

FCR (ie Solvency II; RBC) is conceptually flawed and probably disastrous

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The FSB, South Africa's insurance regulator proposes replacing the current, simple, 'solvency' regulations with a new system the Financial Condition Reporting (FCR) system. In this paper I will argue that FCR is conceptually flawed and if implemented will probably be disastrous. This is not however a criticism of the FSB *per se*. The FSB is simply trying to introduce a system which has found favour in other parts of the world. It is doing the politically correct thing.

Conceptually flawed

Origins of FCR

If such a system, which is so obviously flawed, is to be introduced, it begs the question, how can this be? To understand this one must look at the origins of the system. It comes to us from Basel II, a system introduced to the banking industry and is designed by actuaries. It thus has twin parents; banks and actuaries. Therein lies the first problem. A short-term insurance company is not in any sense a bank. It does not act like one, nor behave like one nor in any way resemble one. In fact it has nothing to do with banks. Secondly we all know that when the Melamet Commission investigated the winding-up of the AA Mutual it found that only one actuary was employed in the short-term industry. Actuaries have no experience, no history in the short-term industry. So we have a wholly inappropriate system, which does not fit, being imposed on to an industry by a profession which knows nothing about the industry! The twin parents of the system have dubious legitimacy. To make matters worse, in the end the proposal is that by law, the short-term industry must now employ actuaries. One must always look with great suspicion at any proposal brought out by a profession, which has the objective of guaranteeing that profession, institutionalised, forced employment. If insurers wish to employ actuaries that is one thing, compelling them by law to do so, is quite another.

Conceptual flaws

The heart and soul of FCR is capital. What is not necessarily clear, not even to persons in the short-term industry, is that shareholder's capital is largely irrelevant to the well-being of a short-term company. Therein lies a major difference between banks and short-term insurers. Banks are concerned with the preservation of depositors capital, the nation's savings; short-term insurers are not. The view that shareholder's capital is irrelevant is not new, it has simply been forgotten. Adam Smith (1776), the father of economics, stated the requirements for the running of a successful insurance company as follows:

"In order to make insurance, either from fire or sea-risk, a trade at all, the common premium must be sufficient to compensate the common losses, expense of management, and afford such a profit as might have been drawn from an equal capital employed in any common trade. The person who pays no more than this, evidently pays no more than the real value of the risk, or the lowest price at which he can reasonably expect to insure it."

If the premiums of an insurance company exceeds the costs of running the company, the

company will exist indefinitely, without one cent of capital from shareholders. The regulatory focus on capital is conceptually wrong. It should be on the income statement. It should be to ensure that short-term companies can operate profitably. Short-term insurance companies are part of the service industry, not the savings or banking industry. It does not need to attract capital to survive.

Experienced insurance accountants not actuaries are required

A further point which is now being misunderstood, is to run an insurance company, meticulous insurance accountants are required, not actuaries. If correctly managed, there are no manageable elements of uncertainty involved in running a short-term company. We can express Adam Smith's statement in the familiar symbols of the income statement.

Premiums = Cost of Claims(C) + Expenses of running the business(E) + Return on investment to the shareholders (RoI) or;

$$P = C + E + RoI$$

As soon as a premium is received, the income statement is credited and the bank debited. Insurers are not supposed to have large outstanding premiums (ie debtors); this is regulated by law. And as any insurance executive or accountant will know, the cost of claims does not mean, cost of claims paid but cost of claims reported. As soon as a claim is reported, the income statement is debited with the provision based on the estimate of the cost of the claim and the creditors' ledger credited with the same amount. As claims are settled so adjustments are made to the provisions. The income statement is debited (or credited) and the insured's claim (in the creditor's ledger) is credited (or debited). When payments are made, the insured's claim is credited and the bank debited. The adjustments may take place in an accounting year other than that in which the claim was first reported. All this requires careful accounting entries. There is no uncertainty regarding an insurer's outstanding claims liability - just look at the outstanding creditors book. Settling claims is nothing other than cleaning-up the creditors' ledger.

