Regulation and Taxation Module

SECTION 1: MODULE OVERVIEW

Introduction

THE REGULATORY ENVIRONMENT

The goal of the Regulation and Taxation module is to provide you with an understanding of, and appreciation for, the regulatory environment that affects the life and annuity insurance industry overall and actuaries in particular.

Regulation reflects a multitude of constraints and rules applicable to insurance companies and relevant to actuaries. Actuaries need to understand the purposes for rules, how they are made, when and where to find the rules and how to identify constraints as they design and maintain products. They need to understand the impact of regulation and taxation on policy design, pricing, reserving and compliance monitoring.

During your study, you will become familiar with the external constraints and forces on life insurance and annuity business and products. The module content explains how government and quasi-government agencies regulate life insurance companies and discusses characteristics of the target market and components of the marketing mix, including product design and distribution channels and the effect on pricing decisions.

This module provides an overview of the regulatory environment in the United States and Canada. You will learn about which government agencies regulate insurance and annuity products and under what authority, but you will not be expected to learn the details of the calculation procedures applied or actually perform such calculations. That level of knowledge is among the learning objectives of the Individual Life and Annuities Design and Pricing (DP) examination.

REGULATION AND TAXATION

Many government and quasi-government agencies regulate life insurance companies. They exercise authority over both the life insurance industry and the individual companies. Regulation and taxation affect product design — sometimes by incentive and sometimes by required standards. For example, the states in the United States have laws that govern solvency of companies and also often levy state premium taxes.

- Regulation: laws and rules that govern financial services industries.
- Taxation: system to raise revenue for governments.

This module addresses regulation and taxation separately.

SOLVENCY AND MARKET CONDUCT LAWS

We cover the purposes of regulation, which are fundamentally intended to protect the public and do so primarily in two ways:

- Solvency: monitoring the financial condition of insurance companies to ensure that they follow minimum funding requirements and other rules intended to ensure that they will be able to fulfill their contractual promises to policyholders.
- Market conduct: restricting sales and service practices in various ways, such as requiring that:
  - Contracts be understandable and contain certain standard provisions.
  - Customers are sold contracts that are suitable to their circumstances.
  - Policy illustrations are reasonable.
  - Contract values meet or exceed specified minimum values.
  - Sales commissions do not exceed certain limits (New York only).
  - Servicing and claims adjudication practices are fair.

With respect to insurance, the role of the government is to ensure that insurers are reliable and that they fairly price and maintain their products for the protection of consumers. In serving the public interest, the life (and health) insurance industry is highly regulated. Regulations relevant to the actuary include solvency and market conduct laws.

Solvency laws are designed to ensure that insurance companies are able to meet their obligations and pay policy benefits when they come due. Generally, these laws regulate an insurer’s capital and surplus, liquidity, investments, reserves and policy design. Market conduct laws are designed to ensure that insurance companies conduct their businesses fairly and ethically. These laws regulate a range of company operations, including company management, marketing, underwriting, policyholder service and claims.

Solvency and market conduct laws are integrated concepts. Solvency laws often affect market conduct. For example, insurers must establish premium rates that are adequate for accumulation of all required reserves. Market conduct laws also directly affect solvency. For example, mandated policy benefits affect premium rates and insurer profitability.

REGULATORS, RULES AND REINSURANCE

While studying this module, you will gain insights into who regulates. State insurance departments are the fundamental regulators of life and annuity products issued in the United States. In Canada, the Office of the Superintendent of Financial Institutions (OSFI) regulates solvency and the provinces regulate how the company deals with customers who are residents of that province. However, there are a few companies that are provincially licensed and are financially regulated by the licensing province. Still, the responsibility for financial solvency is gradually being relinquished to the OSFI by the provinces. The province of Quebec has the most comprehensive insurance legislation and regulates companies licensed in that province.

We cover the rules in both the United States and Canada. If you work primarily in one country or the other, then you may wonder why you need to learn about the other country’s practices. The answer is so that you can see different approaches to similar problems. Although regulations differ and approaches are not always the same, both countries have exactly the same interest in protecting the public. Comparing the regulatory regimes is a worthwhile exercise. Moreover, with increasing globalization, more and more companies are multinational. The United States and Canada have the world's greatest cross-border trade. Anyone working as an actuary in one country should have some familiarity with the rules in the other country. Actuaries working in neither the United States nor Canada need to be aware of regulations specific to their country. It is still important for you to be familiar with the laws of the United States and Canada, as you may find these useful in the establishment or reform of regulations in your country.

