is that the Internet enables carriers and agents to analyze consumer behavior more closely than ever before—and create the initiatives to rapidly capitalize on the opportunity.

Kevin Keegan is president of InsWeb's Insurance Services Group located in Redwood City, Calif.

Online Term Life Insurance Quotes Show Wide Variation among Vendors

by Ara C. Trembly

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While online insurance marketplaces are battling to deliver the lowest quotes from the best companies in the fastest time for today's price-driven, time-deprived consumer, a survey of those marketplaces confirms that consumers should shop around and shop carefully when it comes to term life insurance.

To test the performance and limits of these marketplaces, I conducted an informal online survey of several online insurance marketplaces that offer term life quotes. The purpose of the survey was to see how quickly the services could deliver quotes and how long (or high) the quotes would be at each Web site.

The basic questioning format and content was similar at each of the Web sites, but that's where the similarity ended. The life term quotes I received differed by more than 100% for the same risk between some sites, and in one case the difference was that large even within the same family of companies.

> ***"The purpose of the survey was to see how quickly the services could deliver quotes and how low (or high) the quotes would be at each Web site. In seeking quotes, I specified a $100,000 face amount for ten years."***

In seeking quotes, I specified a $100,000 face amount for 10 years, just to keep the numbers round. Great care was taken to answer the questions in the same way at each site. The results here are reported in no particular order and are not intended to rate the sites or their products.

The first site I visited was that of San Mateo, Calif.-based InsWeb (*www.insweb.com*). It took just over five minutes from the moment I clicked on the icon to get a quote until I received my four online quotes. During that time, I answered standard questions about my health background, risks associated with my occupation, smoking habits, recreational risks (e.g., skydiving) and family health history.

InsWeb delivered four quotes, including Standard & Poors ratings for the companies, as reported by InsWeb. The annual premiums ranged from $306 to $492, but a footnote cautioned that the quotes "are not offers to contract." It's worth noting that the other sites I visited posted similar disclaimers.

A second visit to the InsWeb site a day later produced the same quotes, although, interestingly, they were placed in a different order.

Next, I visited the Web site of Alexandria, Va.-based Quicken Insure Market (www.insuremarket.com), which claimed it could give me a term life insurance quote within four minutes. The actual process took about 30 seconds longer, but the real surprise was that I could not get an instant online quote. Instead, I was invited to contact agents for several well-known insurers in order to get quotes.

In reexamining the questions to figure out why I didn't get an instant quote, I saw that when Insure-Market asked me about whether I was receiving treatment for occasional bouts of asthma, I had answered "no." (Over-the-counter medication is all that's needed in my case.) When I changed that answer to "yes" and re-submitted my information, I received a single instant quote of $342 from Lincoln Benefit Life.

I got yet another surprise when I visited the InsureMarket site again the next day. Again, I tried to submit information that included a "no" answer to the asthma question, anticipating that I would receive no instant quotes as before. To my amazement, however, I received three instant quotes—one from Lincoln as before and two lower quotes ($256, $273) from Old Republic Life and Banner Life. A.M. Best Ratings were provided for all three companies, along with a graphic breakdown of features.

QuickQuote (*www.quickquote.com*), based in Incline Village, Nev., lived up to its name, delivering three term life quotes in about three minutes. The annual premium quotes ranged from $293 to $336, but no independent company ratings were provided. A second visit to the site the following day produced identical results.

Two other sites, both utilizing the quoting engine of Internet Pipeline, Exton, Pa., provided markedly lower numbers for the same risk, and both gave me quotes in under two minutes.

QuoteTermLife, a service of Akron, Ohio-based URL Insurance Agency, Inc., offered five quotes ranging from $165 to $310. The lowest rate came from First Penn-Pacific, which, ironically, lists Lincoln National Life as its "parent," while offering a quote that is only half as much as Lincoln's.

QuoteTermLife offered no independent

ratings of insurance companies, although a check of FirstPenn-Pacific's Web site showed an AA- from S&P.

When I visited QuoteTermLife a second time a day later, however, I received only three quotes—the two missing ones being from First Penn-Pacific. Apparently, one day can make a significant difference in what is available.

The second Internet Pipeline site, Insurance InLinea (www.inlinea.com), is a service of Financial Machine.Com, LLC, a Web site that offers links to almost anything from auto loans to Viagra sources. No phone numbers were provided and no geographical location could be ascertained for the company involved. InLinea claims to be "sponsored by various insurance wholesalers, agents and various firms within the industry."

Despite using the same engine, InLinea produced different results from QuoteTermLife. I did get the First Penn-Pacific quote, but the premium was $6 higher for the same product. Lower quotes came from Banner Life (at $163, the lowest I could find) and Old Republic Life ($168).

Again, there was no rating information on the individual companies. A second visit to InLinea produced the same results.

Needless to say, shopping online for term life insurance via an insurance supermarket is very much a process of the moment. Judging by my experience noted here, consumers would be wise to shop around, get a variety of quotes, research the companies, then try again to actually discuss rates with an agent, either independently or with one of the online services.

The bottom line when it comes to online shopping for term life insurance: Caveat emptor—let the buyer beware.

Ara C. Trembly is associate editor at National Underwriter magazine in Cincinnati, Ohio.

Reflections on Being 50

by John O'Sullivan

I have been involved with actuarial work since 1973, which makes me an old timer. Quite a few changes have occurred in that period: Short-term interest rates went from 4% to over 20% and back to 3%. Insurance companies went from a "mutual" perspective to a "stock" perspective. A few prominent insurers, such as Mutual Benefit and Confederation Life, went into receivership. The industry saw the margins in its products shrink as commodity pricing became the rule and customers went to annuities and term insurance.

On the actuarial front, we have learned to pronounce "stochastic" and "paradigm." Other things that we learned include humility and the need for relevance. In a broader sense, our industry has changed and our implicit decision 50 years ago to tie ourselves to a single segment of the financial services industry has had unpleasant side-effects for many actuaries.

Every once in awhile, it is desirable to reflect on where we have been, the lessons we have learned, and where we want to go in the future. Along with an excuse for a celebration, this is the reason to have milestones like our 50th anniversary.

One of my fond remembrances as a young actuary was being trained by a very seasoned actuary, named Henry Huntington. Henry would have had a more difficult time in our new age; he was not very articulate nor very image conscious. This never stopped Henry from making a contribution to solving any problem. He would always start by laying out some principles to follow and then grind through his logic to an answer. In a tradition that Henry would be proud of, I will lay out the principles that we can follow as we prepare for the next 50.

There are three principles. The first is to keep the good. Actuaries have a great training to tackle a broad array of problems and generally work at keeping current. We should have faith in our abilities as we pursue less familiar paths. The second element is to have a positive attitude toward what we tackle and the future. Unfortunately, all of us have been trained by the actuarial perspective to focus on the downside of following a particular course of action rather than the necessity of doing something or trying to work the idea into something better. The last principle is to work together. Our Society has the hallmark of helping one another through volunteer activities, maintaining a high degree of professional integrity, and a strong dedication to professional courtesy and cooperation. This mutual support will encourage more initiatives and eventually more success for our profession.

Each of us should grind through our own logic to an answer. The Society of Actuaries has had a positive influence on all of us. This milestone is a great opportunity for us to think about how we can have a positive influence on the Society as it prepares for the next millennium.

John M. O'Sullivan, FSA was the 1994-95 chairman of the Smaller Insurance Company Section and is a consulting actuary with Actuarial Science Associates, Inc. in Closter, New Jersey. He can be reached at **josullivan@ asabenefits. com.**

Reflections on 1991

by Robert Dreyer

The year was 1991. The venue was the Annual Meeting in Toronto. The setting was a panel discussion on "Gearing Up to Be Appointed Actuaries" chaired by the new President-Elect Walt Rugland. An observation was made that becoming the Appointed Actuary for a small company was a daunting task and that the existence of a special interest Section specializing in smaller company concerns might prove quite useful to many of our members. Walt's response was "If you really think so, why don't you start one?"

