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Managing the "Free Surplus" Portfolio of an Insurance Company

Track: Investment

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Recorder: NANCY E. BENNETT

Summary: Unallocated or "free" surplus is often treated as a leftover piece of the balance sheet pie. While considerable attention is paid to reserves, benchmark surplus, and its supporting assets, relatively little attention is paid to free surplus and its supporting assets. The panel approaches these assets as a portfolio to be managed with its own set of performance goals, risk tolerances, and characteristics, including issues and alternatives for managing unallocated free surplus.

- *Impact of corporate structure*
- *Diversification and the tools to manage it*
- *Setting asset and liability risk tolerances and adjusting risk in the portfolio*
- *Performance goals for the portfolio*
- *Impact of mergers, acquisitions, and divestitures*
- *Using internal capital formulas to drive growth*

Ms. Nancy E. Bennett: The topic of this session, is very broad, so we decided to briefly cover the aspects or functions involved with managing capital to give you a flavor for the different things. We will use the question and answer session to hone in on some specific issues that may be of particular interest. While we were talking about the content for this particular session, we had some good discussions about the best way to manage the surplus for an insurance organization. Of course, we all know there isn't a best way, but there are a lot of different ways. So we thought we would give you the benefit of that kind of discussion and hopefully, elicit some of your observations as well.

Dave Neve is the second vice president and actuary for The Principal Financial Group, which is a global financial services company in Des Moines, Iowa. Dave is responsible for the corporate actuarial department and the corporate modeling and capital management functions at Principal. Dave has been with Principal for his

entire 23-year career and has had a variety of responsibilities, not only in corporate but as the CFO in the individual division.

Russ Osborn is the senior actuary with Nationwide Financial Services in Columbus, Ohio. Russ's responsibilities include enterprise-wide risk management, investment policy, and developing and applying research in the asset liability management area.

I am a consulting actuary with the AVON Consulting Group in Woodbury, Minnesota. I've been there about a year-and-a-half, and prior to that I was the corporate actuary with Minnesota Mutual.

Managing capital and in particular, the methods for managing capital, have come to the forefront of life insurance company management in the last few years. In the last couple of decades, capital management has become the focus of more and more actuaries. The discipline of risk management has started to evolve and that plays into the topic of capital management. We're all familiar with many of the insolvencies that have taken place over the last couple of decades. These insolvencies have highlighted the inadequacy of some of the existing techniques for managing the financial strength or the capital adequacy of an insurance organization.

So in response, the regulators, the rating agencies, capital markets, and sometimes company management have started to put more of a spotlight on the topic of capital adequacy. More recently, the transformation of the financial services industry has also increased the emphasis on managing capital. Mutual companies are forming mutual holding companies or demutualizing all together. Mutual company management now looks at capital in a whole different light. Those companies that are stock companies, are already accustomed to dealing with capital management from the perspective of the stock market.

As the financial services industry is being transformed, and the returns on U.S. life insurance companies are being compared to other players, such as mutual companies and banks, there are questions about why U.S. returns are sometimes lower than a lot of their counterparts. One of the reasons that is often cited is that there are such high capital requirements for U.S. life insurance companies. So again, this makes members of management in U.S. life insurance companies start to look at capital and how much capital is kept in the company.

During our presentation, we're going to discuss the various functions or activities involved with managing free surplus, namely, the measurement, management, and deployment of free surplus. I'm going to give you a broad overview of all these different topics, and then Dave is going to talk about the capital management process that he is responsible for at The Principal Financial Group. Principal, as you may know, has formed a mutual holding company, and is in the process of demutualizing to a stock company. So this experience of Dave's will provide an interesting perspective on the whole idea of capital management. Russ is going to share his observations about capital management at Nationwide, which is a stock company. In particular, Russ's presentation will focus on the investment strategy

and developing an appropriate strategy that takes into account the risk and returns that a company might want for their capital portfolio.

Finally, in our question and answer discussion, we hope to discuss some practical or real world examples. Now before we get into the bulk of this particular presentation, I want to put the management of free surplus into a broader context, really of financial management. Managing the free surplus of a life insurance company is an integral aspect to managing the entire financial position, or the financial management position, of the life insurance company. So when we talk about managing capital, we're also indirectly talking about managing both short- and long-term earnings. We're also talking about managing the amount of risk that the organization is willing or able to assume. Capital represents the funds needed to cover the risks assumed by the organization, and the income or earnings, represents the change in that capital. The risk represents the variability in that particular income, as the risk materializes.

Now this very fundamental view of capital or financial management then, leads us to one very critical question, which is understanding, Who is responsible for managing that capital position? In other words, who is really accountable for managing that free surplus account? This issue keeps coming up over and over, when the organization tries to develop asset products and then overall corporate strategies. How do we develop those strategies in the context of managing the financial position of the organization? Who is accountable for developing and executing these strategies? Once the strategies have been executed, how do we evaluate the success or failure of those strategies and ultimately pass those results on to either shareholders and/or policyholders?

We're going to discuss the measurement, management and deployment of capital for an organization. But what specifically does that mean? First and foremost when we talk about managing capital, the first thing we need to do is a measurement exercise where we determine the level of capital that needs to be retained by the organization or the amount of required capital that really can't be touched by the organization. That in turn, tells us how much free capital we have to invest in other ventures.

Once we have determined the amount of capital that we need to hold, we have to determine how much we expect that capital to return and how quickly we want that capital to grow. We then move into the practical world of managing capital, which is determining the sources and uses of capital and the growth in earnings. In other words, is most of our capital coming from internally generated funds from our existing businesses? Certainly for a mutual company, internally generated funds are the primary, if not the sole source, of capital. You might be getting capital either from a subsidiary or from a parent and, of course, if you're a stock company, you're getting capital from the public markets or other outside investors, or you may be involved with receiving capital or using capital in the merger and acquisition area.

