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Small Talk

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How Can a Small Company Manage Capital (and Grow)?

By Norman E. Hill

During my career, I've attended and participated in several sessions about small companies. One was titled, "Are small companies going the way of the dinosaur?" Another had an implicit theme, "Can small companies survive?" There may have been yet another one: "Should small companies survive?" My basic answer to these types of questions is, "Yes, they can survive, but, in vernacular, it ain't easy."

One question is: Just what constitutes a small company? The historic FIT threshold is $500 million assets. Today, $1 billion, even $2 billion, might qualify as a "small" dividing line.

Small companies seem pretty much a U.S. phenomenon. I know there are no small companies in Canada, and I'm not aware of similar companies in other countries.

From a 2005 National Association of Insurance Commissioners (NAIC) statistical summary, there are about 700 U.S. companies out of 1,022 with under $500 million assets. The great majority of these are under $100 million. Many of the 700 are affiliated; some are stagnant. Arguably, the ones trying to grow, who are concerned with capital management, carry at least $100 million assets today.

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Good Marketing Equals Growth

Marketing of products is essential to growth. However, since capital usually suffers initial adverse impact from marketing activity, the function is a two-edged sword and must be managed very carefully.

It's been stated before that a small company should seek marketing niches. "Don't try to be all things to all agents" is often advised. This means that several, but not a great many, niches should be attempted. Preferably, they should be "safe" niches. Today, lines like long-term care, stop loss, long-term disability and variable products are often considered unsafe for small companies, due to uncertain claims experience, claims volatility, start-up expenses, specialized personnel required, or a combination of the above.

Small companies have often complained that rating agencies are biased against them, and focus entirely too much on size. In any event, in dealing with rating agencies, a company should avoid the above niches that are out of favor today. At the very least, it should not be deemed overly concentrated in any one of them.

Some companies have claimed that, if they receive a lowered rating, their marketing activities would cease, and they might as well close their doors. However, some small companies can be pointed to that have been able to sell significant new business with less than, say, an A- rating from *Best.* Since selling insurance is highly psychological, a company should decide whether its desired marketing niches will tolerate a relatively low rating.

In any event, a company should measure in advance how high a rating it needs to be successful, and how much a high rating would conflict with its other desired elements of management flexibility.

Some small companies rely heavily on reinsurance. Professional reinsurers can provide surplus relief and thus protect capital, as well as underwriting and related advice. However, reinsurance should not be considered a panacea. First, reinsurance prices seem to be rising today. Due to likely small volumes ceded, some reinsurers are reluctant to deal with small companies.

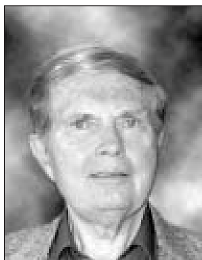
If a company intends to use reinsurance for a product, it should determine in advance what amounts it would need for anticipated sales, how

continued on page 8

continued from page 7

much reinsurance is available and at what cost. Because of complex product designs, in terms of rate guarantees, recapture provisions, etc., reinsurance contracts should be read very carefully.

Of course, small companies that specialize in pre-need or final expense products sell small size policies that often involve no reinsurance at all.



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Modeling and Risk Management Are Key

Modeling and risk management are frequently used terms today, and they are important to small companies.

An efficient, thoroughly tested model is essential in managing a company and its capital. The model must be understood, first by management as to its output, and by competent technical personnel as to its minute working details.

Some particular requirements for a model include:

1. Flexibility, so that varieties of assumptions and products can be included and used, and output can be provided with different formats and sorts.
2. The model should cover the entire company, but separate in force by desired product lines. These lines themselves must have flexible definitions, such as life, annuities, health, fixed versus variable and various products within all the former.
3. New production by product lines must be separable from projections of current in force.
4. Various scenarios of sales volumes must be calculable.
5. Consistent with number one, the model must be capable of running "as if" scenarios.
6. Investment income on capital must be included, often as a separate corporate line, but possibly by allocation to product lines.
7. All expenses must be included, with some possibly in the corporate line.
8. Different accounting bases must be calculable, such as statutory, U.S.GAAP and possibly, GAAP in other jurisdictions.
9. When projecting statutory capital and surplus, the model should also run risk-based capital, the minimum required statutory capital based on NAIC definitions. Possibly, required capital from rating agency definitions (Best "B-CAR") should also be run or estimated. Risk-based capital may be run in total, or, depending on company allocation practices, shown for product lines.
10. The model should definitely project earnings and capital. Possibly, it should also project balance sheets, either in total, or by product line.
11. Some models may also project the runoff of current invested assets, either in total, or separate by product lines. These may be useful for some statutory reporting, such as the frequently used "New York 7" scenarios. Here, assumptions of interest rates, equity returns, defaults, calls, etc. should be included in the projection of investment income and maturities. It should be remembered that, for many long term lines, the performance of reinvested assets is often equally important to long term profitability.
12. If federal income tax is included in model projections, it may be calculated separately by product line, or one overall tax rate may be used.
13. For small companies, lack of critical mass is often a serious problem. Even with reasonable efficiency, current unit expenses may be well in excess of pricing expenses. However, anticipated growth from new sales should increase total in force so as to absorb these expenses.

    In projecting company operations, a key point is when, through these new sales, a company can reasonably expect to reach critical mass. In other words, in what year should the company's unit expenses reduce down to pricing unit expenses? In still other words, when will total expenses by absorbed?

A company's model can be homegrown or one of several well-regarded standard models on the market. Depending on each company's needs, standard models often need substantial modifications to be suitable for operations.

Current and contemplated model requirements will need very significant computer run times. A model system must be compatible with production line and administrative systems, such as master record updates, claims summaries and regular valuation runs. This coordination is necessary for an efficient operation.

Projections from the model should be communicated in detail to top management. Various alternative scenarios should also be communicated. Illustrative labels could include, "results if sales increase 10 percent over budget" or "results if expenses increase 20 percent over budget." Depending on the expertise or inclinations of management, labels can also include "alternative results with an x percent chance of occurrence." However, in the latter case, especially with laymen management, care needs to be taken that they understand thoroughly what this x percent chance means.

As a result of all the previously mentioned steps, if a small company's model includes all the above specifications, the insurer has a successful economic capital model.

Obviously, there are many difficulties and roadblocks faced by a small company in managing its capital. What are some steps it can take?

A model system must be compatible with production line and administrative systems, such as master record updates, claims summaries and regular valuation runs.

1. Use its flexibility in reacting fast, both for making decisions and reacting to unexpected events. A small company should not have the layers of management and bureaucracy that often hamper operations of larger competitors.
2. Make sure that all members of management, both top and middle, and often many other employees, understand its plans of operations and its intended, projected results.
3. Be active in both trade and professional organizations. Lobby to impact official policies of these organizations. If a small company feels that its views and needs are not adequately represented, it may have to lobby on its own.
4. Stay active in the NAIC, where many proposals that affect its operations and very viability are presented.
5. Keep up with current trends and proposals. Today, of course, Principles-Based Reserves and associated changes for Risk-Based Capital are hot topics, involving many complex elements.

Attendance of company personnel at trade and professional conventions, as well as NAIC meetings, involves considerable expense and out-of-pocket management time. Sometimes, hiring consultants to represent, report, and also lobby for the company can be more cost-effective alternatives.

In summary, a small company can manage its capital and still have the ability to grow, if it plans thoroughly in all the above areas, and implements and monitors its plans accordingly. ●