Insurer Capital: Needs and Sources

Chapter 9

Insurer Capital Needs

A significant responsibility of an insurer’s corporate finance department is to ensure that the company has enough capital to profitably operate its business and comply with regulatory requirements.

All financial organizations need capital to fund operations and expansions. Insurers are also required by regulators to have minimum levels of capital as a protection for insureds.

**Operational Needs for Capital**

**The term “capital” can have several meanings, depending on the context**. Capital could mean the total assets used in business. Alternatively, it could mean the financing raised from third parties. In some cases, capital refers to the net worth of an organization, calculated as the organization’s assets minus its liabilities. For an insurer, the term “policyholders’ surplus” is often used in place of capital. Policyholders’ surplus is calculated according to statutory accounting principles (SAP), which involve different valuations of assets and liability than generally accepted accounting principles (GAAP). Net worth calculated using GAAP is often called equity or shareholder’s equity**. For an insurer, capital represents the amount of assets the insurer has available from its policyholders’ surplus and long-term debt.** Long term debt is included in capital because, although the debt must ultimately be repaid, the insurer has use of the borrowed funds for the term of the debt to invest and generate capital.

**Investor Needs for Capital**

The Investors in an insurer have the expectation that their investment will grow. Investors will supply capital to a company if the return on their investment meets or exceeds the return from other alternatives with the same degree of risk.

**One measure of an investor’s return is the change in the net worth of investment. For ease of comparison, the net worth is often expressed per share of stock. However, the change in this value depends, in part, on whether earnings are retained by the company or returned to investors as dividends. Instead, the investor’s return is often measured by return on equity (ROE). The ROE is calculated by dividing the net income by the capital, and it is often considered the bottom-line measure of performance. Attracting and maintaining capital depends greatly on producing a return on equity competitive with other investments**.

**Regulatory Needs for Capital**

**In addition to its operational and investor needs for capital, an insurer must meet certain regulatory requirements regarding the amount of its capital and policyholders’ surplus**.

Insurance regulators are concerned with an insurer’s solvency. Therefore, from a regulatory perspective the amount of capital does not include long-term debt owed to creditors. For regulatory purposes, an insurer’s capital is just its policyholders’ surplus.

The minimum amount of initial capital required for an insurer is set by the state in which it is domiciled. This amount depends on the type of business organization the insurer uses, generally either stock or mutual, and the lines of business the insurer writes. The amounts vary by state statute, from $150K to $5M. However, these requirements are too low for insurers writing any significant volume of business. Consequently, they serve only as bare minimums, not as benchmarks for sound, ongoing businesses. **Regulators review the capital held by insurers against a risk based capital standard.**

**Risk-based capital (RBC) is a method developed by the National Association of Insurance Commissioners (NAIC) that establishes a minimum amount of capital that an insurer needs to support its overall ongoing business operations based on the risk-based capital formula. The RBC requirements depend on the size and degree of risk taken by the insurer. Failure to meet RBC standards requires company and/or regulatory action, up to regulatory control of the insurer.** Therefore, insurers closely monitor their RBC levels to maintain the necessary level of capital and/or reduce their risks (and thus their RBC standard). An insurer’s RBC score can be improved by lowering risk or raising additional capital.

**Internal Methods Used to Meet Insurer Capital Needs**

An insurer may use several methods to generate or conserve capital internally.

The most common way for an insurer to generate or conserve capital internally is through the net income it derives from operations through underwriting and investments. It may also reevaluate balance sheet values, reduce dividends to shareholders and/or policyholders, or reduce its risk.

**Business Operations**

An insurer’s primary source of internal capital is its business operations. It may derive capital from operations through either net income or unrealized capital gains. Net income increases the insurer’s capital (policyholders’ surplus) without adding the financial distress risk associated with increasing long-term debt. Is also directly increases the wealth of the existing owners. An insurer’s net income consists of its underwriting profit, investment income, and any gains or losses from the sale of assets (less income taxes), which are known as realized gains and losses. The insurer’s investment portfolio also can produce unrealized gains on assets, which directly increase surplus. Therefore, an insurer should have underwriting and investment strategies to generate sufficient capital from operations.