These functions of determining the sources and uses of capital are aspects of the management and deployment of a company's capital.

Finally, another key component of managing the capital and then figuring out how to deploy the capital will be to determine the capital structure for the organization whether your capital should be in the form of capital and surplus notes, debts, or stock.

I need to take a step back and define some terms. You probably already notice some inconsistency in my speech in that I tend to use the words capital and surplus synonymously. The actual title that the Society put on this session was Managing Free Surplus, but surplus is generally synonymous with capital. I think probably surplus is more of an older term that goes back to the statutory surplus that's reported in the Blue Book.

For the purposes of our presentation, we're going to try to use the words capital and required capital and then free capital. But generally, surplus is synonymous with capital and so, as such, the concept of free capital or free capital as a term then is defined within the context of total surplus funds. Simply stated, free capital is the amount of funds that can be deployed to fund new ventures.

From an equation point of view, free capital for an organization simply equals the total capital minus retained capital. Now retained capital is another one of those confusing terms. A more common term might be required capital. In other words, free capital is the amount of funds that are available that are not invested in any other activity of the company.

Free capital is defined both at the business unit level and at the company level. Typically, capital management in a life insurance company is based on statutory values because of the regulator's concern and emphasis with company solvency. From a reported point of view, and for life insurance companies, statutory capital is equal to unassigned surplus plus the asset valuation reserve plus one-half of the dividend liability. This is a fairly accepted measurement of capital. I think maybe ten years ago, there was some debate of whether or not that should really be the definition of capital. But I think it's accepted now as the formula for measuring statutory capital.

If you look at capital on a GAAP basis, quite simply, it's the GAAP equity equals GAAP assets minus GAAP liabilities. Now these two formulas that I just described seem fairly straightforward at a total company level. But I will assure you that the definition becomes much more complicated at a line of business level. There are many items that cancel out at a total company level but they're very significant items at a line of business level. So the exercise becomes much more complicated for a business unit level.

I wanted to spend some time discussing this first aspect of capital management, that being how to measure free capital. First and foremost, we need to define the level of capital that is to be retained within each business unit. Generally speaking,

the amount of capital to be retained by a business unit is based on a proprietary formula or a regulatory or published formula. This formula takes into account the various risk profile of the business unit's liabilities and usually the assets.

The life insurance companies today typically use a percentage of the NAIC's risk based-capital (RBC) ratio, possibly a rating agency ratio or maybe they use a proprietary formula. Most companies have moved to a percentage or multiple of the NAIC formula in the last few years, not because it's such a great formula, but because it's such an important measure and most companies want to know how their results stack up, using the NAIC formula.

Once you have the measure of retained capital defined and measured, the next step is a reporting exercise, which allocates that amount of capital to the business units within the financial reporting and within your performance measurements.

There are a lot of different formulas for required capital and no formula is perfect. No formula will capture all of the risks that are faced by an insurance company. Over the years, the formulas have gotten better in terms of how they reflect pricing risks and interest rate risk, but there are other general business risks, risks of lawsuits and other items that probably can't be captured by any particular formula.

It's important that a company understands the risks that are, in fact, measured in the formula and the deficiencies of the formula. I don't think the point is to say, "We can't measure these risks, so we're not going to build a capital management structure." I think you just want to make sure you understand what you're able to capture and where you probably need to apply more judgment.

Now, since one aspect of this particular session was to talk about the measurement of life insurance company surplus, I want to cover some of the issues associated with measuring free capital within a life insurance company, and in particular, at a line of business level. I'm not going to go into a lot of detail.

There are really two levels of measuring capital. One level is at the total company level, and one level is at a business level. If we assume, for just a moment, that most formulas have direct relationships to the NAIC formulas, there are certain items that are going to be allocated or reflected in their required capital for a business unit. In particular, your company may invest in subsidiaries, which gives rise to RBC. That may also include separate account cede money.

Some of those subsidiaries may be investments at a company level, but there is in fact, required capital associated. So the question then becomes how do you reflect the required capital in subsidiaries across the different business units? Other items within the asset default or C1 required capital are some total company adjustments, typically reductions for mortgage experience or maybe bond concentration. Again, these are asset related, and the issue becomes how do you reflect some of those items across the business units? Depending on your asset segmentation and asset/liability management practices, you'll need to take that into account.

On the pricing side, most of the formulas reflect the C2 risk and are banded by net amount at risk. So you have to ask, Does everybody have to start out with the first dollar of net amount at risk or do you give an average net amount at risk factor or do you give some product lines the benefit of the lowest factor? There are a lot of different ways to allocate C2. Finally, there is usually a covariance that is applied to all the different risk factors. So how is the covariance allocated across the business unit?

Once you have your ongoing business units set up and you've dealt with some of these issues I just mentioned, then you have some other items to cover in terms of how do you think you should allocate capital to new ventures? In other words, should you allocate capital based on a marginal basis, giving the benefit of being part of an established organization or do you allocate capital on a stand-alone basis, saying that the new venture must be self-sufficient?

We have to answer some questions dealing with the how-to allocation of required capital for non-business unit operations or decisions, non-insurance operations and then again for certain risks that can't be reflected in any formula. I think a lot of companies commonly know of certain activities that will use up surplus in the future. Companies earmark surplus funds for future use. So the question is, Do you allocate the surplus today or when it actually takes place?

Now we will move into the second aspect of surplus management or capital management—the actual management phase. What that means quite simply is, once you've determined how much you have for surplus funds, then you need to figure out how you're going to invest that pot of money. Are you going to establish an investment strategy for just the required or the target capital, or are you going to have a different investment strategy for the free capital? What is your time horizon going to be? What are going to be your expected returns for that capital? Not only the expected returns on the capital that's just sitting in a pot that has not yet been deployed, but once you then make a deployment decision, what kind of returns are you going to expect on the capital that has just been deployed?

