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# NAIC risk based capital: Where is it headed?

*by Cande Olsen*

In late 1990, when the original industry advisory committee was formed to advise the NAIC on setting risk based capital (RBC) standards, the National Association of Insurance Commissioners (NAIC) stated that it wanted "a simple formula to distinguish weakly capitalized companies from others, based on annual statement data wherever possible."

The final formula was approved by the NAIC in 1992. It was made clear to the industry that the formula was to be used only to distinguish weakly capitalized companies from others, but the NAIC was still concerned that people would use RBC as an index to compare adequately capitalized companies. Therefore, the NAIC included a statement in the model law to prohibit such use.

Even with the law's protection, however, companies are concerned that: 1) their RBC results will be published by the press and other entities not subject to insurance law or 2) that the published annual statement results will be used to compare companies. As a result, many companies have been looking at the RBC effects of everything that they do. Some have even developed specific plans to improve their RBC position. This behavior has been further fueled by consultants and investment bankers who assure potential clients they have the service or the product that will help the company increase or maintain its RBC ratio (in the short-term, anyway).

The introduction of the RBC formula and companies' concerns about inappropriate use of formula results also raised new questions about reporting (e.g., would a particular new asset structure be considered a bond or a mortgage?). The choice of a reporting category becomes important, because it determines what RBC factor is applicable to that asset. Regulators are concerned about agreeing that a new asset structure belongs in a low risk category because of a possible hidden risk component. The plot thickens when investment bankers "promise" companies that some new asset structure will be treated as a low risk bond (it appears that all the normal NAIC approval steps would lead to that), but then the regulators have second thoughts about proper asset classification when they must formally approve the new asset structure.

When the RBC formula was developed, future changes were expected to better discriminate weakly capitalized companies from others. Very few changes have been made, but the NAIC exposed four recommendations in December, potentially effective for 1995, that have not yet been approved. The changes add extra categories and adjust the factors for mortgages, derivatives, joint venture real estate, and common stock. The introduction of health organizations' risk based capital in 1996 also is likely to change the format and level of many health terms in the life RBC formula. If changes are made, will they help identify weakly capitalized companies?

Many people in the industry and in regulation believe that using the formula to compare companies can't be avoided, so the formula should be as exact as possible. It may not be possible to develop a formula that could be used to effectively compare companies. It would have to be extremely detailed and almost custom-made to properly account for all the different assets, products, and practices of different companies. This becomes more difficult because of the almost two-year lag in getting changes approved through the NAIC. Refining the formula to better compare adequately capitalized companies would add credibility to the belief that it can and should be used for this purpose. Companies will then demand further changes, and this would result in a never-ending spiral of changes.

If the NAIC adds more terms to the formula, adjusts the factors, introduces additional non-annual statement information, or does some combination of these, will the formula better meet its goals? Or will it just become more complex, and misunderstood or manipulated? Won't adding more risk categories increase the chances that the current category in which an asset is classified becomes questionable? Are the regulators and the industry putting too much effort into refining the formula, with the concerns of adequately capitalized companies in mind, while some flaw in the formula allows weakly capitalized companies to avoid regulatory action?

As we consider potential changes to the formula, it may be worth remembering that the original goal, as stated at the beginning of this article, was to develop "a simple formula to distinguish weakly capitalized companies from others, based on annual statement data wherever possible."

**Cande Olsen is chair of the American Academy of Actuaries Life Risk Based Capital Task Force. The opinion expressed in this article is the opinion of the author and does not necessarily represent the opinion of the American Academy of Actuaries or the Life Risk Based Capital Task Force.**