The following spring, at the Chief Actuaries Forum, John O'Sullivan and I, recalling Walt's challenge, discussed just what would be needed to start a new Section. After a review of the process outlined in the *Yearbook*, we agreed to take the first step and see if we could find enough support to form an Organizing Committee. The rest is history.

The challenge of becoming Appointed Actuaries proved to be only the tip of the iceberg for smaller company actuaries. (It wasn't very easy for large company actuaries, either, but they had more resources they could apply to the problem.) In the next few years, that challenge has been followed by illustrations, RBC, XXX, ZZZ, a new array of investment-oriented products, a vastly more competitive term market, and now, the prospect of radical changes to the way we calculate reserve and asset values for our certification. Each of these has placed a heavy burden on actuaries and their companies, particularly the need to research and develop new procedures.

Since 1991, my company's actuarial staff has tripled. Without the support of the Smaller Insurance Company Section and the individual members of the Section who participated and shared their experiences, who knows how many more actuaries and support staff we might have needed. I am sure most smaller companies have gone through a similar process with regard to each of those challenges that affected them directly. Inter-member communication of this type was a primary reason why the Section was started, and I think Jim Thompson's efforts as editor of *small talk* were a most significant coordinating factor.

Some people, both members and non-members, have suggested that the Smaller Insurance Company Section should get more involved in research. While I understand their reasoning, I have never seen this as a primary objective. We tried many times over the early years to identify research projects of a scope that was specifically applicable to smaller companies, and we kept coming up dry. In my opinion, the far greater need is for the communication of ideas and approaches that can be used by smaller company actuaries who lack the resources to identify or refine simplified methods or techniques. This will come more from expanded involvement by the Section members and the sharing of their ideas, than from pure financed research. And to accomplish this, we need more volunteers, more participation, and more ideas.

I have played that tune so many times in the past that I must sound like the proverbial broken record. However, I am thankful to *small talk* and the Section Council for the invitation to play it again. As we celebrate the 50th anniversary of the Society of Actuaries, I wish the Smaller Insurance Company Section a most successful future, one that each of you has a wonderful opportunity to help ensure.

Robert Dreyer, FSA, was the 1993-94 chair of the Smaller Insurance Company Section. He is senior vice president & chief actuary at Erie Family Life Insurance Company in Erie, PA. He can be reached at Robert.Dreyer@ reinsurance.com.

Technology Will Level the Playing Field

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network-based computing. Insurers using client/ server networks for their enterprise systems have gotten the jump on competitors.

Now comes the next phase of network-based computing, the Internet. With Internet-enabled systems, participants at remote locations—agents and branch offices—can log onto a Web site, access the insurer's system and produce quotes and issue policies on the spot.

Insurers must also be able to support multiple and blended distribution systems equally well. In the future, most insurers will use multiple systems, and they'll need flexible information systems to support them.

However, most mainframe policy systems were designed to support only one distribution system. As a result, companies with multiple distribution channels have needed more than one policy system—a cumbersome, expensive arrangement. Having a single, flexible system gives an insurer cost and strategic advantages. With a sufficiently flexible computer system, an insurer can plug in a new distribution system with little delay or extra expense.

Tim Pease is senior vice president, operations, with Allenbrook, Inc., in Lowell, Massachusetts.

It All Started with the Small Company Section

by Norma Christopher

When Bob Dreyer called me and asked if I would run for a position on the Smaller Insurance Company Section Council, I was caught in the same quandary we all are as "small company actuaries." How could I possibly find the time to volunteer for the Section? I was the chief actuary of a small life insurance company, the mother of two young boys, and the wife of another actuary. I didn't think I could squeeze one more minute out of the day. However, I had not served on any Society committees or Sections before, and I felt it was time to serve my profession. Somehow I would have to find the time to do this, as we always find time for the things we really want to do, and should do.

I thought I could always run for the position, but didn't think that I could possibly get elected. Then I won the election. Oh well, I naively thought that I would serve as the vice chair, then possibly the chair, then I could go back to my normal life. However, since my days of serving on the Smaller Insurance Company Section, I have been cajoled, coaxed and persuaded into serving on several other Society and American Academy of Actuaries committees to represent the small company viewpoint.

To be fair, I have enjoyed serving on the Council and on all of these committees. In the Smaller Insurance Company Section, I met many actuaries from all over the country, all doing actuarial work that was very similar to what I was doing. I learned more about how the Sections of the Society function and how they can work together on joint projects.

After serving as chair of the Section, I served on an Academy committee reviewing Section 8 requirements of the NAIC Model of the Appointed Actuary regulation. That was a very enlightening and challenging time. This committee had actuaries from several state insurance departments and valuation actuaries from all sizes of life companies. There was a strong political movement by the larger companies to force small companies to do cash flow testing. I felt strongly that every valuation actuary should do some type of asset adequacy analysis. I thought that the small company actuary should do some type of substantiation of the reserve levels other than formulae reserves alone. However, actual cash flow testing should not be required for small companies. This committee took such a large amount of my time that after about six months I had to resign. As you all know, this fight has continued and is still going on.

Next, I served on the Society Committee on Life Insurance Research, which is one of the committees in the Life Insurance Practice Area. This committee serves to review completed life insurance research projects and to determine which research projects should be sponsored by the Society. I try to bring out the small company's viewpoint on every topic. This committee has several conference calls a year and one on-site meeting a year, and I am still a member after two years.

As a result of my service on the Life Insurance Research Committee, I was asked to serve on the Society NAIC Mortality Table Research Task Force. This task force will identify and oversee the research projects needed to support the development of a new valuation mortality table for the NAIC. This new experience table will not be the final table, but it will be the basis for industry and regulatory groups to develop the next CSO valuation table.

Some of the greatest challenges for this task force are:

1) How to extend data to higher issue ages and attained ages; how to select the ending age
2) How to use limited data, such as for smokers, to construct the basic tables
3) How to modify a basic table to reflect new underwriting standards, such as preferred risks, for which relatively little or even no data is available
4) How to modify a basic table to reflect company specific experience
5) How to express mortality rates or adjustments to a basic table as formulae

This task force has similar partisan and political factions as were represented on the Academy committee. There are large companies that are happy with the status quo and don't need new mortality tables. Mainly, they don't want lower tax reserves. There are term specialty companies that need new mortality tables, which more closely reflect actual current mortality, so their term reserve levels won't be as high. There are small insurance companies that need new mortality tables so their company's growth won't strain their statutory surplus levels. It was an honor to be chosen to represent small company interests on this committee and I hope to help everyone get new valuation mortality tables as soon as the underlying bureaucracy will allow.

Every year I vow that I will resign from committee work. However, I must really like it because I continue to take the punishment.

Norma Christopher, FSA, was the 1996-97 chair of the Smaller Insurance Company Section. She is vice president & life actuary at Cotton States Life Insurance Company in Atlanta, GA. She can be reached at nychristopher@ mindspring.com.