That of course, moves us into measuring the performance of the surplus funds. If you're looking at capital on a statutory basis I think the most common measure is going to be the NAIC RBC ratio, or possibly, the more simplistic and older surplus to liabilities ratio.

From a rating agency perspective, you might be interested in the three different ratios that are used by the four large agencies, Best Capital Adequacy Ratio, the NAIC Ratio, used by Moody's and Duff & Phelps, and then finally, the Capital Adequacy Ratio used by Standard & Poor's.

On a GAAP basis, you will probably use GAAP ROE or GAAP return on assets. Finally, if you're a company that has moved out of the accounting realm and into the economic or financial world, you're probably trying to develop or using economic

measures such as economic value added or looking at some measurement based on distributable surplus.

Now moving on to the final aspect of capital management which is deployment. Deploying capital is an integral aspect to the execution of a company's strategic plans. As such, it's very important that a company develop a formal capital budgeting process, whereby it can quantify sources and uses of capital. Deploying capital has such a direct bearing on the financial results of a company, not only your current results, but you can make decisions today that will affect you for many years to come. It's important that when you're looking at deploying capital, that you have a quantifiable and an objective basis for looking at the expected contributions to capital. You need to have a quantified or rigorous process for looking at the sources and uses of capital. Otherwise it is fairly easy for the discussion to focus on the personalities, and who has a better, more convincing story for how the funds should be used, or a more convincing argument as to why a plan just hasn't quite materialized yet.

We can't ignore some of the subjective considerations of managing capital, but I think the point is that we have to or support the discussions with a quantifiable process. Because after all, deploying capital is integral to maximizing the value of the company.

I've tried to cover many of the aspects of capital management and I hope I've given you a brief overview for the complexity of managing capital. I think one of the reasons why managing capital is so complex, is because there are a lot of constituencies that evaluate the capital management of an organization. All of these different people have different and almost conflicting views on what the capital position should be for a life insurance company.

Regulators, of course, are primarily interested in the solvency of an insurance company to be sure it can meet policyholder obligations. From their perspective, more surplus is better.

Rating agencies try to take a little bit different view and look more at a growing concern. Their primary interest is to look at the long-term viability of a company. Though it's hard to really figure out exactly how the rating agencies take capital into their ratings process, I think it's clear that the level of surplus held by a company does, in fact, influence a rating. Generally, more surplus is better, but it's not always one for one.

Now the capital markets have a much different take on capital. They're interested in the company's ability to generate attractive earnings per share. So I'm not sure if they would actually say this or not, but I think it is pretty clear that the capital markets would consider under-deployed surplus to generate an attractive return to investors. With an emphasis on short-term earnings in the capital markets, there's probably every incentive to take free capital down to zero.

Now, of course, we're also aware that company management has their own view of how much capital should be retained within the organization, which is probably

different from these three and of course, as actuaries, all of us have our own opinion about what's right. That's why this is such a complex and interesting subject.

Mr. David E. Neve: Nancy has done a good job of laying out the basic framework for a capital management process, particularly in regards to free capital. In my comments, I'm going to get a little more practical as to how we manage capital at The Principal with the hope that you might find something of benefit that may be applicable at your company. At the end of the session, I hope we can have a lively exchange over some of these concepts.

To give you a context for my comments, I'd like to start by giving you a brief overview of The Principal. Nancy described us as a global financial services company. Not too many years ago, we viewed ourselves as a domestic life insurance company. But several years ago, we changed our strategic direction to become a global operation with a clear strategic direction to focus on retirement services and asset-management services. We're still going to have a large block of risk-based products, such as life insurance and health insurance, but our future direction is to focus on acquiring companies globally and focusing on asset management and retirement services.

This new strategic direction has had a profound impact on the way we manage our capital. We currently are organized as a mutual insurance holding company (MIHC), but our plans are to demutualize in the near future. That raises a new set of issues regarding our capital management process.

I'd like to cover three things in this presentation. First, I'll give you a quick description of how we manage total capital, and in particular, free capital. Second, I'll describe how our investment practices in regard to free capital has changed as we made the transition from a domestic life insurance company to a global financial services company. Finally, I'll make a few brief comments on future issues and areas of concern.

Let me provide you with a description of the basic elements of our capital management process. For the level of target surplus (or required surplus) versus free surplus, many companies manage them differently. At the Principal we bring them both together into a single pooled account. The investment strategy of this combined pool is established by corporate. The lines of business really don't have any direct input into how these funds are invested. From time to time, those of us in corporate get into very interesting discussions with the lines of business with regard to how these funds should be managed. The lines would prefer to manage their own capital directly, and they frequently tell us so! But up to now, we've maintained that the assets backing capital are going to be managed at the corporate level. The main reason is that it gives us a larger pool to manage than if we were to divvy the pool up and allocate it out and let each line of business manage their own portion of target equity. We believe that a bunch of smaller pools is not the most optimal way to manage the assets backing capital.

It also provides more flexibility for senior management to manage enterprise-wide goals. For example, a concern that has recently become more important to our company is the issue of liquidity. We believe that managing the assets backing capital at the corporate level allows us to better manage liquidity targets at the total company level.

Even though all the assets backing capital are in a single pooled corporate segment, we determine target surplus levels by line. I'll explain how we do that in just a minute. We set pricing objectives for our products expressed in terms of a targeted ROE on that level of target surplus. Corporate allocates back to the lines an appropriate portion of the investment earnings on the surplus account in proportion to their target equity. I'll explain how we do that in just a minute.

