The Actuarial Update

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Enclosures

Included in this month's issue of *The Update* are the following:

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McCarran-Ferguson and Data Collection in Trouble?

Legislation that would radically amend the insurance industry antitrust exclusions now contained in the McCarran-Ferguson Act and provide so-called "safe harbors" for industry data collection efforts is the latest in a series of proposals that have been introduced to address the liability insurance crisis. The bill, S.804, was introduced by Senator Paul Simon (D-IL) and would repeal most antitrust protection now enjoyed by the industry under McCarran, but would specifically permit the continued collection of data on past losses. So-called "pure premium" data could be collected, but expense data, trend data, and final rates would not be collectible without violation of antitrust laws.

In addition, the proposal would give the Federal Trade Commission (FTC) authority to study the insurance industry, enforce the provisions of the new legislation, and regulate alleged deceptive trade practices. While insurers could join to create and file policy forms and endorsements, they would be prevented from entering into joint underwriting agreements (JUA) in many circumstances. Unless the JUA was mandated by state law, such agreements would have to meet a rule of reason test under federal antitrust scrutiny.

Simon's bill follows an earlier proposal (S.80) introduced by Senator Howard Metzenbaum (D-OH) earlier this year. That bill would have repealed the McCarran-Ferguson Act entirely. Hearings on that legislation were held in early February and are expected to continue in June. Metzenbaum, a critic of the current law, argues that the antitrust exemption decreases competition in the industry and bears a significant responsibility for the liability insurance squeeze.

Industry representatives contend that McCarran-Ferguson does not negatively impact competition, pointing to the extremely competitive nature of the commercial liability insurance market. Some observers, not necessarily friends of the industry, have argued that the intense competition in the industry is, in fact, a major cause of insurance availability and affordability problems.

Reports now circulating in Washington indicate that additional legislative proposals for repeal or amendment of McCarran-Ferguson are under active consideration. Metzenbaum is expected to introduce another bill similar to Simon's S.804, but which

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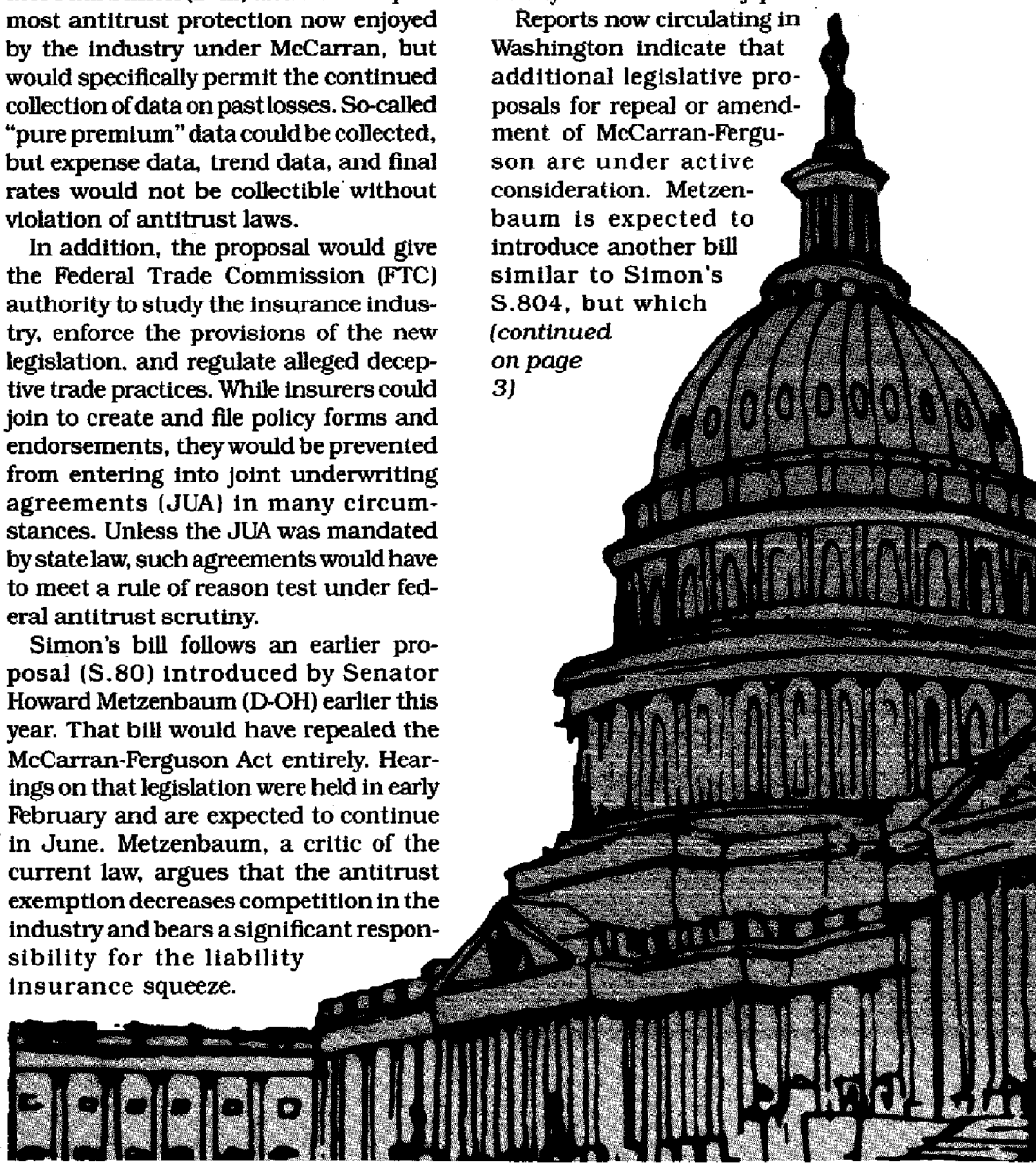

