The Actuary

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Actuaries hold a strong hand in the solvency game

by John J. Palmer

The past few years have been troubled ones for the life insurance industry. It has had solvency problems of unprecedented number and magnitude. These problems, surprisingly, did not result from adverse external economic forces, but from clear cases of internal mismanagement. This led state regulators, and may be leading federal regulators, to conclude that the normal market forces — the threat of failure and loss of company owners' capital — is not enough to coerce corporate behavior that is consistent with public interest. What is needed, it is argued, are more constraints on managements' actions. Also mentioned are more detailed disclosures to the customer of policy details and company practices and stronger guaranty association support for the customer.

Could any combination of these recent initiatives have resulted in less severe problems, given the determination of some managements to engage in risky behavior? The presence of the state guaranty associations may have made it even more feasible to take large risks without paying a price in the marketplace. Strengthening the guaranty system would be a step in the wrong direction unless an appropriate current risk premium was imposed for risky behavior, creating a current marketplace penalty.

It could be argued that enough public information and regulatory power already existed to compel early disclosure and remedial action and that the missing element was the regulatory will to act. Under this view, the industry at large and the actuarial profession specifically might be faulted for failing to support the regulators in their duties. How many in the industry now say, "It was obvious for years that Company X was in serious trouble."?

The result has been a larger and still increasing number of constraints on managements, most of which are directly translatable into capital requirements. The most important ones follow.

The NAIC Risk-Based Capital (RBC) formula
This was designed as a device to categorize companies to determine the appropriate level of regulatory oversight. It also has the potential to turn into a micro-level rating point system. Few companies, however strong in surplus, will undertake significant financial transactions without looking at the RBC impact. More schemes to "manage" against RBC formula are increasingly visible. This is inevitable when it is convenient to use a formula as a substitute for what was formerly a matter of judgment.

Target surplus formulas
More companies use generalized target surplus formulas similar to, but often more stringent than, RBC formulas. These measure surplus required by various lines of business and by the company as a whole.

Judgments of rating agencies
The relevance to companies of rating agencies' judgments depends on the customer markets they serve and their ownership structure and attitudes. While some rating agency actions are formula-driven, often their judgments seem arbitrarily based. Certain products, markets, practices, and even sheer size characteristics move in and out of favor with the rating community.

The valuation actuary
The implications of product design, pricing, and investment strategy will be reflected in the valuation actuary's work, possibly leading to the need for reserves beyond those demanded by statutory formula. There seems little chance in the near term for valuation actuary studies to allow companies to hold less than statutory formula reserves, though this would be logical.

The proposed solvency report
The recent initiative by the American Academy of Actuaries to develop periodic reports to management on solvency, i.e., surplus adequacy as an ongoing business, has the potential to be very useful. It can pose the greatest threat to management, however, by making the company's actuary, in some sense, an agent of the regulators.

For the product actuary, these forces reinforce the notion of surplus as the limiting resource and some form of return on equity (ROE) as the primary measure of profit.

"Equity" for this purpose would consist of the aggregate of the various amounts that the company feels constrained to hold. While some amounts are clearly formula-based, other amounts will be quite subjective, as in the case of the rating agency requirements ("How much do we need to keep the X rating above Y?").

These multiple and loosely defined constraints make it difficult to determine precisely the minimum surplus needed at the company level.

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E&E CORNER

Bilisoly retires; Allen steps in

After a 41-year career, with the last 4 years at the Society of Actuaries as an education actuary in the health practice area, the only statistics Dick Bilisoly will be gathering are his frequent flyer miles. On October 29, he retired from the SOA and began his travel schedule with a trip to Hawaii.

"I think the best part of my job here at the Society was working with so many different people, representing so many points of view, from all over the world," Bilisoly said. "But, you haven't seen the last of me yet. I plan to stay on as a volunteer on the 100 and 110 exam committee."

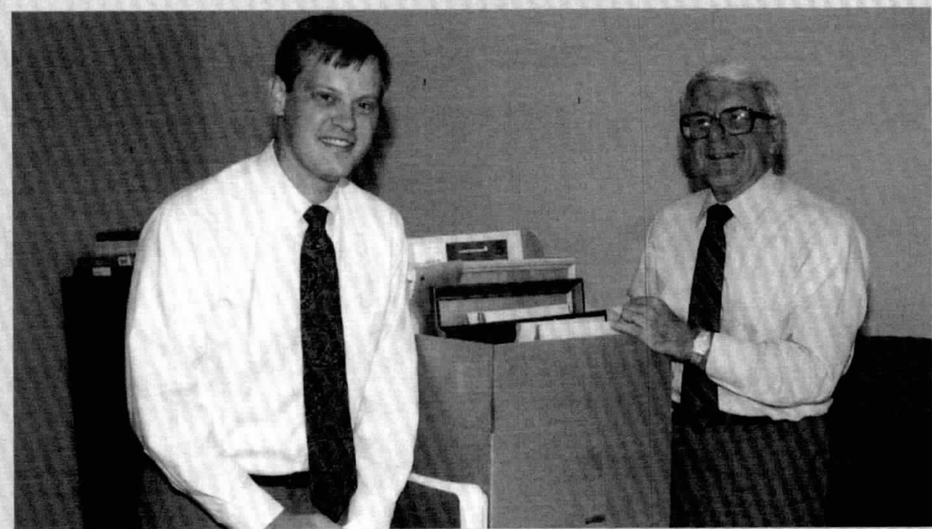
Bilisoly spent much of his last month at the Society briefing his replacement, Jeffrey Allen, FSA 1992.

"The biggest challenge in this position will be dealing with the unknowns in the changing health environment," Allen said. "We'll have to continually address these changes in our examination and practice education areas."

"Jeff will bring a new perspective to E&E," Marta Holmberg, education executive, said. "He is the first actuary on staff who was writing exams when the Flexible Education System (FES) was implemented and who experienced the Fellowship Admission Course firsthand."

Allen's interest in the insurance industry began early. As a child, he puzzled over the rate books his father, who was in insurance sales, brought home. "The numbers have always fascinated me." He went on to get his mathematics degree at Wheaton (Illinois) College. After four years at Blue Cross/Blue Shield of Illinois and short stints at a small health insurance company and a consulting firm, Allen spent the past four years at CNA Insurance Companies in Chicago, where he worked in mass-marketed and small-group pricing and product development. He most recently was heavily involved in the analysis of small group reform at CNA.

Dick Bilisoly (right), retiring from the SOA, packs his pictures to clear the office for Jeff Allen (left), new health actuary on staff.



Solvency (continued)

Transferring company-level constraints to pricing requirements for a specific product is much more difficult, because many formulas are broad brush by design. The usual shortcomings of the single-number ROE measure mean that it often must be supplemented with more minimum profit standards, such as break-even year to force early return of investment or return on assets where surplus requirements are small or poorly defined.

The industry is paying closer attention to this kind of approach for pricing and for other key financial decisions. Retail prices are more consistent and more "rational" than at any time in the 1980s. This is the result of excess capital disappearing from our industry and more or less explicit requirement formulas emerging in various quarters. Surplus levels are already improving in many companies, due in part to greater financial and actuarial discipline and the actuarial profession's contributions.

Much remains to be done, and new potentials for error have arisen, such as undue reliance on formulaic surplus requirements by regulators and business owners. Nonetheless, the actuary now holds a stronger hand than at any time in the recent past. We need to play that hand with all our professional skills.

John J. Palmer is senior vice president at Life Insurance Company of Virginia in Richmond, Virginia.