Reinsurance is discussed briefly in the module. Governments have an interest in protecting the relatively unsophisticated customer from the sophisticated company. Since reinsurance is between companies, the companies generally need less protection from each other, so reinsurance is relatively less regulated. However, many laws affecting the direct writer will apply to the reinsurer as well. States are concerned that reinsurance agreements not be used to transfer risks to inadequately capitalized companies (such as off shore entities) or to inappropriately change statutory surplus of the ceding party. Similarly, the federal government is concerned that reinsurance and reserves should not be used to avoid income taxes.

Module Design

The module design and delivery support your learning by:

- Introducing you to the various government agencies that regulate insurance and annuity products in the United States and Canada and the laws under which they operate.
- Helping you to understand the basis for those laws and how they serve the public's interest.
- Applying the legal and regulatory principles to realistic examples.
- Relating the regulatory environment to product design.

Module Objectives

By the end of your module study you will be able to:

- Explain the purpose of regulation and taxation.
- Explain the regulatory and tax environments for insurance and annuities.
- Explain the regulation of insurance and annuities in the United States and Canada.
- Describe the taxation of insurance and annuities and how it affects product development, reserving, pricing and business practices.

SECTION 2: SOLVENCY REGULATION

Introduction

In this section, you will learn about the enabling laws, history and actions taken by U.S. state governments and Canadian federal and provincial governments that regulate and promote and maintain the solvency of insurance companies.

This section covers the following:

- What are the goals, standards and methods of solvency regulation?
- Who are the regulators?
- What is regulated?
- Required regulatory statements, reports and actuarial opinions.
- The examination and analysis process.
- Guaranty funds.

Objectives

After you complete Section 2, you will be able to:

- Explain why solvency regulation is important.
- Describe implications of insolvency.
- Explain who regulates and what is regulated.
- Explain guaranty funds (i.e., what's the backstop to protect the policyholder).
- Describe the required financial reporting requirements.
- Explain the regulatory processes used to monitor solvency.

SECTION 3: MARKET REGULATION

Introduction

In this section we will focus on the enabling laws, history and actions taken by state and provincial governments that regulate and enforce the interaction between the insurer and the insured or prospective insured. In the United States, these aspects of regulation are established by the various states. There is not the same degree of uniformity of regulation as there is for solvency regulation.

Similar to the federal regulatory body in Canada, provincial insurance regulatory bodies have responsibilities with respect to financial soundness, as it relates to smaller insurers operating in a single province. In addition, provincial regulators are responsible for the market conduct of insurers and insurance agents operating within the province.

Objectives

After you complete Section 3, you will be able to:

- Explain the purposes of regulatory consumer laws and regulations.
- Recognize the key points of a sample of regulations or laws relating to market regulation.
- Explain the standard limitations on rates and the issues associated with the use of rating factors.
- Describe why consumer protections are needed.
- Describe how the United States and Canada monitor the market and regulate.
- Explain how a policy will be illustrated.

To help you accomplish these outcomes, this section will address the following issues:

- The purpose of consumer protections and market regulation.
- Regulation of policy forms, rates and minimum values.
- Regulation of the sales and marketing of products.
- Risk classification and privacy issues.
- Market conduct examinations and market analysis.
- Agency and consumer issues.

Reminder: Continue your *Who Killed Confederation Life – The Inside Story* reading as you work through Section 3.

SECTION 4: OTHER REGULATIONS AFFECTING PRODUCT DESIGN

Introduction

In the previous two sections, we looked at solvency regulation and market regulation. In this section, you'll learn more about these regulations and about other regulations that affect product design.

In the previous sections of this module, we have given relatively equal weight to U.S. and Canadian regulations because the countries have relatively equal functions. In this section, however, we're giving greater weight to the United States because Canada does not always have similar regulatory functions.

Objectives:

After you complete Section 4, you will be able to:

- Explain how contracts are taxed to the owner of the contract.
- Describe constraints on policy design imposed by tax laws.
- Describe other constraints (SEC, antitrust) and highlight different approaches (e.g., direct in the United States vs. indirect in Canada).

