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LTC regulations cont'd

As competition between companies causes benefit enhancements to take place, my view of the scope of the benefit might change.

The regulatory framework is not being developed in a vacuum. An exposure draft of amendments to the existing NAIC Model Act and Regulation is available for review and comments. Interested actuaries can contact the NAIC office for copies of the exposure draft.

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AFIR colloquium set next April in Paris

The International Actuarial Association (IAA) has authorized organization of a new section called The Financial Section (AFIR). In American jargon, the focus is on investments.

With the internationalization of financial markets and operations, the increasing sophistication of financial techniques and products, and the deregulation of financial markets, actuarial methods are becoming more appropriate as tools for management decision making.

To attend the 1990 colloquium as a member of IAA, you must join IAA in the class of 1989 (June 30). With this mailing of *The Actuary* is the application for IAA membership. Be sure you respond before the cut-off date! Dues notices were mailed to present IAA members at the end of April.

AFIR's purpose is to address financial issues of concern to actuaries such as the latest valuation and hedging techniques in financial risks. Members have the opportunity to exchange experiences and knowledge with their foreign counterparts and to have regular contact with financial academics and researchers.

AFIR section activity consists of publishing reports and organizing colloquiums.

The first AFIR colloquium will take place in Paris April 23-27, 1990, and is organized at the joint initiative of the French Actuarial Associations and the AFIR section committee.

Financial actuarial papers will be published in the ASTIN bulletin; ASTIN is another IAA section.

Editorial

Managing the capital squeeze

by Richard K. Kischuk

Recently, the media has begun to focus on the "capital squeeze" facing the life insurance industry. The February 20 issue of *National Underwriter* reported on a study just completed by Standard & Poor's: "The life insurance industry is caught in an unprecedented squeeze on capital... Management can no longer brush aside the issue of capital adequacy." According to the March 20 issue of *Best's Insurance Management Reports*, a review of the life/health industry's experience during the past 10 years indicates the industry-wide C&S-to-L (capital & surplus-to-liabilities) ratio improved for a three- to four-year period but then began to deteriorate again.

The life insurance industry seems caught in a vicious cycle of intense competition. While it's not comparable to the financial crisis in the savings and loan industry, there's cause for concern.

For example, let's look at recent experience with interest-sensitive products. The profit margins of nontraditional life insurance products have been shrinking. This has motivated companies to increase their exposure to junk bonds and to adopt other riskier investment strategies. At the same time, companies have increased their leverage in order to show higher returns on equity (ROE). By maintaining artificially high ROEs, the industry attracts still more competition. This, in turn, leads companies to adopt even more risky investment strategies and to leverage further.

Another form of leveraging has been the pyramiding of capital, intended to further increase returns on equity. Increasingly, the surplus of life insurers includes large illiquid investments in subsidiaries, rather than securities that can be liquidated to pay claims if adverse experience develops. Many of these downstream companies are themselves insurance companies, whose surplus should not count toward the capital position of the parent. In addition, many insurers have experienced sizeable losses by expanding into new lines of business, such as financial services and managed healthcare. In many cases, the losses from these businesses will continue for many years, and the present value of these losses represents a significant impairment of statutory surplus.

The increased severity of the health underwriting cycle also has taken its toll. Many life-health insurers had leveraged themselves to support rapid growth in interest-sensitive products. This occurred at the peak in the underwriting cycle, and large health losses caught these companies at a bad time, causing many to lose their ratings.

While many industry experts are calling attention to the "capital squeeze," other observers blame the life insurance industry's problems on "overcapacity." Actually, the situation is caused by leveraging. The term "overcapacity" implies that large amounts of new capital have been flowing into the industry. This has not been happening. Instead, companies have decided to assume increasing amounts of risk using the capital base that is already there. This, in turn, has driven profit margins downward, creating pressures to leverage still further in order to show attractive returns on capital.

With these trends in place, it isn't surprising that few life insurance companies are creating economic value for their owners. A recent study of 17 publicly-held life insurers showed that from 1982 to 1987, only six companies earned significantly more than their cost of capital. The rest were breaking even at best, and several were destroying economic value. Moreover, the cost of capital is rising for many of these companies because of increased leverage in their capital structures.

How can life insurance executives cope with the "capital squeeze"? Here is a brief list of strategies that most companies can follow.