So a key part of the process is that there is no capital retained or managed at the line of business level. All capital that's generated during the quarter (i.e., GAAP net income) is transferred in cash to corporate. The lines only manage the assets backing their liabilities. As I said, corporate manages the target surplus and the free surplus in a single pooled account.

We use the term available capital for free capital, and as Nancy mentioned, it equals the total capital that we have generated, both debt and equity capital, less the amount of target surplus or required surplus that we have determined by formula.

Up until a few years ago, we managed our capital following a typical life insurance company perspective, which is probably similar to the way many other life companies manage their surplus. For example, since we've pretty much only been involved in U.S. insurance businesses in the past, the way we've defined target surplus by line has been in terms of a percentage of the NAIC RBC. Thus, we looked at each of our businesses as a stand-alone insurance company and calculated what their NAIC RBC level would be. This is the basis that we used to allocate capital to each business unit. But as we are now getting more into non-insurance businesses, and non-domestic businesses, the domestic NAIC RBC formula doesn't work well.

We've had to make changes to our capital management process as we make the transition from a mutual company to a public company. There are three things that I'd like to focus on. First, I'll describe how we revised our investment strategy for the assets backing our capital. Second, I'll describe a more focused approach to identify and manage our sources and uses of available capital. Finally, I'll summarize the process we have implemented that gives us a more disciplined and focused approach to capital budgeting.

Regarding our investment strategy, in the past we followed an investment strategy for the assets backing capital that had a long-term horizon and was focused on maximizing total return. As a result, we invested primarily in stocks, real estate, and other equity type investments such as venture capital investments. We were also following a very passive investment strategy. Basically, it was a buy and hold strategy: whatever was placed on the books typically stayed there until maturity. There was more active management of the assets backing product liabilities in

order to satisfy asset/liability management and immunization objectives, but there was little activity on the capital side.

Also, we did not have a dedicated portfolio manager who was responsible for managing the surplus portfolio. The portfolio was just sort of there, somewhat as an accident of history, with little or no active management. There were a few senior management investment people who looked at it from time to time, but that was about it.

As we are preparing to become a public company and are evolving into more of a global financial services company, we've made some pretty profound changes in the way we invest our capital. We now have a much shorter investment horizon, and are more concerned about the impact on GAAP operating earnings. Our focus is no longer primarily driven by total return. We've made the decision that we're willing to forego total return if it improves GAAP operating income. As you know, stocks and real estate are expected to provide a higher total return than fixed income investments in the long run. But the current dividend income is pretty low, which is what goes into GAAP operating income. Since fixed income investments provide higher current income that is where we are now investing nearly 100% of our capital. We've sold off almost all of our stocks, and are currently downsizing our exposure to real estate.

We have also implemented a much more active management of the capital account to improve GAAP operating earnings as interest rates change. We have hired a portfolio manager whose full-time job is to manage the capital account. We're in the process of establishing performance benchmarks for that account.

The second thing I wanted to describe is the evolution in our thinking regarding the management of free capital (or available capital as we call it). It used to be that we didn't actively manage our free capital. We felt that the more free capital we have, the better, since it gives a higher cushion for unexpected contingencies. We felt that the more free capital we had, the more rating agencies would look favorably on us, since it's an indicator of financial strength.

As we now are moving into a strategy that's going to require acquisitions to support our global expansion objectives, we are now pursuing a more active deployment and utilization of our free capital. We feel we need to do a much better job of identifying where our capital is coming from (sources of capital) and how we can manage it in a more disciplined way (uses of capital). This will help us be in a position to better prioritize potential uses of that free capital to support our strategic direction.

In our uses of capital analysis, we distinguish between capital that's needed to support the growth of existing businesses and the capital that is needed for new initiatives and acquisitions.

An example of this more active approach is the way we view the capital in subsidiary operations. We have a number of subsidiary operations under the life

company. In the past, we just let the capital in the subsidiaries accumulate and grow on their own, without determining whether some of it could best be put to work elsewhere. Now we're looking at the capital levels in these subsidiary companies as a potential source of capital. We are establishing dividend policies for many of them. We are now requiring that each subsidiary business demonstrate why it needs to hang on to its earnings. Otherwise, we will require that it be divided up to the life company (and eventually to the holding company above the life company) to be used for other purposes. So we've established a much more active approach to identify and manage the various sources and uses of capital.

Finally, on the deployment side, we recently implemented a much more disciplined capital budgeting process. Each fall, each business unit submits to corporate its capital requests for the next year. These requests may be needed to support growth of its existing operations, or it may be for a new venture or new acquisition. A top executive group looks at the relative strategic fit and the financial attractiveness of each request, then prioritizes them. It looks at how much available capital or free capital that we have, and then make either yes or no decisions regarding which capital requests are approved for inclusion in the capital budget for the next year.

For our more traditional risk businesses, such as life insurance and health insurance, capital deployment decisions are expressed in terms of growth targets. The growth in these businesses directly impacts the amount of capital they need. We use a NAIC RBC formula to quantify the amount of capital need to support their growth. If we feel like there is too much capital or too little capital going to that operation in order to satisfy enterprise-wide strategic targets and financial goals, we may establish different growth rates for the business, either higher or lower.

If the capital deployment request is for a new venture or a new acquisition, then the capital use is exactly equal to the dollar amount of the needed capital to make the new investment. We then establish a capital budget at the end of this process for those requests that got approved. We monitor the actual amount of capital deployments during the year compared to the budget. New opportunities for capital deployments that arise during the year that are not in the capital budget will still be considered, but a more rigorous approval process will be used for these items. Variances above the initial budget amounts are reviewed carefully to ensure that we achieve our financial goals. In effect, we have a dual approval process for capital deployments: the first step is to approve the request for inclusion in the capital budget, and the second step is to approve the actual deployment of capital when needed.