Bigger Is Not Always Better

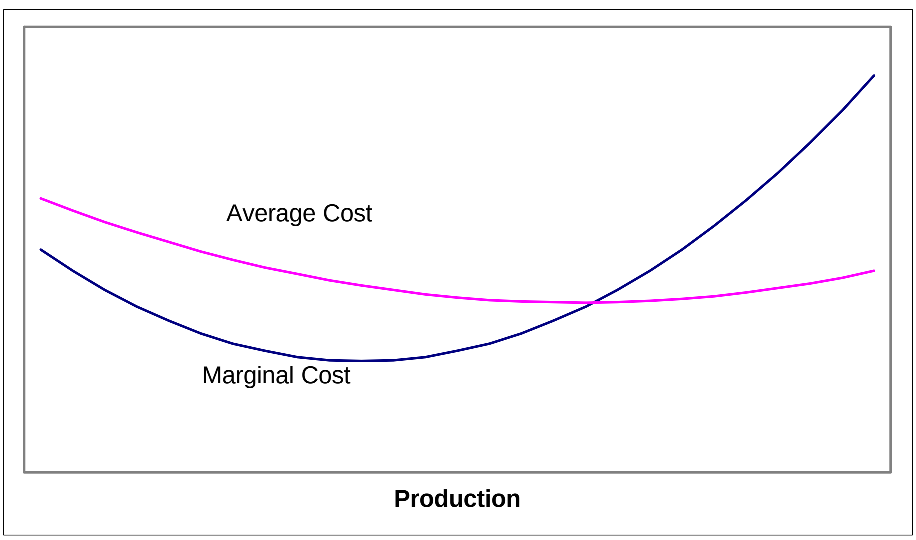
by Grant Hemphill

One of the more memorable experiences of my year as chairperson was a debate which I moderated at the Spring 1996 SOA meeting in Orlando. The topic was "For and Against Industry Consolidation." Scott Cipinko (of the National Association of Life Companies) and Tom Dlouhy argued against consolidation while Mel Young and Mike Sproule argued for it. The debated resolution was: "The public would be well served by extensive consolidation of the industry." We polled the audience before and after in order to see if we had swayed opinions. The shock to me was that a large majority of the audience favored consolidation (before and after the debate). At Smaller Insurance Company Section function, I had expected otherwise.

No winner was declared that day, but the session was very lively and entertaining. Perhaps Mel Young and Mike Sproule were more persuasive, since Tom Dlouhy has gone from small company work to find success at consolidation.

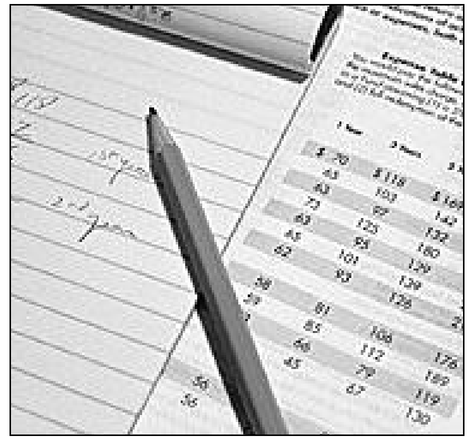
The conventional wisdom that there are economies of scale was mentioned but not questioned. Bigger companies will achieve lower unit costs. All companies must achieve critical mass. Critical mass is getting larger. Consolidating companies will lower costs. Centralizing operations in a larger unit will lower costs. (However, the centralized operation may be less responsive to marketplace needs.) This view is well expressed in Henry Mintzberg's *The Structuring of Organizations*, Prentice-Hall, 1979.

It is hard to find business people who will disagree with that conventional wisdom. Even in the face of contrary data (and there is much), they will not consider the possibility that the theory is wrong. "Management just failed to make the necessary tough decisions after the merger."



Economists do not agree that bigger is cheaper. They view the above arguments as sociological rather than economic. Every microeconomic text has a chart similar to the one on this page.

Economists really believe this. Marginal costs first decline with increasing units and then they increase with increasing units. I have asked many business people about the above marginal cost curve and they think it must apply to industries other than their own. In their industry, they think the curve must continue downward with increasing scale. Some of the texts suggest why the curve turns upward. Perhaps some production variable begins to be strained. Eventually, necessary resources are limited.



A better explanation is found in Oliver Williamson's *Markets and Hierarchies: Analysis and Antitrust Implications*, Free Press, 1975. Williamson believes in the power of free market economics. It drives out inefficiency. Spending decisions that are exposed to market economics will be efficient. Spending decisions that are isolated from market economics tend to become inefficient. How does this isolation happen? A government bureaucrat provides the extreme example. He has almost no idea what expense the public is willing to pay for the function he performs. But the distant, centralized, corporate employee is in a similar situation. She can only try to do her job "better." Each becomes a budget maximizer, sincerely trying to do a better job and needing a larger budget to improve service.

In Williamson's words, "The organization of the large enterprise along the lines of the (product or market divisions, or small companies) favors goal pursuit and least-cost behavior more nearly associated with the neoclassical profit maximization hypothesis than does the [functionally centralized] organizational alternative."

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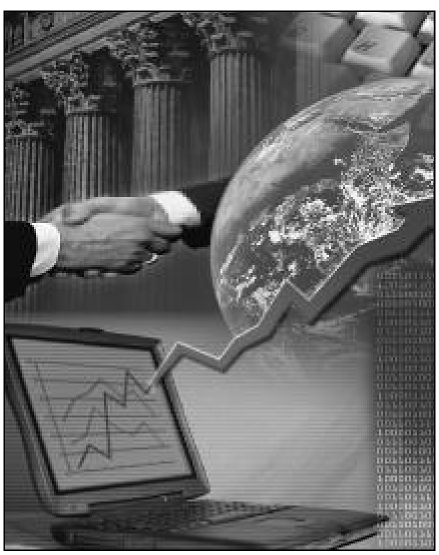
Bank Insurance Regulation—An Update

by James R. Thompson

For over a decade, the banks and the insurance companies have been involved in some marketing problems on the sale of insurance policies (mainly life and annuities) through banks and savings institutions. This has been a source of constant and intricate regulatory conflict. Currently, the states regulate insurance products. They license agents and regulate market conduct. They deal with the solvency and investment practices of insurance companies.

Insurance products enjoy certain advantages relative to banks. The inside buildup of cash value is the main one. This means that a return of, say, 5% is 5%, but with a bank savings account, unless it is an IRA, it is lessened by the interest income being included in personal income tax.

Banks, in the other hand, have certain advantages over insurance companies on raising capital; mainly they are the source of it. They lend each other money at the prime rate. Insurance companies are usually not so lucky.



When each institution had its own bailiwick, and knew the rules, there was no problem. Competition for the savings dollar of the consumer has changed that. In the '80s, insurance companies began to go after the savings dollar through annuity vehicles. Mutual funds, brokers, and banks also competed. Insurance companies began trying to get places selling insurance products in banks. But, what if the banks could issue their own insurance policies? What exactly is an insurance policy? Who would regulate this?

Without legislation, banks will try to design "insurance" products and sell them. Will the Office of the Controller of the Currency or some other federal authority try to allow this and thus create a jurisdictional dispute? If banks sell a product that is classed as insurance, it should come under state regulation. This means market conduct, investments and everything else.

To solve this situation, Congress has been working on legislation. The House has come up with H.R.10 and the Senate with S.900. They are different, and they are being reconciled as we write.

Smaller Companies

BEFORE PROCEEDING FURTHER, we should ask ourselves why the Smaller Insurance Company Section should take an interest in this? "Smaller" has always been a relative term. There are about 9,000 banks, and it is estimated that maybe 100-200 will get involved in selling or developing insurance. They may end up by working with subsidiaries or buying up insurance companies and putting them in a holding group. Banks have more capital than insurance companies, and these few big ones may end up buying, controlling or forming their own.

The other banks, if they get involved at all, will probably let some insurance companies sell their products in the banks. Although it might seem that the insurance companies whose names have appeared in current bank-insurance liaisons are fairly large, in the future, there may be some niche players. Note elsewhere in this issue the article on the importance of technology in operating efficiency. Smaller companies can use PCs-LANs efficiently and enhance their ability to compete. Some may develop a niche of using this technology to work efficiently with regional and local banks. This will be a new marketing opportunity for smaller companies. Thus, there is some interest in how the relations between banks and insurance companies will work.

Other smaller companies may feel left out. Will they be able to survive in a society in which some companies work well with banks? Will the bank-insurance liaison work well? These questions are of interest to smaller companies.

Summary of the Bill

I TALKED WITH Allen Caskie of the American Council of Life Insurance (ACLI). In its efforts to keep up with this, ACLI has produced a comparison of the current versions of the two bills. I have excerpted some of the provisions.

