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Capital Again

If any sign was needed to show how far we have moved from the dotcom era, when the idea of paying dividends was scoffed at as being 'old economy', nothing could be clearer than investors' current enthusiasm for the return of capital that is not needed for running the business or 'share buybacks'. Hanging on to surpluses and using them for acquisitions is no longer in fashion. Too much value has been, and continues to be, destroyed by this process, as shareholders in Wm Morrison will tell you.

In many businesses the answer to the question 'how much capital?' is a simple one: 'as little as possible'. From the use of a high degree of leverage to just in time purchasing and delivery systems designed to reduce inventories, efficient use of capital is synonymous with the lowest possible level of capital.

It isn't like that in insurance, of course, although maybe it should be, a theme to which we will return later. Swiss Re's recent announcement that it would not be following the return of capital trend and would prefer to be over-capitalised for regulatory purposes (FT 18th March 2005) may not have pleased everyone, but it is worthwhile examining the thinking behind this preference.

Firstly, how much capital is 'enough'? At one time insurers only had to be solvent in the generally accepted sense of liabilities not exceeding assets, but following a number of failures that criterion was not considered to be good enough and a margin over the top was deemed to be necessary. We do not intend to go through all the arguments about how the various formulae produced perverse results, but would like to fast forward to current thinking. This says that insurers should be responsible for calculating their own capital requirements and then persuade the regulators of the correctness of their calculations.

The principles underlying these calculations, from class of business volatility to asset/liability matching, are outside the scope of this article. So let's take a deep breath and imagine a fictitious insurer, currently holding a double A rating, that has managed to come up with a capital allocation formula that is appropriate and has convinced its regulators not only of the correctness of its calculations, but also that its own internal controls both work and are used in practice. Now this

paragon adds up the capital required for each line of business and discovers that, even allowing for organic expansion (M&As being off the agenda), it simply has a lot of money that it doesn't really need. What does it do now?

One obvious option would be the return of the surplus to shareholders, but would that be a simple choice? How would the ratings agencies react and what would be the consequences of their reaction be both on business going forward and the share price?

Rather than spend time on these latter two imponderables, likely to be more significant if the company is a reinsurer (which could explain Swiss Re's attitude), we will, instead, consider the first question: what the reaction of the ratings agencies ought to be. This brings us back to the question we raised at the beginning of the third paragraph, viz. 'why should insurance be different?'

Let us suppose that our fictitious insurer is as good at running its business generally as it is at getting its capital calculations and risk management processes right. In this case it will always generate sufficient premium to meet losses, pay expenses and make profits. We will assume too, that its loss reserving is accurate and that it manages the assets side of the balance sheet appropriately. Then why does it need any extra capital at all? And when things do go wrong and the true effects emerge, the result is often bad enough to burn straight through the capital cushion in short order. That was certainly the case with Converium recently and has been with many others too.

So in looking at solvency are we really looking in the wrong place? Do we take too much comfort from a hefty layer of capital and not look at what may be going awry under the surface? Is our obsession with capital requirements and enhanced capital requirements in fact leading in the wrong direction? Should our attention not rather be on the efficacy of the underwriting process, including the loss reserving loop, and being sure of the existence of the sheer discipline needed to maintain sound management in the face of market illogicality?

The Morris Report

As readers of the financial press will be well aware, it has been open season on actuaries for some time. In between interminable articles about the iniquities of split capital investment trusts, endowment mortgages and pensions misselling, actuaries have been treated to headlines such as 'The actuarial profession – making a financial mess of the future', in fact a parody on their own strapline which claims that they are making financial sense of the future. But if actuaries do deserve the treatment that they have been getting, who is really to blame?

The argument that we shall develop here is that the real blame lies with the users of their services, both for having blind faith in actuaries' abilities and for having unreasonable expectations. Such thinking is not without precedent. In the

seventies, and for part of the eighties, it was by no means unusual to encounter the view that there was no business in the world that would not be best run by an accountant and that all accountants possessed the ability to resolve any business issue. Few, if any, think so now, but at the time it took a brave man to argue differently. And even after the well publicised problems with pensions and endowments, there are still plenty in general insurance who believe that there is no problem so great that it cannot be solved by throwing a load of actuaries at it.

So why do such unrealistic expectations exist? After all anyone who criticised the medical profession for having failed to eliminate death would get little attention. And what about lawyers? For every lawyer that wins a case another loses. Does anyone deduce from this fact that the legal profession is divided equally into good and bad lawyers? Yet any actuary is expected to be able to produce penny-accurate pricing and exactly adequate claims reserve levels (both of which are practically impossible) and then faces the hazard of getting beaten to death when they don't.

At the risk of being accused of giving you a blinding glimpse of the obvious, we say that it is critically important always to remember one simple fact: that all professions have limitations. In the same way that successful business leadership requires a subtle amalgam of skills, that will not be guaranteed by an accountancy qualification for example, so the insurance function depends on a mixture of mathematical, legal, risk technical and finance skills, which, if they are to be found in one person at all, will be found in the underwriter.

Actuaries do, of course, have a huge roll to play in the insurance business and sometimes they do have only themselves to blame when things go wrong. For example, if a reserving actuary sets about their task without talking to the claims managers regarding matters such as loss reserving philosophy, claims handling processes and claims filing procedures, then they are just asking for trouble. And it is true that some actuaries do like to go away and develop their own theories about what the business is doing without any regard for what is actually happening.

But even these types of failures are really failures of management, for no CEO or CFO should be prepared to accept the reserve recommendations of an actuary who has not made themselves fully familiar with what is happening inside the claims machine. Sadly, many just don't ask and then blame the actuary afterwards.

Hubris is a terrible thing. An actuary was once heard to say, while dealing with a certain type of criticism at an actuarial conference, that 'the future was wrong'. Well yes, but then if everyone else is prepared to let actuaries' opinions be accepted without rigorous questioning or even a sense check (how can anyone know what interest rates will be in ten years time?), should we be surprised if at least some of them develop the feeling of being omniprescient?

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