The capital budget is a key input in developing the final business plans and performance goals for the business unit. It helps establish its growth targets and its ROE and profit targets. In short, it is one of the key building blocks of our planning process.

I hope you're getting a sense from this discussion that the process we use to manage capital is not a theoretical exercise that goes on only in the dark corners of the actuarial department. These concepts are used by our senior management team as an important set of tools and as information to help us achieve our strategic and financial goals.

I'd like to conclude my remarks by commenting on several future issues/concerns that we're addressing. I mentioned earlier that liquidity is a growing area of concern. As we've looked at our capital position, one of the primary constraints we face is not so much the need for capital to support our risks (using RBC assessments) but rather, the impact on our liquidity position. If we decide to deploy some of our available capital in new ventures, this may drive our liquidity ratios to undesirable levels. For example, if we were to take a big hunk of capital and deploy it over in Brazil, let's say, that capital is not liquid anymore. Even though we may have enough risk capital to support the new venture, we've taken an unacceptable hit to our liquidity position.

This liquidity constraint is sometimes difficult to explain to senior management. For example, if we are considering a potential acquisition, and conclude that we've got enough available capital to do the deal, and that it fits into our strategy, and provides an attractive return on our investment, then it appears to be a slam dunk. But it may create an undesirable impact on our liquidity position. Trying to incorporate both the risk constraints and liquidity constraints can be confusing at times. We're trying to work out a usable definition of liquidity in our available capital formula.

Another issue we are addressing is the fact that most of the growth in our non-insurance businesses is expected to occur outside the life company. Hence, it doesn't make sense to use the NAIC RBC formula for these businesses. So what should be the appropriate target level or target surplus for those operations? This has a direct impact on determining the amount of available capital we have, and is becoming an increasingly important issue.

This concern was clearly demonstrated by the acquisition of BT Australia, a large asset management and retail mutual fund company. This was our first major acquisition, and it essentially used up all of the available capital that we had. So, the question before us now is how much available capital do we really have, and what should be our targeted level of free capital? Is it appropriate to manage our available capital down to zero in the long term? We'll get into a more detailed discussion of this in our question and answer session.

Another important issue is, how should the goal of maximizing shareholder value impact our capital allocation process? Is there a different theory to allocate capital that maximizes shareholder value that is different from the historical RBC approach? Our company has a history of being very theoretical, very actuarial in our approach to allocating capital to our business units. We have always used risk analysis as the foundation to our approach.

Now there's a new element in the equation that we have to consider as we prepare to go public, that is, the perception of the external capital market analysts. They are going to value our company on how effectively we allocate and manage our capital. Are there changes needed in the way we allocate capital in order to maximize the value of the firm in the eyes of external security analysts? This is a new dimension that we're struggling with—how to incorporate this real-world impact into the capital allocation process.

Mr. Russell A. Osborn: I'll just give you a little bit of background on Nationwide Financial's perspective and where we are, what we do. We're a global financial company with assets to the tune of about \$115 billion. About \$92 billion of that is in life companies; \$70 billion is separate account business, mostly variable annuities, and \$22 billion of that is in general account assets. We also own a mutual fund house out in Philadelphia, which manages, depending on how the market is doing today, on the order of \$22 billion of assets. In addition to that, I should tell you that three years ago, the Nationwide Financial became 20% publicly traded when the mother mutual company decided to spin off 20%. We're still 80% owned by the mother mutual company and that company recently acquired a fund management outfit in Scotland, which is our big global play to get into fund management in the European market. Nationwide Financial currently has an option, which it will exercise in a few years, to buy 30% of that company, which currently has about \$82 billion in assets. So we have a lot of interesting things to consider with our surplus usage.

The main objectives for my talk are to explain the role of surplus management as a defined position within the company and to go through an experiment to see how you might devise an investment policy for the surplus. I will then try to raise some issues so we can get some discussion going.

I think Nancy had the main ideas behind the importance of the surplus manager, so I'm going to get right into the role of the surplus manager. At Nationwide in 2000, there was a product task force that, along with its product proposals, discovered some problems with the way surplus was managed or actually it wasn't managed. As part of its proposal to the executive cabinet, it proposed that we hire or assign a surplus manager who would take a look at how surplus is defined and how the earnings on surplus investments are allocated by line. He would also to take care of some problems that we've begun to notice. For example, junky assets always ended up in the surplus account to the extent that there were questions about how you might allocate certain things between the lines and surplus. Surplus always got the bad end of the deal. It's not really surprising given that nobody was managing surplus. The original proposal for our surplus manager defined the following. First and foremost was to develop a cohesive investment strategy for the free surplus assets and to tie in with our current capital structure, strategizing. We needed to manage the cash-flow needs of the company and its subsidiaries and then to give regular financial reporting to the senior management about the results of the surplus line earnings and the risk profile on it.

In addition, there are a number of other things that this position was more broadly defined to include. It would include some management things that are normally considered at the corporate level, like internal hedges between lines. Perhaps a line might want to either sell an asset or take some sort of hedge position, but there's another line in the company that could take the other side of that position. You could avoid going to the capital markets or avoid the tax event or the sale that this position could manage an internal trading desk or surplus would manage that and other things like reinsurance and warehousing. This position also included a very broad definition of capital utilization and trying to maximize capital usage and allocation by line and trying to develop methodologies and return objectives that are risk adjusted, to try and get the best bang for your buck out of your capital deployment.

As this position turned out, management was in agreement with the basic principals of this proposal, but it ended up kind of splitting it up into various pieces and a lot of it ended up within the office of finance. The controller currently handles the investment policy setting and the capital utilization and a lot of the things involved with risk management or setting risk adjusted return objectives that are still on the actuarial side under asset-liability management.

