

The Role of Actuaries Under Federal Charters

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Topics

- **Part 1:** American Academy of Actuaries Working Group on Federal Charters.
 - Academy interest in the issue.
 - Considerations in P&C Working Group.
 - Academy Monograph: "Role of the Actuary Under Federal Insurance Regulation".
- **Part 2:** Prospects for and Consequences of Federal Charters for Insurers.

Academy Role

- Actuaries are actively involved in the design, enforcement, and operation of insurance regulations.
- The Academy's role is not one of advocacy or opposition.
- The Academy's primary role is to provide actuarial assistance in the design of any insurance regulatory system.
- Academy was concerned that OFC proposals had not addressed actuarial issues.

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Academy Activity on OFCs

- In 2002, Practice Councils were asked to prepare a monograph.
- Several working groups were organized.
- During 2002 and 2003 position papers were developed.
- In 2003, work was consolidated into a monograph.
- A Capitol Hill Briefing was held.
- Through 2004 the AAA has been monitoring developments.

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P&C TF: Major Effects

- Traditional rate regulation will be eliminated.
- Solvency focus and the need for methods and techniques to support solvency will be even stronger than today.
- Many of the technical skills that actuaries have offered to companies will no longer be as valuable under a Federal regulatory structure.
- Actuarial Skills will be in demand but will be challenged by other disciplines.

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P&C TF: Position Papers

- Staffing of Federal Regulatory Structure.
- Rate Standards.
- Loss Reserve Opinion.
- RBC and Related Solvency Measures.
- Cash Flow Testing.
- Role of Statistical Agents.
- Basis of Accounting.
- Definition of Insurance For Regulatory Purposes.

Green: Covered in Monograph.

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P&C TF: Rate Standards

- **Issue:** Are rate standards necessary for P&C insurance under federal charters?
- **Recommendation:** There is no need to include rate standards in laws governing FC insurers. P&C actuaries who prepare rates are bound by actuarial principles and standards of practice. Laws governing the solvency of FC insurers should allow the regulator to require a PSAO regarding the adequacy of rates, when it is necessary for solvency protection.

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P&C TF: Statistical Agents

- **Issue:** Is there a role for stat agents?
 - Without rate standards, what is the need?
 - Would activity be allowed at all?
 - Do industry databases serve a purpose?
- **Recommendation:** Federal Charter proposals should contain a provision permitting, but not requiring, the reporting of data to statistical agents that have been identified by the Regulator as authorized to perform this function.

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P&C TF: Accounting Standard

- **Issue:** Should FC insurers use SAP, GAAP, or some other accounting standard?
- **Recommendation:** From an actuarial perspective, there is no reason to have multiple financial statements, and therefore, financial statements provided to the Federal Regulator should be prepared under GAAP principles, provided there is no compelling reasons to use non-GAAP principles.

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P&C TF: Type of Insurance

- **Issue:** What activities constitute "insurance"?
 - Automobile Extended Warranty.
 - Large Deductible Commercial.
 - Title Insurance.
 - Private Mortgage Insurance.
 - Financial Guarantee.
- **Recommendation:** Legislation should:
 - Grant authority for regulator to define what constitutes "insurance".
 - Specify whether there will be differing degrees of oversight on various types of activities (ie. primary vs. reinsurance).

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AAA: Purpose of Regulation

- The primary purpose of government regulation is to protect consumers, particularly to protect the solvency of companies so they can fulfill their promises to policyholders.
- Responsibilities include:
 - Licensing insurers and agents.
 - Monitoring solvency.
 - Managing liquidation of troubled companies.
 - Monitoring company practices.
 - Monitoring advertising to prevent deception.

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AAA: Address Role of Actuaries

- Establish an Office of the Chief Actuary (OCA) to regulate the actuarial and solvency requirements of federally regulated insurance companies.
- Require that the OCA be involved in actuarial aspects of the federal insurance department's development of regulations related to solvency protection.
- Define the responsibilities of the OCA regarding the review of federally regulated insurance companies.
- Define the minimum actuarial requirements that federally regulated insurers must meet and submit to the OCA.