American Academy of Actuaries
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from a Guest President

Michael A. Walters

On Joint Efforts

Virtually all of the actuarial organizations in North America are working together on the major issues affecting the profession, from actuarial principles and standards of practice to continuing education recognition and the advantages of a flexible education system. This commonality of interest and spirit of cooperation are vital to the discussions at the quarterly meetings of the Council of Presidents (COP) of the five North American actuarial organizations.

A topic of mutual interest that will be discussed at coming meetings is the unification of some or all of the actuarial organizations. As the COP recently reconfirmed, it is not a formal body with authority to bind (i.e., not a sixth actuarial organization) and cannot act on such a matter. But it can and does provide a forum for discussion and debate.

Despite any differences that presently exist in our profession, we may be more united than we think, particularly compared to other professions. Imagine, for example, the various bodies of the medical profession—the medical schools, state licensing agencies, specialty academies and the American Medical Association—all getting together to review the medical profession's goals or to plan a centennial celebration. Yet we are doing exactly that.

Our success in working together, in fact, has led the COP to define in writing the five key requirements of successful joint endeavors. The COP focused specifically on effective joint committees, noting that they should: (1) be composed of members of most or all of the North American actuarial organizations, (2) have high visibility, a distinct purpose, and an easily recognizable goal, (3) be temporary in nature (i.e., terminate when the goal is met), (4) have no operational role or ongoing monitoring authority, and (5) provide the organizations with something (a product or service) that they could not produce as easily on their own.

An area that clearly lends itself to a joint effort is public relations. Over the next ten years, given the organizations' missions and long-range objectives, each must deal with various external audiences that do not fully understand actuarial work and the role actuaries can play in solving some of society's problems.

The Academy and the Canadian Institute of Actuaries interact chiefly with legislative and regulatory bodies, accounting agencies, and the general public. The Casualty Actuarial Society and the Society of Actuaries, by contrast, are more involved with companies employing actuaries, prospective actuaries (recruiting), and academia. Although these organizations primarily work in different spheres, there clearly is some overlap. Thus, joint action to approach these vast non-actuarial audiences seems sensible.

To coordinate our activities and ensure that they support the profession's overall goals, careful planning is essential. First, each organization should review its mission and goals and identify what issues require what type of communication to what kinds of audiences. Second, we might consider selecting a public relations program appropriate to our

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Board of Directors Nominations

The Academy's Nominating Committee is seeking your nominations for six new directors to be presented to the membership for election at our annual meeting in November 1987. These members will replace the six directors whose terms expire at that time.