I'm going to move on quickly to investment policy. Just thinking theoretically here, if you have free surplus in the company, what should be your main objectives? One would be to make sure, to the extent that you would have specific capital deployment plans, you want to be able to meet those. Beyond that, you want to have as much liquidity in the remaining investments to meet any sort of project demands that might come up or opportunities as they arise.

In addition, because of what Nancy said about the drag of capital on the earnings of your company, you really want ideally to invest your free surplus in something that would get your return up close to what your return objective is for your entire enterprise. You're not going to be able to do that for various reasons, but I think in general, you do have a high return objective for the surplus line and on the risk. You want high risk. I'm not saying you want to go seek risk, but the fact of the matter is, given the high capital requirements for insurance companies and the fact that you have this excess free surplus, it is causing you to seek a high return. Capital markets require high risk for high returns.

I should also mention that your choice of a framework is going to drive your results. Dave got into that some. Depending on whether you're looking at long-term value using Option Adjusted Value Distributable Earnings (OAVDE), or whether you're looking at the short-term performance of your stock and focusing on quarter after quarter GAAP earnings, is going to make a big difference in results.

For now I'm going to live mostly in an ivory tower and assume that we can take a long-term perspective, that we're not publicly traded, or that we're European owned and we don't have a focus on GAAP. Let's see where that leads.

First, you do have a number of constraints obviously. You want to make sure that you're meeting all your liquidity guidelines from a risk management perspective. You want to make sure that you have capital that will roll over from your investment policy into the capital plans that you already envision and in addition, your management probably has its own constraints on risk profile for your company.

In addition, as a life insurance entity there are state basket limits on what types of assets you can own and what percentages and those vary by state. To the extent that you're going to want to hold derivative assets or hedges, at the corporate level and include them in your surplus *FAS No. 133* has certainly become the issue because *FAS No. 133* accounting from a GAAP perspective often has no intuitive results. We found at our company that if you're trying to place a hedge that would make your long-term riskiness look better, generally what ends up happening is because of the way *FAS No. 133* works, it makes your short-term earnings a lot more volatile. That's something you want to keep in mind. Also keep in mind your investor expectations and tax strategies for any of the things that we're talking about. I highly recommend that you have your tax people at the table when you're discussing these things.

Like I said, when we talk about invest policy today, I'm going to focus on maximizing your risk return tradeoff of present value of distributable earnings, given the constraints that we just talked about. We're going to be seeking high yield, high risk, high liquidity, and tax deferral if we can get it. All those things point toward equities. Equities have all of these characteristics if they're publicly traded equities.

We need to look at what deployment plans you have for your capital, and think of that deployment as a future liability cash flow in effect and for that portion of your business. We have known capital plans. You can think of your investment policy setting as akin to setting investment policy for a line of business and you'd probably invest it in a diversified portfolio of fixed income securities that consider the maturities of these liabilities, which are the dates of these future capital deployments. The remaining surplus I'm going to argue is what you would put into equities.

Now there's one concern that a lot of people would immediately raise with equities and that is, that the extent that you're managing to a RBC formula or a risk surplus, there's a very punitive factor in there for equities, 30%. But I want to remind you, when you're talking about the free surplus line, you need to think about it a little differently than you would for a line of business. With a line of business you look at that line's reserves and then you tag on an additional amount of risks according to the formula. When you're dealing with the free surplus line of a company, as long as the formula driven surplus on these assets is less than the assets themselves, then the risk surplus that you're required to hold on that free surplus line is already included within those assets. So, for example, if you had a target RBC ratio and that's how you drove your risk surplus, of say 200%, then and you invested the entire amount for that free surplus line in equities, we take the 200% times .30 and I need to hold 60% surplus. Well, it's already there. The 60%

is probably the 100% of your free surplus. So as long as your target RBC ratio is less than or equal to 333.33% then you're okay.

Another point I want to mention, like with any investment, you definitely want to keep diversification. Just to give you kind of a gut feel for the materiality of these investments and how the numbers look, I'm going to walk through just a very simple example. Let's assume that your corporate objective is 11%, you're trying to manage all of your lines of business to earnings after tax return on total capital of 11%, bonds currently earn 7% gross and your expected return on stock investments is 9%. What you want to do is compare the after tax returns from investing either in bonds or stocks, assuming that you have say, a five-year horizon. The length of your horizon obviously matters if you're investing in equities, because there is no tax event until you actually sell them. I solved for rate of interest that compounds that for five years. So that it's equal to the 9% growth over five years and then taking the tax at the end. When you solve, you get 6.19% and that compares to a bond investment after tax of 4.55%. As I worked it out, you got 34 extra basis points on your return from the tax deferral. Compared to 11%, these are terrible returns. This should remind you of the terrible inefficiency of holding free surplus, and in particular the tax inefficiency, and to show how this might effect your overall corporate earnings. Let's just assume that of your total invested capital, 70% of that is going to the lines and 30% is what we're calling free capital today. Then the average weighted after tax return for your entire company, depending on whether you invest in bonds or stocks is 9.06% or 9.55%. So it makes about a 50-basis-points difference, if you hold the long-term value perspective in making these decisions.

Now in practice, obviously, this is a lot more complicated and requires sophisticated tools. If you have stochastic models of your companies with all the relevant risk factors built in, I think those are the things that you should be using and then making sure that any particular strategy that you run meets all of your constraints. By doing some experimenting and looking at the results of your stochastic analysis you can check that it meets all your constraints. Having your tax, capital management, and liquidity management people at the table throughout this process will be a benefit.

At Nationwide, our framework is primarily driven by present value distributable earnings, and their distribution across stochastic scenarios. With the caveat that we also, because we're interested in the way the market views us, have a constraint, that is expressed in terms of GAAP earnings predictability, and GAAP earnings growth. So what we normally do is experiment with different strategies and run a stochastic analysis across the set of random scenarios. We generate what I'm going to call S curves and then we solve for an optimal solution.