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AAA: Office of Chief Actuary

- Direct report to Federal Commissioner.
- Responsible for staffing with actuarial specialists to effectively regulate all FC life, health, and property and casualty insurance companies.
- The Office should include separate functions staffed by actuaries in various practice areas.

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AAA: Review of FC Insurers

- Review reserve opinions; inform and advise Commissioner on solvency or financial problems.
- Develop and implement changes to insurance laws and regulations that involve actuarial and solvency requirements.
- Advise on actuarial aspects of rehab & liquidation.
- Review & evaluate product related actuarial certifications.

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AAA: Requirements for Insurers

- A qualified actuary should submit at least the following to Federal Regulators:
 - An annual statement of opinion on the adequacy of reserves.
 - An annual calculation of risk-based capital.
 - All product-related filings that require an actuarial certification.
 - Documentation requested by the Federal Insurance Regulator to demonstrate compliance with Actuarial Standards of Practice.

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Part 2: Disclaimer

- This section of the presentation has nothing to do with the Academy material.
- The presenter is taking no position pro or con of the issue of OFCs; the following comments are intended to illustrate forces which will help drive whether or not OFCs become a reality.
- The presenter does believe that OFCs are a matter of when, not if, for reasons outlined in following slides.

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Prospects and Consequences

- **Prospects:** Optional Federal Charters are likely; timeline will depend on:
 - NAIC and State Regulator actions.
 - A major insolvency.
 - A major catastrophe or expansion of TRIA.
 - Growth of insurance on the Internet.
- **Consequences:** Major Changes for Insurers.
 - Increased competition.
 - Consolidation.
 - Pressure for rapid product development.

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State Regulation Issues

- Standardization:
 - Agent Licensing.
 - Rate and Form Filing.
 - Coverage and Rate Mandates.
 - Residual Markets.
 - Financial Examination.
- Rate “Modernization” (deregulation).
- Credit Scoring.

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Credit Scoring, CLUE, etc.

- Private insurance markets naturally seek out the best information for pricing; it is difficult, if not impossible, to ban the use of powerful information.
- Credit is a very powerful predictor of future losses, and leads to lower rates for most consumers.
- Regulators cannot stop its use, but they can create significant barriers and cause market disruptions.
- If regulators succeed in enacting major restrictions on credit, market dynamics will force major insurers to forcefully advocate for OFCs.

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Banning Credit

- Market reaction to a credit prohibition:
 - Established insurers would comply, but seek other shadow variables.
 - New entrants will not use credit in underwriting or rating, but will simply target market to pre-screened lists of customers with good credit.
 - Long term result:
 - The market becomes unstable, established insurers lose customers and money, the market uses credit anyway.
 - Major insurers demand Federal Charters to survive.

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Financial Services Consolidation

- Insurance is being offered with other financial services.
- Providers do not want one regulator for banking and another (51) for insurance.
- Providers want the same rules for credit.
- Standardization is essential for cost control.
- Providers are used to open competition in banking, mortgages, etc. They will not tolerate current rate regulation regime.

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Other Factors Forcing OFCs

- The Internet.
 - Consumers have more choices.
 - Geographic boundaries are less relevant.
- Federal involvement in insurance.
 - TRIA.
 - Natural Disasters.
 - Cleanup of a major insolvency?
- Need for Capital.
 - Catastrophe exposures.
 - Huge reservoir of capital is available on national and international markets, but it will demand free market pricing and a fair rate of return.
- Globalization.

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Consumers

- Most consumers are satisfied with the current system, but many pay higher rates than necessary due to subsidies, inefficiencies, and lower competition.
 - Restrictions on credit.
 - Restrictions on territory differentials.
 - Residual market subsidies.
- If enough consumers find they can pay lower rates in a different system, there will be significant pressure for change.

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Consequences of OFCs

- Strong pressure for innovation and new product development, increase in speed to market.
- Integration of financial products.
- More focused rating using GLMs and other advanced pricing tools.
 - Use of non-insurance data (census, credit, CLUE, engineering studies).
 - More individual risk based, less class based.
- New entrants, opportunities for specialty carriers.
- Consolidation of "traditional" insurers.
- Significant changes in the role of actuaries.

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