SOCIETY OF ACTUARIES

Article from:

The Actuary

May 1989 – Volume 23, No. 5

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.

Larry M. Gorski is Life Actuary, Illinois Department of Insurance.

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

Continued on page 6 column 1