With an S curve, you end all of your random scenarios, look at present values of distributable earnings, sort them from the worst to the best, and then graph it. Because it's difficult to specify an exact metric that boils down to one number, your tradeoff between risk and return is an S shape. At Nationwide we just prefer to look at these graphs and we'll run different strategies and compare them. We haven't

actually done this yet, but we're on the road to doing this with the surplus investment policy as well. You can do this either at the line level or at the total company level. Run different strategies and then compare the S curves. If you have a second strategy with the S curve entirely above the first S curve, that would obviously be a better strategy. To the extent that it's flatter, but has some scenarios that are better and some that are worse, and maybe the mean is a bit lower, well then that's when your management has a tough call.

With the new tools of asset/liability management analysis, I think it is possible now (this is very relevant here to capital planning and free surplus investment policies) to look for a given strategy that you propose and look at how surplus evolves over time and under different scenarios. I've analyzed a distribution of accumulated surplus where there is a median across your large set of random scenarios and the lower end represents the 5th percentile and the high end represents the 95th percentile. You can show this gross or net of your capital deployment plans. You can show a gross or net of your free surplus at times zero. There are a lot of different ways you can look at it. But if you did do it for your capital deployment plans and you showed that at least on the 95% confidence, you never go below your starting amount, I think that you're safe from a risk management perspective.

You may actually have to do a dip into your capital. Everything I said so far was long-term value, present value distributable earnings. You also probably want to do your own S curve charts, eventually if you can on GAAP earnings and look at the distribution of GAAP earnings and make sure that that range of possible variances is as tight as possible. As Dave mentioned earlier, because of the GAAP concern, The Principal actually took the opposite approach, from what I just proposed, by investing in fixed income securities so it had those earnings coming in. Whereas, if you got your portfolio invested entirely in equities, you're not going to see any earnings until you actually realize them.

Ms. Bennett: What should be the level of surplus retained within a company? In other words, what are the pros and cons to keeping under-deployed surplus on hand? Should you in fact have a policy that free surplus should be zero, because returns will be maximized?

Mr. Neve: As I said earlier, we've gone through a profound change in the way we'd answer that question. A few years ago, we would have said, "we're going to try to get as much free surplus as we can, because that gives us more financial cushion." I think we're now moving in the direction of saying, "In the long term, we want to manage free surplus essentially to zero." Why? Because free capital is not deployed, and thus, is only getting a passive after tax return of say, 5-6%. This would not be viewed favorably by the market. There obviously are going to be practical constraints that will prevent us from maintaining a zero-free capital position at all times, but we'd like to keep it as low as we can. If a new opportunity comes along that needs capital, we can go the market and borrow it through debt, or raise it through an equity offering. But of course, we can't do that on the turn of a dime, which means we probably want to keep some free capital around to take advantage of these opportunities. So there's going to be some practical constraints

involved. I guess I would answer the question by stating, keep it zero or as close to zero as you can.

Mr. Osborn: I agree, but there are some factors working the other way. I mean to the extent changes in the financial market required your entire risk surplus and suddenly you're below your target surplus level, simply because of something that happened in the market. I think you want to mitigate that risk and at least have some buffer, so that every time the market goes down, you don't have to borrow or try to raise some capital. Also, if you want to move quickly on opportunities that will present themselves in the product market, I think you need that buffer there so you can act quickly.

Ms. Bennett: I think common stock investing is a pretty interesting topic, in particular, for mutual companies. We had two different views presented here, so maybe we can go into this a little bit more on the pros and cons of investing surplus in common stock.

Mr. Neve: We're basically getting out of all the common stock we have. For one, common stock has a huge RBC burden. Russ, you made the point that if the RBC equity factor is 30%, if you take it times a target RBC ratio of 333.33%, you've got enough capital to support the risk. That's true, but it's still a big risk need. Our preference is to invest capital in fixed income assets that have a much smaller capital requirement. Then we can use the excess capital that isn't needed to do other things. But if we have our capital tied up in common stock, a lot of our capital has to be devoted to backing that risk, rather than deploying it in a business. So it's interesting how you've come up with the wrong answer!

Mr. Osborn: I was just presenting an opinion. Nationwide doesn't really have investment policies as yet. It has just defined this new role. As it turns out, over the next six months, I'm going to be involved in the task force with our company's controller, actually determining what this policy should be. One of the large concerns that I always hear from our investing relations people is, "What's your story?" What is it that you're telling the analysts? What do they expect?" One of the things that I want to explore is how would it work if we tell the story that we have good reasons for investing in equities? You're not going to see predictable earnings, but you're going to see earnings that follow the market. We'll be able to track that and show that we've looked at our capital deployment plans and this is the best way to get our returns up. You can see if that's the way it works out, but I don't think that's actually been tried yet.

Mr. Neve: That's a key point. We've not been in the capital market yet, so this is all new to us. But at least what we've been told is that capital gains, even if they are realized capital gains, are not really given a lot of credit in the eyes of the security analysts. Yes, they contribute to a higher net income this reporting period, but they're not expected to be there long term. They come and go. So we've been told that the market basically gives you no credit for them when they value your firm. This is the reason we've pushed away from investments that produce capital

gains. But you're right, if you can position it right and explain it, tell the story right, you might get some credit for them.

Mr. Osborn: I think some of the reasons that the analysts are discounting capital gains is because they are never expected. If you plan to sell early and tell them that you're going to expect some gains, you just don't know when exactly because they are equities, then I think you have a better case for trying to get some credit.

Ms. Bennett: I think that if you don't expect capital gains on common stock, you wouldn't invest in them.