Please forward your suggestions for nominees to Nominating Committee Chairperson Stan Hughey, using the postal card that has been included for your convenience in this mailing of *The Actuarial Update*. The committee needs your nominations promptly.

Letters to the Editor

Discrimination Within the Ranks?

My initial reaction to seeing that the Academy had appointed a task force on non-discrimination rules was delight. I assumed that the Academy was at last tackling the problem of discrimination within the Academy itself.

Imagine my disappointment on reading further to find the task force was dealing with non-discrimination in a totally different area!

Jan R. Harrington
New York, New York

Funding Retiree Health Benefits

The Reagan Administration's latest proposal concerning retiree health care funding is an example of taking a simple concept and making it complicated.

Under the proposal, employers would be allowed to transfer excess assets from ongoing defined benefit pension plans to special Voluntary Employee Beneficiary Associations (VEBA) to finance health care benefits for *current* retirees. The transfer, and subsequent earnings on the funds, would be tax-free.

At the same time, the proposal would repeal Internal Revenue Code Section 401(h), which allows limited tax-free contributions to pre-fund health care benefits for *future* retirees.

Sound public policy should result in the development of participation, vesting, benefit accrual, and funding standards for retiree health benefits. Pre-funding should be encouraged, whether by expansion of 401(h) or by other means. The Administration's proposal *appears* to discourage pre-funding 401(h), but it actually endorses limited pre-funding in a complicated way.

An employer could make an immediate transfer of excess assets from a defined benefit plan to VEBA to fund health care benefits for current retirees. Then, the employer could make maximum tax-deductible pension contributions under a rapid funding method for several years, after which that layer of excess assets could be transferred to the VEBA to support the health care benefits of the employees who retired during those years.

There is no doubt that the proposal provides a valuable resource to employers who want to fund health plan liabilities for current retirees. However, pre-funding of benefits for future retirees should also be encouraged in a direct, logical way that supports sound public policy.

Michael R. Gross
Betty K. MacLaughlin
Hartford, CT

1987 Issues Digest

With this issue of *The Actuarial Update* you are receiving the Academy's *1987 Issues Digest*, which was first distributed at the Academy's annual Washington Luncheon on March 24, 1987. (The luncheon, attended by members of Congress and their staff, regulators, representatives of other professional and trade associations, Washington press correspondents, and Academy leadership, will be covered in next month's *Update*). The digest analyzes in summary fashion the significant issues confronting the actuarial profession and the publics we serve. We commend this publication to your reading.

McCARRAN-FERGUSON
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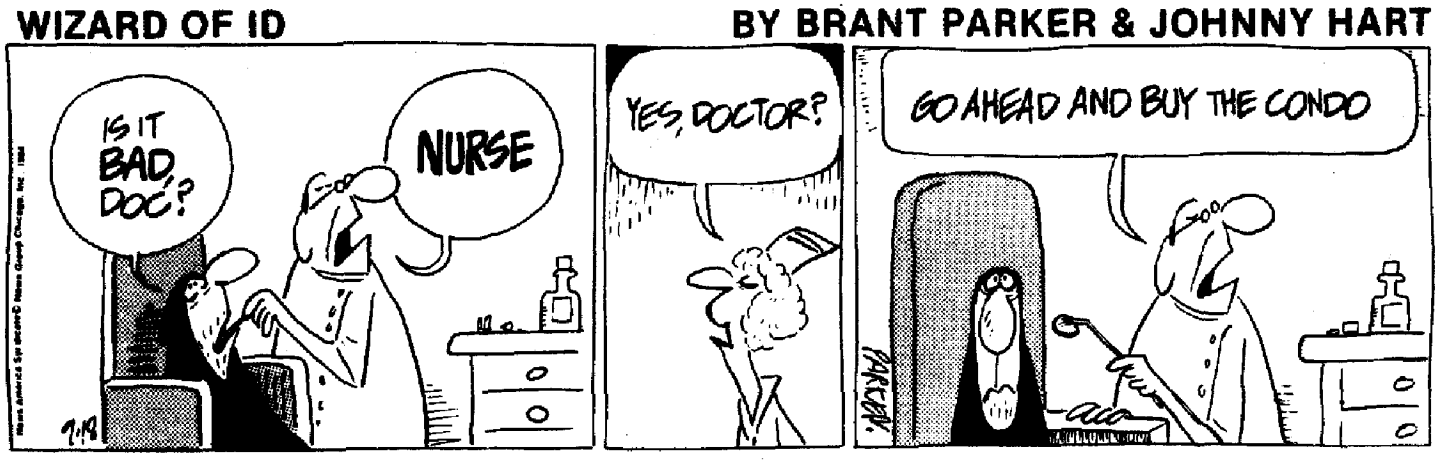
will also include a specific declaration guaranteeing the primacy of state regulation. Several similar proposals are reportedly being considered in the House of Representatives, although legislation has yet to be introduced there.

