Insurance capital: keeping a close watch

Over several articles, we have reflected on the complexity of insurance and the responsibility of boards of directors to ensure that these entities are well managed. How do these boards ensure that the executives and staff are doing a good job of designing and pricing products, contracting with reinsurers, reporting financial results accurately, setting reserves, monitoring operational risks and serving customers? Today, we consider one of these crucial tasks, which is to determine how much capital should be held to meet uncertainty obligations when they fall due.

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Rules and regulations are seldom popular and nearly always intrusive. Nobody loves being told what to do. But well-designed regulations help a little by encouraging us to do the right thing. Speed limits, white lines and traffic lights keep us alive. Minimum regulatory requirements act as guardrails to keep insurance boards away from reckless behaviour.

In truth, uncomfortable as they may occasionally be, insurance regulations in most countries are rational. They help directors to do what they ought to be doing in any case. Since insurance is complex, and since customers depend on insurers to live up to their promises, holding sufficient assets in reserve to fulfil these obligations is in everybody's best interest.

Helpful principles

So how do directors balance the interests of shareholders and customers. The capital that an insurer holds to cover expenditure and the costs of claims is typically constrained in some way. It is allocated to low-yielding, liquid securities like cash or money markets. It certainly cannot be used for expanding the business or investing in new offices. For shareholders, then, the lower this capital the better. Customers—more often referred to as policyholders—have a different perspective. They would like the insurer to set aside as much as possible, safeguarding the possibility of paying a claim should it arise.

The regulator plays a part in adjudicating this tension. Over decades and several iterations, the rules under which insurers determine this capital requirement have become progressively more appropriate to the obligations of these insurers. While in the early days of insurance, it might have been considered prudent to set aside a percentage of premiums subject to an absolute minimum of several million dollars, the calculation to put a floor to this capital is now considerably more complex.

The principles under which such minimum value are set are simple in concept: (1) determine the expected value of outflows in the next 12 months, (2) assess the range of uncertainty of this expected value, and (3) hold enough capital to avoid running out of money in all but 1 year every 200.

This sounds good in theory. Determine the level of capital sufficient to avoid disaster except in extreme events, the types of events that have occurred five times in the last millennium. Regulators have gone further than this. It is challenging for an insurer not only to predict with reliability not only the obligations that it must meet in the next year but the range of uncertainty of such obligations. Rules in most countries provide sophisticated formulae that help insurers to determine a level of capital consistent with this 1-in-200-year principle.

Practical challenges

Such rules sound complicated. How do they work? Over years of development, backed by hundreds of pages of published analysis, regulators in different jurisdictions have stipulated models that aim to meet these requirements. They do so in different ways.

An insurer holds a range of assets. Among these assets are share portfolios. We can study the behaviour of shares over history to determine what might constitute a price fall that would occur once in 200 years. This might be 50 percent say. Require the insurer to hold in reserve an amount equal to half of its share portfolio. Bonds are less volatile, so the requirement in this case may be 25 percent. Ditto the reserve requirement. But since share and bond prices (generally) move in different directions, the rules can allow a small offset for insurers that hold both shares and bonds. Their reserve may be less than the corresponding sums of the share reserve and the bond reserve. Use a formula for this as well.

Generally, the assets represent the simple part of the calculation. Determining the uncertainty in one year of claims from a portfolio of 100 000 sedans and 4 000 18-wheelers is more complex, let alone a fleet of Gulf oil tankers, a flock of wind turbines in the North Sea or a portfolio of New York lawyers needing liability cover.

The rules might help, but the regulator has the last laugh. It is not sufficient for boards to ensure that the experts under their responsibly are calculating minimum requirements under the rules. They must also determine how appropriate those rules are to the circumstances and portfolio of the insurer in question.

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