Reminder: Continue your *Who Killed Confederation Life – The Inside Story* reading as you work through Section 4.

SECTION 5: TAXATION: REVENUE COLLECTION

Introduction

The prior section included discussion of policyholder taxation. These were items that affected how the policyholder is taxed on distributions or deemed distributions from the insurance policy. This section will cover company taxation for both the United States and Canada. It will address ways in which an insurance company is taxed, who is doing the taxing and the major components of the taxes.

The U.S. section will discuss both state and federal taxation of insurance companies. Federal taxation is based upon income tax. This section will include details on the pieces that have the largest impact on an insurance company's taxable income. The Canadian section will cover both provincial and federal taxation. This includes income tax, capital tax, premium tax, investment income tax, withholding tax, branch tax, sales tax and excise tax.

The U.S. taxation system has general taxes (e.g., income tax and premium tax) that have a few main drivers. The Canadian taxation system has more special purpose taxes (e.g., capital tax and the Goods and Services Tax (GST)) in addition to the more general taxes such income and premium tax. Adding to the complexity of Canadian system, there are many different tax rates depending upon the type of business and where it is located.

This section will not cover taxation regarding all income and asset items for the United States and Canada. Only the items that are more specific to insurance companies will be covered.

It is very important for you, as a candidate, to thoroughly understand the key concepts presented in this section as tax is one of the major cost items for an insurance company. Optimizing the taxable position of the company is generally one of the key goals to accomplish in a competitive environment.

Objectives

How are insurance companies taxed? What are the "big drivers" of the taxes paid? How do taxes impact pricing a product?

After you complete Section 5, you will be able to:

- Describe the two major categories of differences between pre-tax earnings and taxable earnings.
- Define retaliatory tax.
- Explain the rationale behind the Deferred Acquisition Cost (DAC) tax.
- Identify the differences between statutory and tax reserves.
- Define the Dividend Received Deduction.
- Explain how the Dividend Received Deduction impacts a company's taxes.
- Distinguish between the different forms of taxes paid by Canadian companies.
- Understand the differences between federal and provincial taxation.

Reminder: Continue your *Who Killed Confederation Life – The Inside Story* reading as you work through Section 5.

SECTION 6: OTHER EXTERNAL FORCES

Introduction

You have now completed the major topics of this module: regulations on solvency, consumer protection and other insurance-related topics and taxation. This section includes three shorter topics affecting actuaries' work. They are vitally important, such that if ignored, it could ruin an insurance company.

Objectives

After you complete Section 6, you will be able to:

- Describe the purpose of reinsurance.
- Describe the effects of rating agencies.
- Explain quasi-regulation.
- Understand and apply these concepts to model exercises as well as to your work as an actuary.

Reminder: You should complete your *Who Killed Confederation Life – The Inside Story* reading as you work through Section 6.

SECTION 7: WRAP-UP

Module Wrap-up

Before starting this module, you very likely were aware that the taxation and regulation of insurance affected insurance companies at the corporate level, but in this module you have learned how and why taxation and regulation impacts the practicing actuary at the very detailed level of product design, product illustrations, rating, reinsurance, investments and reserving. You have learned about the regulators, other governmental agencies and non-governmental organizations (such as rating agencies and the NAIC) that will impact your professional career and determine the rules under which you must perform your professional duties. In addition, you have been exposed to many of the differences — and similarities — between Canada and the United States in these areas.

Congratulations on completing the first six sections of the ILA Regulation and Taxation Module. You should now have a good understanding of the framework within which actuaries in the life and annuity practice must work. You must always remember that the trust placed upon you as a professional actuary carries with it responsibility to be aware of and abide by all applicable laws, as well as to meet the highest ethical standards.

As you fulfill this responsibility, you will affirm and enhance the excellent reputation of actuaries and our businesses, while contributing to the paramount goal of serving the public.

Objectives

What Are Your Next Steps?

Are you able to answer the questions below?

- What is the purpose of regulation and taxation?
- Can you explain the regulatory and tax environments for insurance and annuities?
- Can you explain the regulation of insurance and annuities in the United States and Canada?
- Can you describe the taxation of insurance and annuities and how it affects product development, reserving, pricing and business practices?

If you are able to describe and explain the responses to these questions, you are ready to take the Regulation and Taxation End-of-Module Test.

END-OF-MODULE TEST

END-OF-MODULE EXERCISE