States' authority to regulate bank insurance affiliations

THE SENATE BILL (S.900) has the usual general authority to review and approve proposed acquisitions so long as they do not discriminate because a bank is involved. Under the House bill (H.R.10), states may not prevent or restrict, but may require information and may reject only based on issues of capital, solvency, and managerial fitness. The states are pushing for the Senate Bill.

States' authority to regulate bank insurance sales and cross-marketing

BOTH CONTAIN EXPLICIT requirements for a state insurance license, but there is a nondiscrimination test for sales or cross marketing. The House bill gives explicit functional regulation for banks' insurance sales through small town locations.

(continued on page 13, bottom half)

The Future of Life Insurance Products: Lessons from the Past

by Christian DesRochers

As the Society of Actuaries celebrates its 50th anniversary, it is instructive to consider some of the changes that have occurred and those that have not occurred in the life insurance products over the past 50 years. To say that we are not the same industry as we were 50 years ago is an understatement. There have been significant changes in technology and communications that have affected all industries, including life insurance. With the conversion of many mutual life insurance companies to stock life insurance companies, we are seeing a change in structure that goes back to the very beginnings of the life insurance industry in the mid-1800s, as well as the reforms made in New York in the early 1900s by the Armstrong Committee. The most popular forms of life insurance are not the traditional whole life products of the past, but are newer forms of policies, including universal life and variable universal life insurance.

In the midst of this change, however, not everything is new. Although many of the products have been updated and contemporary products have more flexibility than their historical counterparts do, the basic structure of life insurance products (and the life insurance contract) has not changed in the past 50 years.

Many of the changes that have occurred have been directed at more customization of existing products and not the development of fundamentally new products. There are more underwriting classes today than in the past. This includes not only the differentiation of smokers and non-smokers, but also the addition of preferred underwriting classes. Products have becomes more flexible. There is little economic difference between modern participating whole life insurance policies structured with term and paid-up additions riders and universal life insurance. Both provide flexibility to the buyer in terms of the flow of funds to the insurance company. Both can provide a degree of flexibility in the policy costs.

However, all contemporary life insurance products exist within a framework that is more than 50 years old. There are two fundamental parts of the current framework in which all life insurance product development occurs. These are: (1) the standard nonforfeiture law and (2) the preferential tax treatment of life insurance found in sections 101(a) and 72(e) of the Internal Revenue Code. Without fundamental changes in both, the past will continue to be a prelude to the future of life insurance products.

Nonforfeiture Values

THE DEVELOPMENT OF contemporary nonforfeiture values can be traced back to the first state nonforfeiture laws in the 1860s. The current nonforfeiture structure, the prospective adjusted premium method, has its roots in the 1942 work of the Guertin Committee. Before that time, nonforfeiture values were generally based on reserves. Within a few years after issue, the full reserve held under the policy was often made available to a terminating policyholder, reduced by a surrender charge. Under competitive pressures, liberalizations occurred until the early 1930s during the Great Depression when increased terminations, reduced interest margins, increased taxation of life insurance companies, and the depressed economic conditions generally led to a reduction in surrender values. The work of the Guertin Committee in the early 1940s was intended to address the equities of granting surrender values between terminating and persisting policyholders. It is from this effort that the current system of mandated minimum nonforfeiture values arises. Although changes have been made in the required assumptions, there has been no fundamental change in the methodology arising from the Guertin Committee work in the early 1940s.

While changes to the nonforfeiture law have been proposed from time to time, the actuarial community, the life insurance industry and its regulators have yet to agree on the scope or structure of a revised standard. As the Society of Actuaries celebrates its 50th anniversary, it is notable that the fundamental structure under which life insurance cash values are provides to policyholders has been fundamentally unchanged.

Tax Preference for Inside Build-up

THE SECOND ELEMENT that indirectly governs life insurance cash values is the tax treatment of life insurance under the Internal Revenue Code. Unlike the nonforfeiture law, the tax treatment of life insurance has changed fundamentally since the 1940s. The result is that the current products, as well as the way in which those products may be financed, has been significantly limited. The result is that the variety and flexibility of life insurance products has been curtailed since the 1940s, with entire classes of products effectively eliminated from product portfolios.

While the most significant change in the taxation of life insurance was the enactment of the definition of life insurance in 1984, there were a number of changes in the tax treatment of life insurance policies that restricted product design and marketing throughout the period. Most of the changes can be attributed in one way or another as congressional reactions to specific life insurance products. These include:

- The Revenue Act of 1942 eliminated the deduction of policy loan interest paid to purchase a single premium life insurance policy. This limited the sale of single premium policies, which had been popular in the late 1930s and early 1940s.

- As a response to the 1942 limitations, the life insurance industry used a premium deposit fund and an annual premium policy for financed single premium policies (interest on premium deposit funds was not taxable to the insured). The Internal Revenue Code of 1954 limited the use of advance premium deposit funds to pay "substantially all" of the premiums for a life insurance policy.

- In 1964, in response to the sale of minimum deposit policies with advance premium deposit funds, the deduction for policy loan interest was limited to policies under which no more than three of the first seven premiums were paid using a policy loan.

- In 1982, in response to universal life insurance policies, Congress enacted section 101(f) of the Code, which provided a definition of life insurance for flexible premium life insurance.

- In 1984, Congress enacted section 7702, which extended the 101(f)-style limitations to all life insurance policies. Section 7702 effectively eliminated endowment policies maturing before age 95, as well as other forms of high cash-value plans, including retirement income policies.

- The Tax Reform Act of 1986 eliminated the deduction of policy loan interest by individual taxpayers, thus effectively eliminating the individual financed insurance or "minimum deposit" market. The deduction of policy loan interest to corporations was limited to a $50,000 loan per insured employee.

- In 1988, responding to the increased sale of single premium life insurance policies, Congress enacted the modified endowment rules in the Technical and Miscellaneous Revenue Act.

- In 1996, the deduction of policy loan interest was phased out for corporations, with interest effectively non-deductible after 1998.

"Unlike the nonforfeiture law, the tax treatment of life insurance has changed fundamentally since the 1940s. The result is that the current products, as well as the way in which those products may be financed, has been significantly limited."

Whether the "abuses" that Congress sought to eliminate were perceived or real is a matter of one's perspective. However, the numerous legislative changes related to the tax preferred treatment or the interest earnings inside a life insurance policy limit product flexibility. Currently, the section 7702 limitations serve as the mirror image of the nonforfeiture law. The nonforfeiture law mandates an actuarial floor on the allowable cash value based on the insurance benefits to be provided and the pattern of premium payments. The section 7702 limitation provides a ceiling on the allowable cash value. For products in which the cash value floor exceeds the tax law ceiling, the product simply disappears from life insurance product portfolios.

A View of the Future

WHAT IS THE net outcome? There are, I believe, two consequences of the relationship between the nonforfeiture and tax code limitations. First, the range of allowable products is narrow. All life insurance products must function between the two limitations, and there simply isn't much room to operate. Second, the probability of meaningful reform of both the nonforfeiture law and the tax definition to allow a wider range of permissible products is low. Thus, the current product structure, with all of its complexity and limitations, is likely to continue for the future.

One thing that could alter the status quo would be a change in the current life insurance tax preference. This could occur as a consequence of a change in the tax law to a consumption tax, in which case no interest would be taxed, thus eliminating the need for special limitation on life insurance. It could also occur as the result of the direct imposition of a tax on the interest earnings in a life insurance policy. However, as Professor Joseph M. Belth wrote in 1978, "the implications of taxing the inside interest are scary" and is not a prospect that the insurance industry would accept willingly.

Because of the dual limitations, life insurance companies are faced with the reality of continuing to refine the current portfolio of products within the existing tax and regulatory framework. If we have managed to do so for the first 50 years, perhaps we can manage to do so for the next 50.