I may add that in practice the expenses are not adequately categorized, especially in insurer's management accounts. Expenses should be separated into four categories, claims expenses, cost of acquiring and retaining business (commissions), general management expenses and costs of producing an investment income. The costs of claims are usually treated as part of the claim (ie cost of adjusting the loss, legal costs and so on) and cost of producing an income as part of general expenses.

Most managers are conservative by nature and realise that something should be put aside for a rainy day. So out of current income an amount should be set aside for years in which the claims are abnormal. In this way a claims reserve is built-up. Traditionally the claims reserve has been set at 15 percent and the Melamet Commission recommended a further 10 percent be set aside. The solvency requirement was quite simple; a reserve equal to 25 percent of premiums. With the advent of the highly (not called professional for nothing) reinsurance market, it is equally doubtful if the reserve should be as large as 25 percent of premiums.

It is clear that asset balance exists on the capital account of an insurance company, which will produce an investment income. This arises from three sources, firstly balance needed to settle outstanding claims (the creditor's ledger balance), secondly insurance reserves (25 percent of

insurance premiums) and thirdly, the unrequired shareholders' capital.

So Adam Smith's symbols can be refined.

$$P + I = C + Ec + Rc + Ear + Ei + Em + RoI$$

Where:

- I is the investment income from assets held in the company.
- Ec are the claims expenses (usually not shown separately from claims)
- Rc is the contribution to the claims reserve.
- Ei is the investment expenses, (usually not shown separately but forming part of general management expenses.
- Em are the general management expenses (this is shown separately).
- Ear are the expenses associated with acquiring and retaining business, usually commissions (this is shown separately).

Of course if an insurer is to survive, the matter which should be the concern of the regulator, the insurer must make a profit; called the operational profit to distinguish it from the underwriting profit. Adam Smith's refined equation can be re-written in the form of a profit.

$$RoI = (P - (C + Rc) - Ec - Ear - Em) + (I - Ei)$$

$$RoI = Up + Ip$$

Operating profit = Investment profit + Investment profit.

So to place the regulatory emphasis on capital and not income is flawed, the existing simple reserve of 25 percent is more than adequate; in fact with reinsurance, the original 15 percent is adequate. It will be interesting to learn how many times in the past 20 years since the Melamet contingency reserve became required, has this reserve been accessed. I doubt if it has ever been so accessed, let alone for catastrophic purposes.

Probably dangerous

Driving companies out of the market

As I have indicated, not only is FCR conceptually flawed, it is positively dangerous. By that I mean it will cause liquidations not prevent them. To understand that, Figure 1 which indicates the underwriting profit of the SA market over the period 1975-2004. From the figure it is clear that on the average the underwriting is zero. The years 2001 - 2004 have been exceptionally profitable to say the least. If these are discounted, the average underwriting profit is negative.

From the above equation the $RoI = Ip$. The operational profit has been coming from investment income. Companies face liquidation during periods of the downward cycle of the underwriting cycle. The AA Mutual was liquidated in the 1980s, during the downward cycle. During this part of the cycle market premiums are driven below the point of underwriting profitability and company's which are over capitalised (in excess of 15 percent) are able to subsidise the underwriting losses from income on excess shareholder's funds. Under capitalised companies are not able to do so and will be liquidated. By demanding excessive capital, the regulator will

in fact cause companies to be liquidated. The regulation causes the liquidation. It has an effect exactly opposite to that which is planned. Of course in the long run, the regulation will force companies out of the market, and the remaining companies may be able to reap monopoly profits or will simply continue to hold unnecessary. The insuring public in the end will be paying the