Data availability, the second major area of congressional concern regarding the property and liability insurance problems, has its genesis in the fact that the intensive probing of insurance profitability last session failed to satisfy some congressional investigators. According to proponents of some additional data collection efforts, the true profitability of the industry is not available, and specific inquiries regarding particular lines of business could not be adequately responded to by industry spokespersons, at least in the eyes of Congressional critics.

Senator Simon is preparing a bill related to data collection that is expected to be quite similar to legislation he introduced last year, which was not adopted. The bill would establish a requirement for the submission of claims data by line of business and by state, including much information regarding the settlement of claims, litigation theories, and judgments. Much of the information to be sought would be similar to that required for a closed-claim study. Other similar proposals being considered include the creation of an Office of Federal Insurance Analysis in the Department of Commerce to collect and analyze the data. Senator John D. Rockefeller IV (D-WV) and Representative John J. La Falce (D-NY) are reported to be considering their own versions of data collection requirements.

The Academy's Committee on Property and Liability Issues has been at work



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NAIC Report

by Stephen G. Kellison

The National Association of Insurance Commissioners' (NAIC) Blanks (EX4) Task Force and the Life and Health Actuarial (EX5) Task Force held back-to-back meetings in New Orleans during the week of March 16. Both of these meetings had lengthy agendas; some highlights of major actuarial significance follow.

Blanks (EX4) Task Force

The Blanks Task Force had its usual long list of proposed changes to the various blanks to consider. All changes approved by the Blanks Task Force are submitted to the NAIC at its June meeting for ratification and ultimate inclusion in the 1987 blanks. Two items of particular actuarial significance stand out.

Casualty loss reserves. Proposed changes in Schedule P of the Fire and Casualty Blank to identify loss experience resulting from claims-made policies were adopted. These changes introduce an interrogatory requesting 1987 premium volume resulting from claims-made policies. For insurers whose 1987 claims-made premium volume is greater than $100,000 and exceeds 15% of the 1987 Column (2) figure for that part of Schedule P, a parallel Schedule P must be completed for 1987 claims-made business only. These changes were developed by the Casualty Actuarial (EX5) Task Force as an interim step pending more extensive investigation into the question of claims-made treatment.

Non-guaranteed elements. The Blanks Task Force also adopted the proposed disclosure requirements concerning non-guaranteed elements developed by the Subcommittee on Dividends and Other Non-Guaranteed Elements of the Life Committee of the IASB. These changes were developed in tandem with the standard in this area released by the IASB in January 1987. (For more information see the article by William T. Tozer, chairperson of the subcommittee, in the January 1987 issue of *The Actuarial Update*).

Life and Health Actuarial (EX5) Task Force

Standard Valuation Law. This task force has formed a special advisory committee to develop a new Standard Valuation Law for individual life insurance. The advisory committee has divided itself into eight different work groups to deal with various aspects of this project. The advisory committee holds open meetings and is soliciting broad input from all interested actuaries. Membership on the eight work groups is flexible to accommodate those who would like to participate directly. For further information, contact Robert Maxon, advisory committee co-chairperson at his Academy yearbook address.

Standard Nonforfeiture Law. The Life and Health Actuarial (EX5) Task Force is also revisiting the major work on the Standard Nonforfeiture Law done by the Unruh committee in the mid-1970s. A new committee has been appointed, with Walter N. Miller as chairperson and Douglas C. Doll as vice chairperson.