1. Aggressive management of expenses

It isn't news to most insurance executives that there is plenty of potential to reduce expenses. Today's products

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Capital squeeze cont'd

won't support the same level of overhead that could be supported with traditional products. Yet these levels of overhead expense remain in the cost structures of most companies. After some efforts toward reducing expense ratios, many companies have decided to maintain the status quo and are turning instead to increased leveraging and more risky investment strategies.

Traditional "functional cost" and "unit cost" allocation systems represent a major roadblock to cost improvement at most companies. These systems treat every expense as if it were a variable cost. As fixed costs and overhead expenses have increased, these systems have become less and less relevant. Most insurance executives don't have any useful information to tell them what their cost structure really is. In many instances, management decisions based on functional costs will have the opposite of the intended effect.

To make real progress, many companies will need to scrap their functional cost allocation systems. Instead, they must make an effort to understand what their cost structure really is and what forces drive each element of expense.

2. Managing the cost of capital

In order to create economic value, a company must earn more than its cost of capital. To manage to this result, executives must first know what their cost of capital is. And to manage the cost of capital itself, executives must understand all possible sources of surplus and the cost associated with each. With this information, the cost of capital can be actively managed.

3. Managing vitality surplus

"Vitality surplus" is the amount we have left after providing for surplus needed to support the risks of the inforce business. Most companies use traditional approaches to determine surplus needs. This method consists of applying somewhat arbitrary factors to each type of asset and to various indicators of business in force. Because these factors do not vary much from one company to the next, there is a tendency to overstate surplus needs for some companies and understate them for others.

As in managing expenses, companies must identify the forces that drive risk. The most important factors are not actuarial, although they can be quantified using models and other approaches familiar to the actuary. A company's management systems, rather than external forces, tend to be the key determinants of risk. This was the leading cause of insurance company failure in the Great Depression, and it still is today. In traditional approaches, this risk has been swept into a catchall category called C-4 and is ignored by most companies. But it is the main reason why some companies can operate safely with relatively little surplus, while no amount of surplus is enough for other companies.

We must begin using available techniques to quantify these risks and build them into surplus formulas. This approach provides management with useful information that often allows a company to reduce risk and increase its vitality surplus.

4. Managing the use of surplus

Each business unit and product line should be looked at from two perspectives. First, is it generating economic value? Second, is it generating or consuming surplus? Using this approach, we could have anticipated that the profitability of interest-sensitive products would be the key strategic issue facing the life insurance industry today. We also could have anticipated the recent losses from health insurance and the impact of acquisitions and diversification efforts. Companies could have adjusted their surplus allocations accordingly.

5. New approaches to incentive compensation

Many companies have tried to adopt new strategies, only to find that traditional approaches to incentive compensation motivate managers to do the opposite of what is intended. These traditional approaches reward executives based on a combination of sales growth and short-term profitability. Unfortunately, outside forces often have more impact on sales and profits, in the short run, than management's performance. So a company's executives may do a fine job in a given year but receive no bonus because the health underwriting cycle turned in the middle of the year. Or management may do a poor job but receive high bonuses because mortality experience was very favorable.

A better approach is to identify the factors that drive profitable growth over the long haul. Then management is rewarded when they have made fundamental improvements in these areas. Short-term financial results should be irrelevant. If management has done a good job of identifying the key risk and profit-drivers, performance will be rewarded in an appropriate manner over the long run.

The "capital squeeze" is alive and well for most companies. But for companies able to follow sound strategies, it will merely make interesting reading in the trade press. For the industry as a whole, implementation of these strategies will be a key toward halting the increase in leverage and the continuing decline in profit margins as we enter the 1990s.

Changes in SOA professional staff

Several SOA staff changes have been announced.

- Richard S. Mattison, FSA, joins us as Education Actuary primarily concentrating on Individual Life and Annuities courses. Dick was previously with Allstate.
- Richard Bilisoly, FSA, comes on board as Education Actuary primarily responsible for the Group Benefits courses. Richard comes to us upon retiring from The Wyatt in Chicago.
- Wayne Berney, FSA, FCIA, leaves his position with us as Education Actuary (Pension courses) to join the Edmonton office of The Alexander Consulting Group.
- Warren Lucker, FSA, is moving within the office from his position as Education Actuary (ASA courses) to assume his new responsibilities as Research Actuary.

We wish all four gentlemen well in meeting the new challenges facing them. While sad to say goodbye to old friends and colleagues, we are quite pleased to welcome the new players to the staff and are confident that they will make significant contributions to the quality of our basic actuarial education.