Christian J. DesRochers, FSA, MAA, is a consulting actuary & partner at Avon Consulting Group LLP, in Avon, CT. He is also the current chairperson of the Smaller Insurance Company Section and he can be reached at cdesrochers@ avonconsulting.com.

Annual Meeting Sessions

Monday, October 18, 12:15 p.m. - 1:45 p.m.
Session 27

Smaller Insurance Company Section Luncheon - Open to Section members only, advanced registration is required, no charge.

Hear an expert talk about a virtual world in which business must learn to exist. The capabilities of the virtual company may be limited by the realities of today, but not by the imagination.

Tuesday, October 19, 8:00 a.m. - 9:30 a.m.
Session 65

"R" Rated - Risk in Capital Management

Interviewer: John E. Wade
Interviewees: Richard Kirk
David H. Lister
James D. Maughn
Michael J. O'Connor

This session features interviews with several authorities on the following current topics:

- How the rating agencies view capital management in determining company ratings
- How the rating agencies view the independent review process
- How capital management is addressed with a non-insurance company parent
- How financial reinsurance can be used to strengthen your capital position

Attendees are encouraged to submit questions in advance to the SOA Continuing Education Staff at *bchoyke@soa.org* or fax to (847) 706-3599, please reference San Francisco Annual Meeting, session number 65 I.

Wednesday, October 20, 8:00 a.m. - 9:30 a.m.
Session 136

Building Bridges With Alternative Marketing Methods

Panel:
Norman E. Hill
James B. Smith, Jr.
Robert H. Dreyer

The panel addresses alternative marketing methods that bridge buyers and sellers. Alternative marketing methods for discussion are:

- Worksite marketing
- Non-traditional marketing survey results
- Marketing through property/casualty agents

Presenters lead participants through various aspects of new and existing marketing methods.

Bigger Is Not Always Better

continued from page 8

Two examples will illustrate.

I once worked for a small life subsidiary of a distant, giant manufacturer. Fortunately, we were usually quite autonomous. But, I remember the day when corporate engineering showed up with the parking lot signage. The signs were beautiful and very substantial. They were built to the same standards and quality as those used at the corporate palace. Economies of scale certainly applied because we could never have purchased such opulent signs for the expense that was allocated to us. But in our small town, there was no need for any signs.

Competitive term is sold with inexpensive advertising. However, I have known more than one company that used an expensive, glossy, multicolor, multipage term brochure because corporate standards suggested one for each product. Again, the cost was lower due to centralized economies of scale but too high because the expense was out of touch with the market.

> ***"Competitive term is sold with inexpensive advertising. However, I have known more than one company that used an expensive, glossy, multicolor, multipage term brochure because corporate standards suggested one for each product."***

There is one counter argument to the idea that centralizing functions isolates them from market economics. In theory, a very good communication, cost allocation, and budget system could restore market pressure to remote expenses. Williamson says that the cost of such a system quickly exceeds the savings it can produce as organizational complexity increases.

I think the future is good for small, focused insurance companies because we have marketing, service and expense advantages that come from being in touch with our consumers.

Grant Hemphill, FSA, was the 1995-1996 Chairperson of the Smaller Insurance Company Section and is vice president and actuary at Western Security Life Insurance Company in Indianapolis, IN, a term insurance subsidiary of Indianapolis Life Insurance Company.

Bank Insurance Regulation—An Update

continued from page 9

Definition of insurance

THE ACLI WAS involved in negotiating this. Both bills are the same. It defines insurance with reference to the federal tax code.

Insurance underwriting

THIS IS A MAJOR issue. Both bills stipulate that insurance can only be written by holding company subsidiaries. The Senate bill, however, allows an exception for small banks (for banks, it is less than $1 billion of consolidated total assets). Will the Treasury or the Fed have jurisdiction over this? This may be a deal-breaker. Obviously, the insurance industry wants to maintain control over the underwriting. The only hope of smaller companies that might get involved in providing products for this market is to make sure the insurance industry has this control.

Other Issues

THESE BASIC ISSUES involve clarifying the roles of the banks and insurance companies and who will regulate them. Insurance has generally been regulated by the states, and large banks have generally been regulated by federal law.

There are many aspects of federal law that do not apply to insurance companies. The Democrats are trying to include various issues in this regulation. Some of these are: downstream commercial investments, the control of takeovers of recently demutualized insurers, the application of the Community Redevelopment Act (CRA), application of domestic violence, and the privacy of medical and financial information.

According to Allen Caskie, much of the compromising will be partisan with Democrats trying to insert these provisions, and the Republicans trying to keep them out and focusing on the bank—insurance issues. We should all be watching how this turns out. If nothing has been finalized by the time you received this issue, you should contact your state representative with your views.

***James R. Thompson, FSA, is a consultant with Central Actuarial Associates in Crystal Lake, Illinois, Editor of small talk, and a member of the Smaller Insurance Company Section Council. He can be reached at* jrthompson@ ameritech.net.**

Headlines from NALC Group

by Scott Cipinko

Editor's Note: The following excerpts were taken from the newsletter of the National Alliance of Life Insurance Companies (NALC) and are reprinted with permission.

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State-Federal Relations Committee Report NAIC Leadership Rebuked

THE NATIONAL COUNCIL of Insurance Legislators (NCOIL) State-Federal Relations Committee met on Friday, July 16, 1999 in Cincinnati. The chair of the Committee is New Jersey Deputy Speaker, Clare Farragher, who is also president-elect of NCOIL. Also in attendance at the meeting on behalf of the NAIC leadership were Commissioners George M. Reider, Jr. (CT-NAIC President), George Nichols, III (KY-Vice President and Chairman of NAIC Executive Committee), Kathleen Sebelius (KS - NAIC Secretary-Treasurer).

The meeting had just begun when the discussion turned to financial services reform and H.R. 10. NAIC President, David Counts (TX) began to speak about the NAIC's position on financial services reform. Representative Counts recalled that the NAIC had urged NCOIL, along with the National Governors Association and the National Conference of State Legislators, to join in with the NAIC on a letter to Congress objecting to financial services reform, due to the potential preemption of state regulation and legislation. Representative Counts' tone became more urgent and eventually he began to admonish the NAIC leadership.

Representative Counts explained that he was upset because the NAIC, without discussing the potential shift in the adopted policy with the coalition partners, held a conference call among all of the state insurance regulators. This position shift was decided during a conference call held in Executive Session among the insurance regulators. During the conference call, the regulators apparently gave the NAIC staff and leadership broad authority to change the NAIC position in opposition to H.R. 10. As a result the NAIC leadership approached Congress for a specific grant of authority to regulate state insurance licensing to the preemption of state legislators. This issue was covered fully in the June 1999 edition of the Newsletter. Representative Counts admonished the regulators because that decision was made to the exclusion of the coalition partners, including NCOIL. Representative Counts stated the history of the involvement of the NAIC in an attempt to avoid the federal regulation created by Congressman John Dingell (MI). He then accused the NAIC of becoming exactly what everyone was trying to avoid, a national regulator.

In response to Representative Counts' statements, NAIC President George Reider took the microphone and apologized without making any excuses for the actions of the NAIC, even though its actions were in contradiction with the agreement that had been struck with NCOIL. The same conciliatory tone was taken by Commissioner Nichols. However, Commissioner Nichols went farther and promised that the NAIC leadership would invite the NCOIL leadership to participate on a going forward basis in conference calls and other meetings to determine policy decisions on Capitol Hill in connection with financial services reform.

This promise was very short-lived. Only moments after Commissioner Nichols left the microphone, Commissioner Reider returned to rescind the broad promise and replace it a promise that the NCOIL leadership would be kept informed of the decisions made by the NAIC.

Senator Dale Schultz (WI) pointed out that the NAIC and state regulators have no power to convince members of Congress to support state regulation of insurance. However, as congressional districts will be redrawn by state legislators, members of Congress have a reason to heed the concerns of those state legislators.

