1993 VALUATION ACTUARY
SYMPOSIUM PROCEEDINGS

SESSION 7

Surplus Planning and Allocation

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SURPLUS PLANNING AND ALLOCATION

MR. STEPHEN N. STEINIG: My remarks are going to focus on the NAIC risk-based capital (RBC) Formula. I'll begin with a quick overview of the background and development of the formula, its current status, items being considered for possible future revision, and then relate RBC to some other specific items.

Background

The NAIC began thinking about developing an RBC formula in 1990. When it decided that such an approach was feasible, the project was launched with a meeting of regulators and about 50 industry representatives in late October 1990, more specifically, on Halloween in 1990. It is not just coincidence that some regard the outcome of that effort as a witches' brew.

The RBC formula, which was adopted by the NAIC in December 1992, has a specific purpose. The formula is a regulatory tool for assisting regulators in distinguishing weakly capitalized companies from all others. For companies that do not have the amount of capital called for by the formula, there are a series of graduated regulatory steps, beginning with the company submitting a plan to its Insurance Department, and ending with mandatory takeover of the company by the regulators.

The purpose of the formula cannot be overemphasized. Again, it is a regulatory formula designed to be a tool to help regulators distinguish weakly capitalized companies from all others. The formula was not designed to be an exam study note or prize-winning actuarial paper in how one assesses and measures risk characteristics of assets and liabilities.

I think the actuarial work done by members of the Advisory Committee was of the highest quality, and I am not trying to diminish that in the slightest by this remark. The reason I put so much emphasis on the regulatory nature of the formula is that I am frequently berated, and I know that my colleagues on the Advisory Committee are also berated, by our peers in the actuarial community because this factor or that factor in the formula does not take account of some particular distinction in risk characteristics, and so on. Only by recognizing that this

formula was intended as a regulatory tool to distinguish weakly capitalized companies from all others do you appreciate that the formula, by its nature, had to be broader, simpler, and embody more compromises than a formula that was solely theoretical and actuarial.

Current Status

The formula was adopted by the NAIC in December 1992, for implementation in the 1993 Annual Statement. It is an Annual Statement requirement for all companies in all states, even if a company's state of domicile has not yet passed the RBC Model Law. However, the penalties for having a capital shortfall are not applicable if your state has not passed the law.

Over the summer, the NAIC distributed diskettes to all companies asking that they submit their RBC data for 1992. This request is designed to serve as a test of the mechanisms NAIC has developed for gathering the data, for a dry run on the instruction material, and to create the start of a database for each year's RBC results in the future.

Future Changes

There are a number of areas that the Technical Resources Group has been asked to review for possible future changes. In fact, it is possible that the NAIC will approve some changes at its December 1993 meeting for exposure to the industry. However, in all likelihood these changes would not be implemented until the 1995 Annual Statement.

The item of greatest significance concerns the several RBC factors for mortgages -- mortgages in good standing, as well as mortgages in default and restructured mortgages. The original mortgage factors were set by a combination of judgment, analysis of limited experience in specified companies, and by a loose process of fitting the mortgage factors in with the bond factors. Since our original work, the Society of Actuaries and the ACLI have gathered more detailed experience data that can be used as the basis of more refined RBC factors. A number of people have been working with these data quite intensely through most of 1993, and they are getting closer to a proposal for revised mortgage factors. It is possible that this subject will be discussed at the December 1993 NAIC meeting.

One other change that might be discussed at the December NAIC meeting concerns Schedule BA assets. Currently, one RBC factor applies to all such assets. Separate factors might be proposed for BA assets depending on their underlying nature, e.g., fixed-dollar assets, real estate, and venture capital equity.

Several other long-term investigations are underway. One of the items in this category is off-balance-sheet risk, particularly derivatives. There are also ongoing studies concerning pricing flexibility and asset/liability liquidity and concentration.

Strategic Allocation of Capital

The title of this session is Surplus Planning and Allocation, and one of the specific items to discuss is strategic allocation of capital. How are those topics related to the NAIC RBC formula?

Required surplus formulas such as the NAIC RBC formula are traditionally used not just to assess a company's overall capital position but to allocate capital to various operating divisions and business units. At New York Life, we use a formal process of capital allocation, and we have found it very helpful for internal management purposes; analysis of financial results; focusing business units on their relative levels of profitability; and in discussion with the Board of Directors.

Should Companies Use the NAIC Formula for Strategic Allocation of Capital?

I'd now like to tie the NAIC RBC Model Law more closely to the subject of strategic allocation of capital. The first question is whether companies should use the NAIC formula internally. Certainly, a great deal of the news media coverage of RBC suggests that it will bring about significant changes in how companies manage themselves, and many authors seem to think that large numbers of companies, if not the great majority, will be managing themselves by the NAIC formula.

Only time will tell as to whether that is the case. Certainly, neither the regulators who adopted the formula nor the Advisory Committee members who worked on it were attempting to develop a required surplus formula for the 1,800 companies in the industry. My prediction is that companies will not use the NAIC RBC formula to the extent being predicted.