Reinsurance issues. The task force is concerned about a number of issues relating to the treatment of reinsurance. One action taken was to request that the IASB develop standards of practice for actuaries in providing an expanded actuarial opinion regarding reinsurance agreements to accompany the annual statement blank. A second action taken was the creation of a new reinsurance working group.

AIDS. The task force expressed a great deal of concern about the impact of AIDS on the solvency of life insurance companies. Most of the concern over AIDS thus far has focused on risk classification and underwriting for new policies. However, the Life and Health Actuarial (EX5) Task Force is concerned whether companies have enough surplus on existing business to withstand the extra mortality. Task force members are looking at various avenues to address these concerns.

Interest indexed annuity policies. The Advisory Committee on Indexed Products Other Than Universal Life Products, chaired by Gilbert V.I. Fitzhugh, is developing a model regulation on interest indexed annuity products. The task force asked the advisory committee to reformat their work into a form appropriate for submission to the NAIC as a model regulation. The model regulation contains a requirement for a statement of actuarial opinion.

Actuarial Guidelines. As noted elsewhere in this issue, Actuarial Guidelines I-XX are being printed in the *1986 Journal*. At the March meeting, the Life and Health Actuarial (EX5) Task Force approved four new Actuarial Guidelines to be submitted to the NAIC for adoption in June. Two of these guidelines pertain to the variable life model regulation, one of them relates to the specifications for the 1980 CSO Tables, and the final one concerns nonforfeiture for indeterminate premium policies. In addition, some changes in Actuarial Guideline XIV were approved for submission in June.

Health reserve standards. The debate concerning proposed health insurance reserve standards to be adopted by the NAIC continues. Paul Barnhart, who chairs the Academy Health Subcommittee on Liaison with the NAIC, presented a revised proposal based on comments received in response to the second discussion draft distributed in July 1986. After spirited discussion, a few changes to the March 11 draft were made. Subsequently, the task force decided that the current draft has changed significantly enough from the last published draft that further exposure is warranted. In particular, one such change involves the use of lapse rates. It is recognized that this further exposure will delay the intended final adoption of the health insurance reserve standards from the June 1987 meeting of the NAIC to the December 1987 meeting. The draft will not be distributed to the entire Academy membership, since the issues are well known and have become highly specialized. However, copies are being distributed on request. If readers would like a copy, contact Christine Nickerson in the Washington office of the Academy.

NAIC Staff

In one final item of interest, the NAIC is actively seeking to hire a director of actuarial services in its Kansas City office. Interested readers should contact NAIC Executive Director Karl W. Koch at (816) 842-3600. Δ

Look for Them in Your *1986 Journal*

Just so they don't get lost among the journal's forty-eight statements, annual meeting business session transcripts, and assorted other reports, we are calling to your attention two items of particular note contained in your *1986 Journal*: NAIC Actuarial Guidelines I-XX (which can be found on pages 344–368) and "An Actuary's Guide to Compliance with Statement of Financial Accounting Standards No. 87" (which can be found on pages 381–391). The new journal will be mailed the latter part of March.

on a range of activities to address the actuarial aspects of these policy debates. Last fall, as part of a submission to the National Association of Insurance Commissioners (NAIC) on the potential for "costing" tort reform proposals, the committee noted that data on hand may often be insufficient to provide the kind of detailed analyses that Congress is now seeking, short of undertaking expensive and time-consuming closed-claim studies.

Representatives of the Academy's committee are continuing to assist the NAIC in these areas through participation on NAIC task forces addressing various aspects of the matter. To assist Congress in understanding broader issues of the business cycle, the committee will shortly present to interested Hill observers a paper on the cyclicality of the property and liability insurance industry.

While McCarran-Ferguson may not immediately appear to be an "actuarial" issue, the committee is developing comments on the impact that repeal would have on data pooling arrangements that

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FROM A GUEST PRESIDENT

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profession. (Use of an outside public relations firm seems advisable, because public relations is not typically a discipline we cover in our education process). Finally, once the program design is in place, we should take steps to ensure that we have the necessary staff and resources to implement the appropriate strategies. In this regard, any actuary who has a particular interest in public relations and who is not already on a committee dealing with this area should contact the relevant committee chairman or officer.