As a result of this rather one-sided exchange, a follow-up meeting took place in Cincinnati between the NCOIL and NAIC leadership and the staff of both organizations. We believe that both sides now understand each other better as a result of these meetings, which were not attended by members of the industry.

Confidentiality Takes Center Stage

A NUMBER OF months ago, the NAIC leadership determined that it was very important for regulators to be able to share confidential information about insurance companies with other regulators. However, it was not clear which regulators would receive this information, or how they would receive the information. It is also not clear what information will be shared.

Many questions have been raised, including the issue of waiver. The NALC and other trade associations have pointed out that the NAIC Access to Information Working Group has been specifically dealing with the issue of privilege and waiver and that the broad language used in the draft Confidentiality proposal circulated by the regulators has, in fact, raised these issues and connected the work on Confidentiality with the work of the Access to Information Working Group. On July 22, 1999, the NAIC leadership held a joint conference call with the industry concerning this matter. Once again, the leadership insisted that the work of the Access to Information Working Group is not linked with the Confidentiality issue. The regulators had hoped to have the industry buy-off on the proposal so that a hearing would not be required. However, given the fact that numerous questions have not been able to be answered by the leadership, it is clear that a hearing is necessary.

Unfortunately, the hearing is scheduled to take place after the Standard Valuation Office (SVO) Restructuring Hearing at the same location, (Hyatt Regency O'Hare) and on the same day. It is doubtful that the SVO hearing will wrap up in time to permit a full and open discussion of the Confidentiality issue.

On the conference call, the NALC asked the following questions:

1. Which models were chosen as

appropriate for amendment and why were they chosen? There is a concern that some of the models chosen may not require amendment, while others that have not been considered should be amended. A discussion of the selection process would help us better understand the rationale behind these decisions.

2. We have an overriding concern about the type of information that would be shared with other regulators and which regulators would be involved in the disclosure. Further, how will any information that is shared be used?

3. Would the companies that are subject of the information sharing have the right to be notified? Would there be a right to review and/or rebut any errors?

4. How will information be shared with international regulators? Would electronic transmissions be made? If so, how will the information be safeguarded?

5. Will other regulators be bound by the same confidentiality requirements as state insurance regulators?

In addition to these concerns, we share a number of concerns with other trades who have also written to the regulators in connection with this project.

Members interested in additional information should contact the NALC office. If you are interested in attending the meeting in Rosemont, please contact our office so we can meet with you while you are here.

AOMR Discussions Will Continue In Kansas City

FOR THOSE OF you who follow the NAIC Life and Health Technical Task Force, you know that the NALC attended what is generally now referred to as "LHATF Week in Kansas City." This year, meetings took place during the week of August 23. On August 25, discussions turned to Actuarial Opinion Memorandum Regulation (AOMR). Specifically, discussions will continue regarding a proposal to remove the small company exemption and require that all companies file a Section 8 Opinion. The NALC will continue to object to this expansion of costs without benefit for smaller companies.

> ***"Discussions continue regarding a proposal to remove the small company exemption and require that all companies file a Section 8 Opinion. The NALC will continue to object."***

Members interested in additional information regarding this matter should contact the NALC office.

GIC Bailouts Raise NAIC Due Process Questions

AS PREVIOUSLY REPORTED, Larry Gorski (IL) and a number of other members of the NAIC/LHATF have raised many questions regarding Municipal Guaranteed Investment Contracts (GICs). In particular, the provision that troubles these regulators would allow for a municipality to withdraw from the contract in the event that a rating agency downgrades an insurance company. The stated concern is that in an insolvency situation, a preference would be created in favor of the municipality, to the detriment of other policyholders.

As a result of this concern, Gorski and a number of other regulators have attempted to circulate a "fact sheet" about these products. Unfortunately, the fact sheet would be sent on any NAIC letterhead directly to state regulators in an attempt to persuade them not to approve these agreements.

The NALC and other trade associations and members of the industry objected to this attempt to circumvent the due process provided by the NALC bylaws. Our objections have been heard, and a number of conference calls have been held in connection with this matter. It is the general position of the NALC that insurance products should not be banned. In this particular instance, these types of instruments may be underwritten by non-insurers. Further, due process requires that the NAIC, prior to sending out such a statement to the states, expose any language to all 55 insurance regulators who will have an opportunity to review the matter before voting.

A conference call of the Innovative Products Working Group of the LHATF regarding this matter was scheduled for July 29, 1999. This newsletter went to bed prior to that date, so we will update the membership on the decisions made on that conference call in the August edition of the NALC Newsletter. Further, on August 17, 1999, the LHATF will have a joint conference call with the Life Insurance & Annuities (A) Committee on the fact sheet.

A troubling theme has persisted in connection with this and a number of other matters. It is the "opinion of the NAIC legal staff," that the NAIC process allows for the circulation of such a fact sheet to the states, without following the due process requirements of any NAIC Bylaws. We will continue to object to this position, however, we have a concern that the conference call of the Life Insurance & Annuities (A) Committee will provide an authorization that the fact sheet be sent out to the states in violation with the NAIC Bylaws.

(A copy of the NALC's letter to the NAIC leadership on this matter is on page 18. The NAIC fact sheet is on page 20.)

Scott Cipinko is Executive Director of National Alliance of Life Companies, located in Rosemont, Illinois. He is also editor of its monthly newsletter.

Small Companies & Federal vs. State Regulation

by Norman E. Hill

Long-established state regulation for insurance companies started to come under fire in the early '90s. Primary causes were insolvencies of several large life insurers. Congressman Dingell wrote a very critical report about inadequacies of the state structure. In response, the National Association of Insurance Commissioners worked to establish an accreditation system. In general, there was increased concern about passing more model bills faster and pushing for more uniform adoption of models across the 50 states.

In 1994, when Republicans gained control of Congress, agitation for federal preemption lost momentum. New Congressional leaders seemed to support continued state regulation, although for some legislation such as the Health Insurance Portability and Accountability Act (HIPAA), they did not hesitate to establish federal mandates for states to adopt.

Recently, several small life insurers have been victimized in a scam. Whether through ownership or reinsurance ceded, their invested assets were removed to a common location and then transferred overseas. Although the total amount for guaranty associations to make up is small compared to previous bankruptcies, the question of the adequacy of state regulation has again arisen. One article in *Business Week* called for complete preemption by a federal authority.

Also, a liquidity crisis suffered by one large company has affected its ability to pay cash values on certain large GIC/type policies. Even though its solvency does not appear threatened, this incident may lead to similar attacks on state regulation.

Democrats believe they have a chance in 2000 to regain control of at least the House of Representatives. If so, Congressman Dingell would again be in charge of a key committee looking into insurance matters.

Both of the above developments have once again made state versus federal regulation a hot topic for insurers. Property-casualty associations have been mixed in their sentiments. So far, life and health trade associations have rallied behind the existing state framework. This is especially true for the association representing small life companies.

Areas of Concern about State Regulation

KEY ASPECTS OF the existing regulatory framework are often attacked as inadequate, inconsistent, or onerous. In a few cases, I have provided some counter arguments.

Products

TO MANY, THIS area is the most troublesome aspect of state regulation. There is a distinct lack of uniformity in state regulations governing policy forms, rates and advertising material. The problem is worse for large companies or even small companies that market across a substantial number of states. This problem is even more acute with health insurance than life insurance.

Some critics go even further and claim that, besides lack of uniformity, there is lack of objectivity. Individual insurance departments are inconsistent in treatment of one company versus another. Often, this depends on what analyst reviews submissions. Moreover, departments may be inconsistent in treating an individual company across time. Some claim that individual department analysts are often arbitrary and capricious in reviewing submissions. Since regulations are often generally worded, analysts' own whims govern. In such case, the insurer has no option but to amend its filing for that state or demand a hearing.

This lack of uniformity makes it virtually impossible for uniform national products and marketing campaigns. The cost of doing business is increased as a result, both in home office attempts at gaining approval and in lost sales due to regulatory delays.