Ms. Josephine Elisabeth Marks: To what extent do you find that your surplus investment policy is driven by what you're doing in the operating segment? You both described models that have a fairly clean separation between them, but in practice do you find this offsets and overlaps between the two?

Mr. Neve: I would say that they are managed very differently, with little overlap between the two. There are going to be times when a particular deal comes into the house and both the corporate segment and the business segments want it. But basically, there's a very big disconnect between the way the two portfolios are managed.

Ms. Marks: I meant in terms of setting the policy itself. In terms of setting the surplus investment policy when coming up with the policy itself, will it be offsetting the policy in the operating segments?

Mr. Neve: Well again, in the past there was obviously a very different investment strategy between the corporate segment and the operating segments: one was equities and one was very much fixed income. Now I would say that they're both much more in sync. The investment strategy established by the lines is pretty much the same as the corporate segment investment strategy. So there is more conversation between the two in trying to make sure that we're efficiently executing both strategies in a similar fashion. But as for the strategy of one segment impacting the strategy of another segment, there isn't much of that. For some of the operating segments, liability matching is a key part of the strategy. This has no impact on establishing the investment strategy for the corporate segment.

Mr. Osborn: Right, I was going to mention something similar. Historically, up until this year, Nationwide's surplus, was not handled efficiently. One of the incidences behind the proposal to get surplus management was the fact that lines were often, very unwittingly, controlling the liquidity of surplus assets or even controlling how they were invested. This was done in subtle ways, that would take too long to explain, but often surplus investments were tied up as pieces of long investment. Nationwide has identified the problems and built the capability to do corporate risk modeling. We use the S curves that I explained to you, in fact, derived from our new model, those were S curves for the entire company for all lines of business. If you're trying to manage risk return, it really does need to be at that level. Going

forward, we're hoping that we can look at that entire S curve before and after free surplus and tie in our surplus investment policy with any sort of corporate level hedging that we're doing.

Ms. Bennett: This question also deals with the accountability aspect. Who is really accountable for the management of surplus? I think that's the issue that underscores a lot of these comments. It's not only where the investment strategy is set, but does the investment strategy apply to part of clients assets or also to required capital? Both companies that are represented here are very large organizations. The product lines are big enough segments where you can efficiently run a segregated portfolio. For a smaller company, it may not be efficient from an investment standpoint to segregate your asset portfolio. There are a lot of transaction costs. At least with these two companies the decision has been made regarding accountability. Will there be a corporate surplus manager? I think the decision has been made and implicitly somebody is managing surplus or oftentimes nobody is managing it, which is of course, is a decision by itself.

From the Floor: It seems to me we're talking about free surplus over and above target surplus. But very little has been said about how target surplus is both internally as well as relative to the outside world. You've only got so much free surplus, once the target surplus has been determined, how do your companies go about determining what target surplus you're going to set for each of your lines of business?

Mr. Neve: First of all, we manage them together. So from that perspective, it doesn't matter. But obviously, it's a very critical issue to determine how much capital you allocate to each of your businesses. We base our allocation on a fixed percentage of the NAIC RBC calculation as if each line of business was a stand-alone company. That determines the amount of target surplus they need.

From the Floor: It sounds like your particular approach would invest the free capital in a very similar fashion to what you would the target surplus.

Mr. Neve: Right.

From the Floor: I guess maybe more dramatic would be, How do you determine for Nationwide because it seems like there are dramatically different investment strategies for the target surplus versus free surplus?

Mr. Osborn: Yes, and there is still a debate going on within Nationwide about how to actually manage the risk surplus portion. In answer to your first question, Nationwide has done a theoretical risk surplus calculation to determine how much risk surplus we think we should hold. So our current target surplus formula is 225% of NAIC RBC. We found that 25% of the C2 factor is a good approximation for the covariant.

Mr. Neve: We did the same thing. We have an internal target equity formula too, but it never comes into play. The NAIC RBC is the higher constraint.

From the Floor: I had a question about the treatment of a line of business manager. The manager doesn't have any control over the investment earnings on that equity which formed part of his return on equity. Have you ever done any special kind of reporting that maybe you use as an average or expected return on those rather than actual returns in order to give the line of business manager some feeling of more control over what they're being measured on?

Mr. Neve: We've often talked about doing this sort of thing, but we've always rejected the idea. Since capital is invested in fixed income assets, the return is going to go up and down as interest rates go up and down. But that's just a given risk that we expect the business unit managers to manage. If they wanted to invest in high-risk assets for example, they really don't have the option to do that. They have to take what they're given.

Mr. Osborn: In the past, if you did have it in high-risk assets, how did you handle that?

Mr. Neve: In the past, we had most of the assets backing surplus invested in equities, but we were passing on a return to the lines that was based on a fixed income investment. So there was a real mismatch between what was actually being earned and what we were crediting to the lines on their surplus. This mismatch was managed within the corporate segment. In the good old days of the past that was probably okay. We don't want to do that moving forward.

From the Floor: Dave, when you went through your demutualization, or as you're going through it, what are your thoughts about how you structured the organization?

Mr. Neve: We have changed the way we look at our company as far as how we organize our businesses in terms of how the market would best value the firm.

From the Floor: I was thinking more of along the lines of getting capital allocated to those units. You're kind of creating an internal competition for capital. Do you see that in a positive or negative?

Mr. Neve: I think it's definitely a positive. The capital budgeting process that I explained earlier does create an environment where lines of business are competing for capital. I think it's a very positive exercise for senior management to look at the different requests and prioritize them. It forces the line of business to come up with a good business case that demonstrates why this is a good use of capital.

Ms. Bennett: I suggest that within almost any kind of organizational structure, whether it's business unit or product or distribution strategy, there will be a natural conflict for allocating and getting the highest returning assets.