We need the support and active involvement of members of all the actuarial organizations. With the 1989 centennial year fast approaching, we need to begin our public relations coordination efforts soon. The centennial offers some unique opportunities to publicize our profession and enhance our organizations' goals.

Walters is president of the Casualty Actuarial Society.

Checklist of Academy Statements February 1987

Copies are available from the Washington office.

TO: South Dakota Division of Insurance, February 6, 1987. RE: Insurance consultant laws. BACKGROUND: This statement is in response to a request from the South Dakota Division of Insurance regarding information concerning actuarial designations.

TO: Department of Treasury, February 23, 1987. RE: Accident and health plans. BACKGROUND: This statement was submitted to the Department of the Treasury in response to a request for comments on the valuation of accident and health benefits under the Tax Reform Act of 1986. The Academy proposed methodology to determine whether an employer's accident and health plans are discriminatory, and, if so, the taxable value of the discriminatory portion. Δ

Valuation and Nonforfeiture Laws: New York Places Greater Reliance on Actuarial Opinions

Regulations 126 and 127, recently promulgated by the New York Insurance Department, and proposed Regulation 128 deal with different aspects of the 1985 amendments to New York's valuation and nonforfeiture laws for annuities and guaranteed interest contracts. All three place greater reliance on actuarial opinions. The regulations affect the nationwide annuity business of all life insurance companies licensed in New York and all authorized reinsurers in New York.

Regulation 126 requires an actuarial opinion and supporting memorandum, in form and substance satisfactory to the Superintendent of Insurance, stating whether the reserves and supporting assets make good and sufficient provision for projected product cash flows. Testing is to be based on cash flow simulation along interest rate scenarios. If an acceptable filing is not made, penalty reserves apply. The following types of annuities are affected: group and individual annuities, guaranteed interest contracts, structured settlements, IPG, and deposit administration contracts. There will be a three-year phase-in period. For 1986 year-end, the regulation only applies to contracts issued in 1986 and to 1986 changes in funds for contracts valued on a change-in-fund basis. For 1988 and later year-ends, all contracts issued on or after January 1, 1982 and any older contracts valued on a change-in-fund basis will be affected by the regulation.

Regulation 127 governs the use of market-value adjustment formulas in determining cash surrender benefits, the use of withdrawal charges and the availability of cash surrender values under individual deferred annuities subject to Section 4223 of the Insurance Law, and the funding and reserves for such annuities with market value adjustments. Each contract form containing a market-value adjustment formula filed with the Superintendent of Insurance must be accompanied by a memorandum that includes an actuarial opinion stating that "the market-value adjustment formula provides reasonable equity to terminating and continuing contractors and to the company."

Proposed Regulation 128 would prescribe the terms and conditions under which: (1) life insurance companies may issue annuity contracts and funding agreements providing for guaranteed benefits funded by separate accounts in which assets are valued at market, and (2) such accounts shall be established and maintained. Under the proposed regulation, the actuarial opinion should state that the account assets make "good and sufficient provision for account liabilities." For separate accounts funding fixed benefit payments, the actuarial memorandum should clearly describe the assumptions the qualified actuary has used for projecting cash flows under each class of assets, including common stocks and real estate.

The New York Insurance Department is also considering a proposed bill dealing mainly with the valuation of single premium life insurance and again placing greater reliance on actuarial opinions. The proposal is expected to be introduced in the New York state legislature this year. Δ

Academy Task Force Begins Discussion of Proposal for Valuation of Health Benefits under Tax Reform Act

An Academy Task Force on Non-Discrimination Rules has been appointed and has released a statement of preliminary views on the valuation of accident and health benefits under the Tax Reform Act of 1986. The preliminary views indicate a proposed methodology for determining whether an employer's accident and health plans are discriminatory, and if discriminatory, the taxable value of the discriminatory portion of benefits.