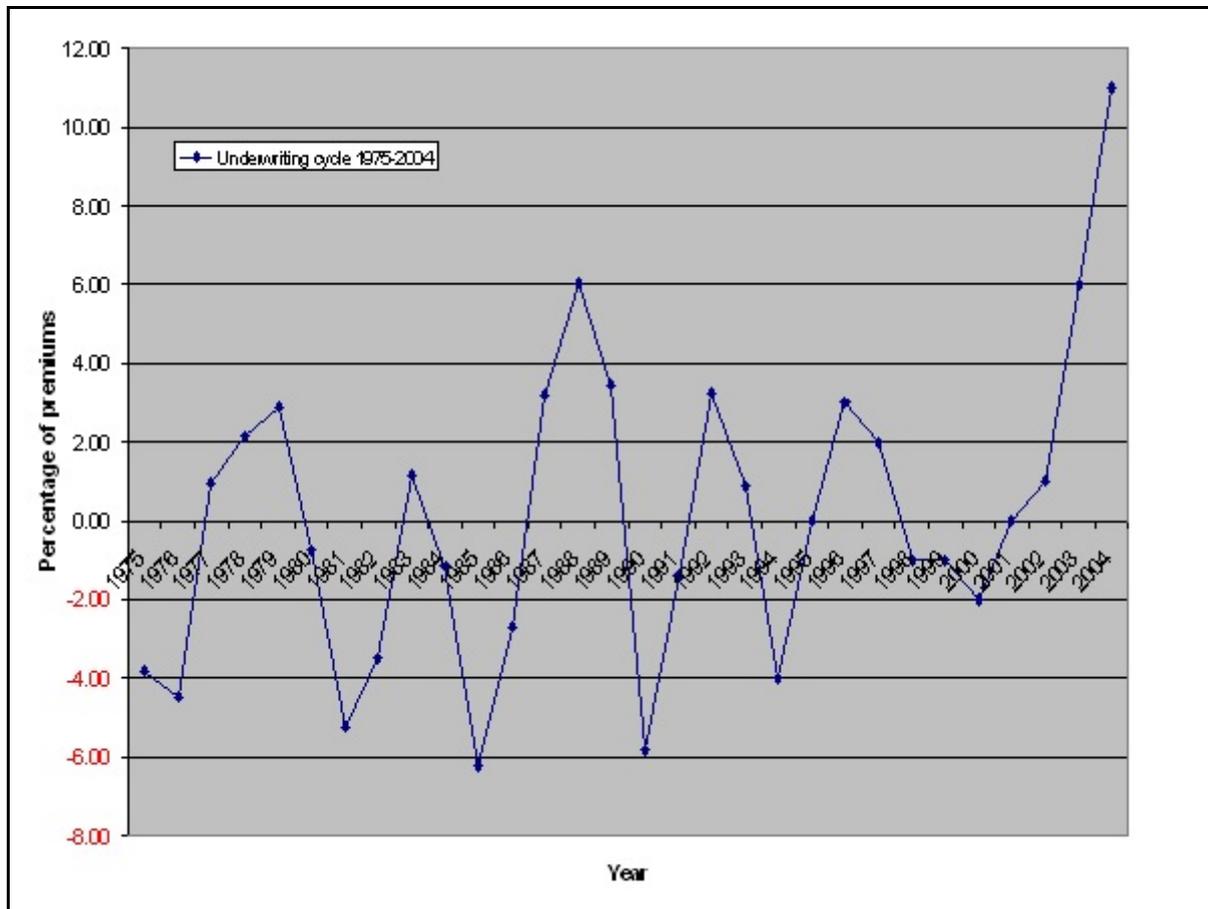


Figure 1: South African market underwriting profit: 1975-2004

price of the new system.

The American experience

What the theory says will happen appears to already happened in the American market. After the introduction of Risk Based Capital (RBC), liquidations when up, significantly, now down. To deal with the increased insolvencies, consideration was given to increasing the RBC requirements - if it do not work - do more of it!

“At the 2003 fall meeting of the NAIC, the NAIC's Risk-Based Capital Task Force announced that it was considering whether to raise the Risk Based Capital (RBC) requirements of insurers by as much as 50 percent. This considered change in RBC requirements was spurred on by the dramatic increase in insurer insolvencies over the last three years. For example, a representative from the National Commission of Insurance Guaranty Funds testified that over the last 30 years prior to the year 2000, a total of around \$10 billion in guaranty funds had been paid out. Yet, over just the last three years, a total of \$14 billion in guaranty

funds had been paid out. Hence, the NAIC is receiving pressure to take greater actions to protect insurer financial solvency.”

Conclusion

The FSB has released its FCR for comment, it seems to me that the industry should take this matter seriously and examine the proposals and if unhappy, say so.

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