One answer could be uniform policy provisions for standard benefits. Such change, of course, would not help with innovative new products. Nevertheless, the approval process could often be speeded up.

Perhaps, a new designation such as "Certified Policy Analyst" could be devised. With centralized training, state insurance department employees could become more knowledgeable of products. Adoption of model laws is not enough; more uniform interpretation of complex concepts is needed to improve the process.

One proposal in a particular state would have allowed automatic policy approvals for any form previously approved in a large number of states. However, the governor vetoed the bill on the grounds that it would interfere with existing insurance department authority.

Currently, rate filings with new health products must certify uniformity with minimum loss ratios. Recently, there has been a movement to do away with these. Instead, rates would have to be actuarially certified as "sufficient," but still not "excessive." If this change were adopted, there would be no objective standards for approving rates at all.

Even more recently, regulators have expressed concern over rate increases on existing long term care products. Once again, minimum loss ratios have been proposed as a precondition for granting such rate increases.

For health medical policies, states routinely adopt bills that require additional mandated benefits. In some cases, these may be considered as clarifications of existing policy provisions. In other cases, they definitely provide additional benefits. These bills apply not only to new sales but also to policies already inforce under previously approved forms. Policyholders must often be notified in writing of such mandated benefits.

Accounting and Auditing

UNIFORM REQUIREMENTS FOR annual CPA audits and opinions based on statutory accounting are in place. Originally, the expectation was that this change would free up department personnel for market conduct and similar exams. However, states routinely duplicate and sometimes contradict outside auditor conclusions on all aspects of financial statements.

Statutory CPA audits are in addition to SEC GAAP audit opinions required by most insurers. They add a significant cost for companies. Lack of reliance in them by insurance departments adds further to costs under state regulation.

Recently, statutory accounting was codified after a study that took several years. However, at the last minute, the scope of the new statutory accounting was watered down. Now each state can set its own accounting principles. General conformity with codification will eventually be required for accreditation. However, codification has set no uniform standards for investments or minimum reserves beyond the existing Standard Valuation Law. One state has been adamant about retaining investments standards more liberal than most other states.

Receivership

IN INSURER BANKRUPTCIES, receivers are appointed to run the companies temporarily. Receivers are usually insurance department employees. In some cases, there have been complaints about extensive delays in resolving company problems, selling off blocks of policies or assets, and ending the receivership. It is uncertain whether commercial bankruptcies have similar problems with court-appointed receivers and whether such bankruptcies are resolved more efficiently.

Market Conduct

SOME INSURERS HAVE complained about a generally hostile attitude on the part of market conduct examiners. Instead of concentrating on identifying and correcting problems, their emphasis is on maximizing company fines, i.e., on raising revenues for the department. Instead of defining one general type of violation, fines have sometime been levied for each individual instance of a violation.

Arguably, this attitude is similar to federal inspectors from the Environmental Protection Agency and the Equal Employment Opportunity Commission. There is no reason to believe the situation would be improved under federal regulation.

Health Insurance Portability and Availability Act (HIPAA)

RECENT FEDERAL LEGISLATION on health insurance instructed the Treasury and the Health Care Financing Administration to prepare various interpretive regulations. These were to cover areas such as long-term care, renewability and definition of certain health products. After over two years, none have been prepared. Someone argued that if this is an example of the effectiveness of federal regulation, it makes the current state structure look good.

Reserves

SOME INSURERS MAY support federal preemption, because they believe that current reserving standards under the state system are overly conservative. Their hope may be that a unified federal system would lead to more liberal statutory standards.

This opinion is questionable. There is no evidence that federal authority would call for radical changes in accounting and reserving standards, such as under GAAP accounting. Also for solvency purposes, intangible assets such as deferred acquisition cost and goodwill might not be admissible. Many products today require full account values for GAAP, which might even surpass statutory requirements.

Agent Licensing and Company State Admissions

THERE HAVE BEEN general complaints about extensive delays in obtaining these types of licenses.

General Considerations

SOME HAVE ARGUED that, for state regulation of insurance to survive and ward off federal preemption, greater state uniformity is needed. In other words, laws and regulations cannot continue in the current patchwork structure. For this change to occur, education is needed to convince sensitive state regulators and the National Conference of Insurance Legislators (NCOIL) Currently, several legislators have stated publicly that they “won’t allow the NAIC to tell them what to do.” In New York, one legislator has deliberately bottled up one small, technical piece of legislation that has prevented New York (the most prominent regulatory state) from keeping its NAIC accreditation.

These groups will have to be convinced of the following:

1. Significant problems do exist in the current state structure.
2. The only alternative is greater uniformity among states or complete loss of their power to federal preemption.

Use of state compacts is one possibility for achieving uniform legislation. To curb problems with narrow majorities, significant regulations, models and amendments might require super majorities of states, such as 60% or higher. Such requirement might solve the very touchy question of states’ rights.

In the industry, there may be increasing sentiment for federal regulation. This seems more prevalent among larger companies. Today, many of these are subject to the New York Insurance Department, considered the toughest state.

The concept of dealing with only one regulatory body on a national basis has a certain appeal. However, it should be remembered that once a switch to federal regulation is in place, there is no appeal from that regulatory body (except to the extent that decisions of the SEC or the IRS can be challenged in court). With onerous regulation in certain states, companies have the option of redomesticating or of setting up new subs. No such alternative would be available under federal regulation.

Possible Options

SEVERAL OPTIONS ARE available for companies to promote, including:

1. State charters continued on an improved national standards basis; these standards could come from state compacts or federal mandates to states.
2. Federal charters, preempting all state powers.
3. Retain the status quo and struggle with existing problems, while pushing for uniform adoption of existing models.

Conclusions

So far, the NAIC has vigorously supported state regulation of insurance, both in public and in testimony before Congress. Key segments of industry have supported them. Nonetheless, key changes in the current system may be necessary to retain a state regulatory structure.

Norman E. Hill, FSA, is senior vice president and chief actuary of Kanawha Insurance Company in Lancaster, S.C., and a member of the Smaller Insurance Company Section Council.

Letter to Commissioner Vaughan

July 30, 1999
Honorable Terri Vaughan, Chair
Life Insurance and Annuities (A) Committee
National Association of Insurance Commissioners
120 West 12th Street
Suite #1100
Kansas City, MO 64105-1925

RE: Life Insurance and Annuities (A) Committee Conference Call "Fact Sheet" on Municipal-GIC Surrender Charge Provisions

Dear Commissioner Vaughan:

The NAIC has historically offered regulators the opportunity to exchange ideas and, where possible, agree on coordinated efforts in the regulation by the several states of the business of insurance.

The National Alliance of Life Companies (NALC) has long supported the efforts of the NAIC in this respect. While the NALC has not always agreed on the outcome of the deliberations, we have always encouraged a full discussion of the issues in open and participatory forums. The discussions that occur often lead to decisions by technical committees and working groups as well as recommendations to substantive task forces and subcommittees, and eventual consideration by the NAIC Executive Committee and Plenary Sessions.

Sometimes, the pace of a response needs to be accelerated. In those rare cases, the Executive Committee, acting through its officers, has chosen to approve the dissemination of a NAIC position before it has completed the policy approval process. We understand the need for this expedited treatment under extraordinary or exigent circumstances. This is illustrated by the limited number of serious issues, which have lead to the use of this power. Such actions have been taken only where exigent circumstances exist such as litigation deadlines, Congressional testimony, and other cases where time is of the essence.

We are, however, not supportive of the recent Ultra Vires decision by the Life and Health Actuarial (Technical) Task Force. The decision was to consider policy, make decisions, and then, either at the Task Force or Life Insurance (A) Committee level, express the views of the Task Force directly to each state insurance department and the public before that policy is adopted by the NAIC Executive Committee and Plenary.