Yes, companies that require regulatory attention based on the formula have received a wake-up call, and have certainly been taking actions to increase their capital or reduce their risk. These companies may need to raise capital externally, significantly change product and pricing strategies, seek substantial amounts of reinsurance, or dramatically change their investment strategy to reduce dependence on high risk assets.

But the number of companies in this category, those with less than minimum capital, is a small minority of the industry. We have always been, and we remain, a financially strong, well-capitalized industry, and we should not let the failure of Executive Life and Mutual Benefit and a handful of others obscure that fact.

Companies that have capital only modestly above the amount required, with each company defining modestly as it sees fit, have probably also been taking some actions to improve their RBC ratios, but such actions would not represent sudden or inappropriate strategy shifts, just fine-tuning. There may be a fairly large number of companies presently in this category, companies not as far above the standard as they would like to be. In part, this is because no one knows where their competitors' ratios are, and no one knows exactly what the financial press and the public will do with the RBC ratios.

But even the companies that we are talking about, which are taking actions because the RBC Model Law has been adopted, are not necessarily using the NAIC formula for capital allocation. Please note that the fact that management is paying attention to a company's RBC ratio, and even has a specific minimum ratio that it wishes to achieve, such as 150% or 200%, is far different than using the formula for capital allocation.

Let me illustrate this with an example. The RBC formula uses a 30% factor for unaffiliated common stock. If the company with a 150% RBC ratio goal uses 150% of the formula to allocate capital, it means it is using a 45% factor for common stock. Even less appropriate, the company with a 200% goal would be using a 60% factor.

My conclusion is that it is not sound management practice to use the NAIC formula for capital management and that doing so is almost impossible to implement in any event. Now, my saying that is the equivalent of theoreticians saying hummingbirds can't fly, because some of you may be from companies that are using the NAIC formula for internal management. So during the discussion session, I would hope that you would share your experiences with us, how you define the formula for internal purposes, and what your preliminary experience has been.

When Your Own Assessment of Risk and RBC Are at Odds

One of the questions listed in the program is "When Your Own Assessment of Risk and RBC Are at Odds." Guess what I am going to tell you? Use your own assessment.

I mentioned a moment ago that the Advisory Committee was not attempting to develop a required surplus formula for 1,800 companies. The fact is, we know nothing about the specifics of your distribution system or your product line; nothing about your underwriting standards and utilization of reinsurance; nothing about the expertise and risk tolerance of your investment management people; nothing about special niches you might inhabit in product areas such as hospital indemnity nor investment areas such as residential mortgages for garden apartments. How could we possibly come up with a formula for your company that is better than you can do? Why should you ever give more credibility to our assessment than to your own?

When I considered the idea of when your own assessment of risk and RBC are at odds, I thought to myself, boy, that's an easy one. But when I saw questions like that on actuarial exams, years ago, my reaction was actually fear: "That's too easy, what am I missing?" So perhaps during the discussion period, some of you can tell me what I am missing.

Competitive Use of Companies' RBC Ratios

I want to close with another NAIC RBC issue, but one that will affect the extent to which managements feel they must pay close attention to their NAIC RBC ratio, even when it is safely above 100%. And that is the extent to which a company's ratio will be in the public domain and will become a competitive factor within the industry.

At the public hearing held by the NAIC in November 1993, prior to final adoption of the formula and Model Law, the issue of public disclosure and the public's right to know the financial condition of an insurance company was one of the most prominent issues. There were those who felt that the public's right to know was absolute, and that all aspects of a company's RBC calculation should be entirely public. There were others who thought that misinterpretation of a company's RBC position was so potentially damaging that a company's RBC position should be entirely private, a matter strictly between the regulators and the company.

The NAIC took a middle position. A company's RBC position will be disclosed in the Annual Statement, but in a manner that sends at least a psychological signal that the RBC ratio is not the sole piece of information that the public should know about a company's financial condition. In addition, the details of the RBC calculation will not be available to the general public.

There will be keen interest in companies' 1993 RBC positions after they become public in early 1994, and it is certain that financial journalists will compile and publish lists of companies' ratios, often without proper explanation that it is not appropriate to use the results to compare adequately capitalized companies, because the formula is suited only for its regulatory purpose.

To minimize the wrongful misuse and abuse of the formula, the NAIC Model Law prohibits companies and their agents from publicizing their RBC position, emphasizing the fact that RBC is not intended as a means to rank insurers. This means that, although insurance buyers may periodically see RBC rankings in newspapers and magazines, such rankings cannot be used by agents at point of sale.

Are the regulators so hopelessly naive as to think that this will prevent all misleading comparisons? Of course it won't, but the NAIC prohibitions should minimize their impact. In addition, the public, in assessing the financial strength of companies, will probably continue to look first and foremost to the rankings of the leading rating agencies, not to companies' RBC ratios.

If I am wrong about how the semiavailability of RBC ratios will affect the buying public, and if in fact RBC ratio becomes a critical ingredient in the marketplace, then probably many companies will feel a strong need to use the NAIC formula in just the manner that I have deemed unlikely in my remarks.

Should that come to pass, I have two predictions:

1. There will be a topic on next year's Valuation Actuary Symposium program entitled, How To Adapt the NAIC RBC Formula for Internal Capital Allocation, and
2. I will not be invited to speak at next year's meeting.