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AVR, IMR update

by James F. Reiskytl

The mandatory securities valuation reserve was replaced at the end of 1992 by two reserves — the asset valuation reserve (AVR) that now covers the default risk on all assets and the new interest maintenance reserve (IMR).

Several changes recommended by the Industry Advisory Committee in 1992 were approved by the National Association of Insurance Commissioners (NAIC) for implementation in 1992 and 1993. Other issues are being considered for introduction in 1994 or later.

Changes effective in 1992

The most significant change made in 1992 was the approval of a new public common stock maximum factor (effective in 1992) for the AVR of either (1) 20% adjusted up or down by the average beta of the company's portfolio or (2) 30%, if the company elects not to do the beta calculation. (Beta measures the risk of the portfolio relative to that of a standard — Standard and Poor's 500 or other appropriate index for non-U.S. portfolios.)

Changes effective in 1993

Noteworthy changes made in 1992 that will be effective in 1993 include:

- Refining the exemptions for the IMR to include the release of any existing IMR, whether positive or negative, at the time of sale of a block of business (The earlier exemption only covered gains or losses on assets at the time of sale.)
- Clarification of AVR/IMR treatment of most separate account products with guarantees
- Permitting transfers between AVR

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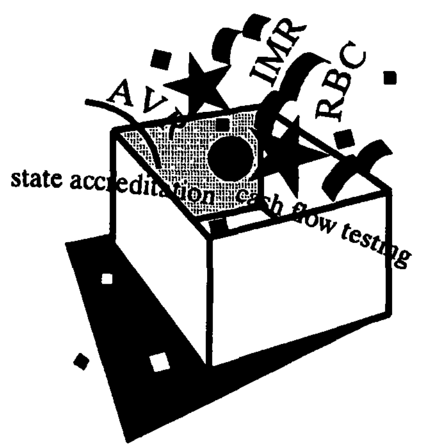
RBC standards part of new regulation package

by Thomas K. Gross



The new risk based capital (RBC) standards adopted by the National Association of Insurance Commissioners (NAIC) at its December meeting ushers in a new era of scrutiny and control by state insurance departments. The standards are just one part of a package of new requirements that will allow the insurance departments to regulate more effectively. Other enhanced regulatory features are cash flow testing, state accreditation, the asset valuation reserve, and the interest maintenance reserve. Together, these should help the regulators do their job better and should serve as a cornerstone to help improve the industry's public image.

Features of RBC standards formula

The risk based capital standards involve calculation of a company's exposure to the classical categories of risk: asset default, pricing risk, interest rate risk, and general business risk. The formula, an evolution of

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RESEARCH CORNER

- The Society has released the Credit Risk Study's preliminary results for private placement bonds, and more detailed analyses are being prepared. Preliminary results for commercial mortgages will be available soon. Seminars on the Credit Risk Study are planned for April 13 in San Diego, May 5 in Boston, and June 16 in Quebec.
- The Universal Life persistency study has begun with a recent organizational and planning meeting with cosponsor Life Insurance Marketing and Research Association.
- The Catastrophic Claims Data Base Project has attracted several data contributors and is in the final stages of selecting a research team.
- A monograph on the possible application of fuzzy set logic to actuarial science is now available from SOA Books and Publications, 708-706-3526.
- The Actuarial Education and Research Fund is holding its annual individual grants competition.
- The 28th Actuarial Research Conference is August 19-21, 1993, at the University of Wisconsin - Madison in honor of Professor James C. Hickman.

Consulting cont'd

management in scoping out assignments, consultants learn to look at the big picture, instead of just the actuarial or technical implications of corporate decision-making. A good consultant must be familiar with broad industry trends beyond the actuarial aspects.

We are in a postindustrial society. This means more emphasis on management information. Corporations selectively using the expertise of the consulting community to adapt to the trends and consultants able to provide services to them will prosper.

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RBC cont'd

earlier efforts by various companies and a few insurance departments, introduces these new features:

- Size gradations for the bond portfolio and for insurance risks
- A concentration risk factor that doubles the required capital for the 10 largest assets
- Mortgage loan default experience factors
- Use of a covariance term to recognize that asset default and interest rate risk are generally independent of the pricing risk
- Lowered risk factors for companies that issue an unqualified actuarial opinion incorporating cash flow testing

Formula defines minimum capital

The new formula will become effective with the filing of the 1993 annual statement. It will define the minimum capital for companies to operate. It is meant to replace existing statutes that have a fixed dollar minimum capital amount such as $2 million.

Each year, a company's actual surplus, increased by 50% of the dividend liability, any voluntary investment reserves, and the asset valuation reserve, will be compared with the risk based capital produced by the formula. Based on this comparison, a company may be subject to regulatory action. Such action may range from being required to file a five-year recovery plan to a full-scale examination and, if surplus is entirely inadequate, to mandatory control by the insurance department.

Some companies may adopt a more complicated or a simpler target surplus formula than the NAIC's. The NAIC formula was never meant to be a target formula. It was designed to identify weakly capitalized companies and requires only a threshold level of capital, the level below which regulatory action is mandated. Most companies will want to operate with much more capital than this. The NAIC formula does not address the nuances of each company, and the interest rate risk is only properly addressed by cash flow testing.

Effect on companies

Most companies have found that their capital is substantially more than is required by this formula. Some weakly capitalized companies have already begun to respond to the new RBC standards by strengthening their balance sheets through additional paid-in surplus, increased reinsurance, selling noncore businesses, and bond trading to higher-rated securities.

Some companies may decrease their common stock and mortgage loan portfolios. Consolidation by merger, acquisition, and demutualization also is a possible reaction to these standards.

A less obvious reaction might be to reduce surplus because a board of directors believes the formula indicates the company has too much surplus and is not producing the desired returns on equity.

It is hoped the long-term effect is for companies to increasingly emphasize profitability, the only viable way to remain strong after shorter-term actions have been taken. Without long-term profitability, our industry will continue to struggle. Companies also should give risk management increased emphasis and focus on the risks they can afford.

Possible negatives

Some adverse consequences of the new law may occur. The press may misuse the formula and publish company rankings. This would be unfortunate, because the NAIC formula is not meant to rank various well-capitalized companies, but to discover weakly capitalized companies. The press may comment about the relative strength or weakness of the formula or its components. An important point to remember is that the new law prohibits companies and agents from advertising or publicly announcing any RBC results, including their own.

A few companies likely will be closed, which is good in the end. The public eventually will believe that we have more effective regulation and companies have become stronger financially because of the RBC law.

Although some have expressed concern that certain "high priced" investments might dry up, this is very unlikely. Most companies have very ample surplus and will not be concerned about the RBC formula.

The new RBC standards should help regulators perform their job of financial surveillance better, improve the image of the industry, and help each of us manage our companies better.

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