Interested parties have expressed their serious concerns with the substance of the proposal and we expect they will continue to make their feelings heard to your Committee. Unfortunately, the process as established in June 1999 at your meeting will mean that nine insurance departments will decide what recommendations will be sent out to the states under the cover of the NAIC, and, thus under the signature of, yet without the advice and consent of, all 51 domestic insurance jurisdictions. Under the formal process established by the NAIC, this is an inappropriate exercise of Task Force and Committee discretion.

This issue transcends the matter of a provision in a Guaranteed Investment Contract. Such extraordinary action does not conform to the Due Process required by virtue of the powers delegated by state legislatures. Further, such extraordinary action does not provide for deliberations among the members of the NAIC at public forums where policy decisions may be fully discussed. Nor does this action provide for the full consideration provided in the Due Process of the NAIC Bylaws by the Executive Committee and Plenary Sessions, the formal policy-making bodies of the NAIC where all 50 states, plus the District of Columbia would be able to determine such a policy position.

We submit that, whatever the results of the review, the only legitimate action that may be taken by any working group, taskforce or subcommittee is to report its recommendations to its parent committee. This process should continue until the Executive Committee and Pleanary Sessions decide on a policy position or the elected officers take accelerating actions, after due deliberations. This was done only last month when it was determined that the Viatical Settlements Working Group's package of notices required expedited treatment. At your suggestion, the Working Group held a conference call, which was followed up by a joint call with the (A) Committee. Within weeks after the June NAIC Meeting, the package was adopted and will be considered for adoption by the Executive Committee and Plenary at the next meeting in Atlanta. In fact, the adoption could be accomplished prior to the Atlanta meeting by a conference call.

The same process may be followed to expedite the matter before you now. We could urge that if the matter is so vital as to require the extraordinary action of circumventing the NAIC's own Due Process requirements, then it is important enough to meet to adopt this matter by conference call. However, we would suggest that if a conference call of the Executive Committee, followed immediately by the Plenary, is *not* required by the urgency of this matter, then final adoption must wait until the next regularly scheduled Executive Committee meeting and Plenary Session in Atlanta.

While this specific issue is about certain provisions of Guaranteed Investment Contracts, in fact, if such extraordinary action were to become an accepted procedure at the NAIC, it would open the door to any Committee, Working Group, or Task Force submitting unlimited numbers of "Fact Sheets" to the various insurance departments and the public without the necessary oversight and review. When one considers the changes in the understanding of an issue at the regulatory and industry levels from the time of its inception, often in an article in a newspaper, to the development of a NAIC policy, we are sure that you would feel the same apprehension. This fear should be common among regulators, consumer groups, and the industry, since any task force, committee or working group could circumvent the process with letters to insurance departments that never had the opportunity of full review by the NAIC. In some instances, commissioners may be embarrassed by these actions, as, in the case before you, those same commissioners have approved the forms that may now be considered flawed.

We have discussed in the past, the challenge of a small state insurance department, small insurance company or a small trade association. It takes every ounce of energy the NALC staff has to follow the actions of the multiple working groups developing NAIC policy. Many times, we return from meetings only to find that a group decided some issue while we were covering another important issue at a conflicting meeting. It is for this very reason that we must rely on the Due Process afforded by the adopted procedures of the NAIC. Without that safeguard, smaller companies at the committee meetings, faced with a large volume of recommendations, commissioners argued they could not be expected to make decisions since their staff had not even attended most of the committee meetings. The NAIC Bylaws were changed so that insurance departments and the public would have a 90-day opportunity to review these.

If you allow the issuance of a "Fact Sheet" it will be contrary to established NAIC policy that the public and all 51 commissioners should have at least 90 days after a recommendation from a Standing Committee of the NAIC before any actions are voted on or taken.

We strongly recommend that the Life Insurance and Annuities (A) Committee reject the request of the Life and Health Actuarial (Technical) Task Force with respect to the immediate issuance of a "Fact Sheet." If the Committee is not persuaded by the arguments of interested persons and agrees with the recommendations in the "Fact Sheet," it then has the option of forwarding the request to the officers for their dissemination or forwarding their recommendation to the Executive Committee for its consideration.

We appreciate your review of these important issues. If you have any questions or need additional information, please contact me.

Respectfully Submitted,

Scott J. Cipinko
Executive Director

cc: Members NAIC Life Insurance & Annuities (A) Committee
NAIC Executive Committee
Catherine Weatherford
NAIC Executive Vice President

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NAIC Fact Sheet

The NAIC Life and Health Actuarial (Technical) Task Force has recently become aware of a development in the Guaranteed Investment Contract (GIC) market that may be of interest to you. GICs are relatively simple products typically used to fund employer/employee pension benefits, municipal obligations, i.e., muni GICs, and other programs. The chief characteristic of a GIC is the accumulation of an initial consideration at a guaranteed rate of interest for a specified period of time. GICs may provide for a penalty in the event the contract holder cash surrenders the contract prior to maturity. While this fact sheet will use the phrase "guaranteed investment contract" or "GIC," the product may be called by different names such as standing agreement or deposit fund contract.

Some of the life insurers in the GIC market, in response to market demand, have introduced a provision in the contracts they market that permits the contract holder, in the absence of a standard surrender provision and under certain circumstances, to surrender the contract for cash without penalty in advance of the maturity date of the contract. One form of contractual provision waives the surrender charge in the event the insurer's rating has been downgraded generally by several levels. Another form of the provision requires the insurer to repay the contract holder the account value without surrender charge in the event of the occurrence of any one of several events identified in the contracts. Typical events enumerated in GICs with this type of provision are: default in the payment of any indebtedness for money borrowed or raised by the insurer or any of the insurer's subsidiaries, and the insurer or any of the insurer's subsidiaries fail to pay when due any amount payable by it under any guarantee (howsoever described) of any indebtedness for money borrowed or raised. In some cases, the life insurer may be able to defer or otherwise avoid paying cash to the contract holder by using an alternative course of action described in the contract.

These downgrade and creditworthy contract provisions continue to raise the following concerns for some members of the NAIC Life and Health Actuarial Task Force: Is the event covered in an insurable risk or is it the equivalent of self-insurance, and therefore a non-diversified risk? Can a non-diversified risk be adequately priced? Are contracts with this provision reserved appro-priately for statutory purposes? Does the provision create a preference for a specific class of policy/contract holders? As to the preference issue, the benefit triggers in each situation are related to the deterioration of the financial condition of the insurer.

The contractholders of contracts with these provisions may be able to withdraw their funds from the insurer prior to any regulatory action that may be taken. Note that the GICs are purchased by large, sophisticated customers and are oftentimes for large dollar amounts. Withdrawing funds from the insurer in a finan-cially deteriorating situation may be harmful to the remaining policyholders. In effect, some large, sophisticated contractholders may be given a preference relative to the insurer's other policyholders.

It has been brought to the attention of the NAIC Life and Health Actuarial Task Force that some products sold in the corporate-owned life insurance (COLI) and bank-owned life insurance (BOLI) markets have provisions similar to the ones discussed in this Fact Sheet. This situation creates similar regulatory concerns as previously identified.

It should be noted that external sources of funding such contract benefits arguably solve the self-insurance or non-diversified nature of the risk. External sources include reinsurance or some other form of third party participation in the delivery of the contractual benefit.

However, a public policy question remains. That is, what extent is the public welfare harmed by the existence of special contractual benefits, which have the effect of exercising liquidity and other financial concerns at a time of institutional financial distress ("run-on-the-bank").

NEWLY-ELECTED SMALLER INSURANCE COMPANY SECTION COUNCIL MEMBERS

- **Edward F. Cowman,** *Bruce and Bruce Company,* Lake Bluff, IL
- **R. Dale Hall,** *Midland Life Insurance Co.,* Columbus, OH
- **Paul R. Retzlaff,** *United Farm Family Life Ins. Co.,* Indianapolis, IN

**** All have been elected to three-year terms.***