The Tax Reform Act requires the Treasury Department to develop regulations to implement new non-discrimination tests for such plans. Treasury officials and other interested participants have quickly discerned that the most difficult task facing the department in fulfilling this requirement is formulating a method for valuing the benefits offered under health plans. Given the huge number of plans in existence, the myriad options frequently available to participants, and the range of special features, such a valuation methodology appears daunting. This is particularly true for sponsors with plans in diverse geographical areas, with differing demographic characteristics, and with disparate concentrations of highly compensated and non-highly compensated employees in different locations.

According to the preliminary views statement of the task force, the proposal is intended to be practical to administer with a minimum of subjectivity in application, while resulting in reasonable precision and equity. Recognizing that a more refined approach would substantially increase the difficulty of administering the tests, benefit values are based on plan provisions, instead of employer cost.

The proposal was forwarded to Treasury at an informal meeting in mid-March and was received by Treasury officials with much interest. Nevertheless, significant amounts of work need to be done to complete the proposal. To foster broad input, copies have been supplied to interested parties outside of the Academy, and additional copies are available on request from the Academy.

For medical benefits, a "standard plan" will be defined and assigned an index value of 100. Values and adjustment factors will be developed to determine the relative value of other common plans and variations in benefit features. The plan can then be tested against the plan population based on the value index. The value of the discriminatory portion, which is taxable under the Tax Reform Act of 1986, can be calculated by multiplying the number of units of discriminatory benefits by a dollar value per unit. This dollar value would be based on U.S. population cost data.

An alternative valuation technique, based on employer cost, was considered by the task force but rejected. Among the reasons for rejecting the use of an employer's actual cost were the problems of cost fluctuations from year to year (especially for small groups), time delays in cost reporting by the administrator, problems in segregating data by plan, line of business, and location, and the distortions caused by demographic characteristics of the plan. Basing the methodology on future costs projections was also dismissed due to its subjectivity.

Other benefits, such as dental, vision care, flexible spending accounts, and accidental death and dismemberment would be valued in a similar manner. The greater homogeneity of some of these plans might make a more simple approach workable.

Certain other benefits are deemed to be of such a small value that they need not warrant the development of a valuation methodology. As a yardstick, the task force has preliminarily determined that benefits that have a typical value of less than 3% of the average benefit value will not be reflected in the valuation methodology for medical and dental plans.

Several major matters are still unresolved. One, valuing the appropriate factors for HMOs, PPOs, and other non-indemnity type plans, may prove to be particularly troublesome. In general, the task force believes that an HMO plan with benefit features identical to an indemnity plan should be valued equally. This, however, may lead to a relative overvaluation of many HMO plans, given the fact that they frequently lack the copayment and deductible features of most indemnity plans. Similarly, special adjustment factors for psychiatric care will be required.

In any case, the methodology under consideration by the task force will require extensive review and comment; given the great difficulty imposed by the statute itself, any regulatory approach will be subject to criticism as unnecessarily complex and an administrative nightmare. The task force's aim is, however, to produce a system that will be accurate enough to satisfy the needs of the Treasury Department and simple enough to be undertaken by a non-expert.

More discussions are anticipated among the task force, Treasury officials, and other interested professional and trade groups.

Richard Ostuw, who chairs the Academy's task force, invites comments on the proposal. They should be sent to the Academy's Washington office.

McCARRAN-FERGUSON
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have traditionally been used by insurers and actuaries in establishing prices and costs. In addition, the committee has continued to serve as a background resource to members of Congress and their staffs, who are serious in learning about the complexities of the property/liability industry.

These complexities were addressed by Congress in 1986, during a lengthy series of hearings on the availability and cost of commercial liability insurance. Much attention was directed to the escalation of premiums, increase in deductibles, and elimination of various coverages. Senate and House committees became enmeshed in the technical aspects of cost-underwriting, the business cycle, reinsurance, and the general profitability of the property/liability industry.

Industry representatives argued that the "crisis" was most appropriately laid at the doorstep of the civil justice system and suggested that growing damage awards, court expansions of liability, and structural deficiencies of the tort system necessitated reform in that area.

Following much heat and smoke, Congress recognized its relatively limited role in insurance regulation and contented itself with significant amendments in the risk retention statute, expanding its coverage from product liability matters alone to a wide range of liability coverages. McCarran-Ferguson repeal and new data collection suggestions both failed in 1986. Δ