**Underwriting Profits**

**Achieving an underwriting profit depends on a number of internal and external factors. Internal factors include expense control, marketing, and appropriate ratemaking and underwriting**. External factors include competition in the marketplace, inflation effects on claim costs, and regulation.

**Investment Income and Gains**

An insurer’s business operations generate funds from the premiums the insurer receives when it sells policies. These also create insurer liability which are similar to accounts payable in other industries. The two most significant liabilities that arise from the sale of insurance policies are unearned premium reserves and loss reserves (including loss adjustment expense (LAE) reserves).

The unearned premium and loss reserves constitute a significant portion of an insurer’s liabilities.

**Reevaluation of Balance Sheet Values**

**Assets and liabilities already reported on an insurer’s balance sheet may provide an additional source of capital. Two types of activities commonly used to provide capital on a balance sheet are these:**

* **Actions to change loss and loss adjustment expense reserve valuations**
* **Transactions that recognize existing asset market values**

**Loss Reserve Valuations**

Precisely estimating loss and LAE liabilities is impossible. However, because these liabilities are, on average, greater than policyholders’ surplus, their valuation is important. An insurer must carefully review the value of these reserves for reasonableness. While the establishment of loss reserves is usually done in the context of capital management, even a small adjustment in their estimated value can have significant effect on an insurer’s policyholders’ surplus and can affect its business activities and options.

**Another action that affects the valuation of loss reserves if the discounting of less reserves for time value of money. Discounting loss reserves directly increases policyholders’ surplus and increase net income**. Generally, statutory account does not permit discounting of loss reserves. However, for some long-tailed lines such as work comp and medical malpractice, discounting is either explicitly permitted by insurance law or can be approved by the regulators in the insurer’s state of domicile. The effect of discounting depends on the interest rate used and the assumed payout of losses over time.

**Existing Asset Market Value Recognition**

A technique insurer’s frequently use to increase their capital is to sell at market value assets that are not carried on their books. The primary method of recognizing these asset value is through a sale and leaseback transaction. The insurer can sell its office building to another company in exchange for cash and then lease the building sot that its use is uninterrupted. Before the transaction, the difference between the building’s fair market value and historical cost is not included in the insurer’s capital.

The economic rationale of a sale and leaseback transaction must be carefully considered because the insurer will be required to pay rent to the new owner of the building, thus reducing its future profit.

**Reduction of Shareholder Dividends**

Capital, whether from current or prior earnings, may be distributed to the owners of a stock insurer through dividends paid to the shareholders. Each dividend (usually made quarterly) must be approved by the insurer’s board of directors. Stock insurers in need of capital can conserve it by reducing or eliminating the dividends to shareholders.

**Because a stock’s price reflects steady dividend payments, reducing or eliminating dividends may cause investors to lose confidence in the company, thus causing the stock price to decline.** Therefore, an insurer generally reduces shareholder dividends only when it has a serious need for capital.

**Reduction of Policyholder Dividends**

In many cases, the payout of policyholder dividends is not guaranteed and must be approved by an insurer’s senior management. Therefore, if the insurer wants to conserve capital, it may be able to reduce or eliminate these dividends. However, such action usually prompts negative reaction from policyholders and the marketplace, and therefore occurs infrequently.

**Reduction of Risk**

An insurer’s capital provides a cushion against the risk of unexpected losses. Therefore**, an insurer can reduce its need for capital by lowering this risk. This may involve limiting expansion or even reducing the amount of business it writes. An insurer could also refrain from writing, or withdraw from, riskier segments of business, such as long-tail liability lines or property in hurricane prone areas**.

**External Methods Used to Meet Insurer Capital Needs**

A stock insurer can generate capital externally by issuing equity, although for a mutual insurer to generate external capital in this way, it would be required to undergo some form of reorganization. Other ways in which an insurer can generate capital eternally are to issue debt, use reinsurance, or take advantage of alternative sources of capital such as catastrophe bonds.

The primary capital markets provide stock insurers with the ability to bring additional cash into the organization through the sale of new shares of common or preferred stock.

Capital can also be generated by issuing long-term debt, such as new bonds or surplus notes, to investors. Other external sources of capital are reinsurance transactions and catastrophe bonds.

**Equity**

**Issuing Equity Shares. Equity capital can be used to improve liquidity and solvency. Although it is more expensive to raise equity capital than to issue long-term debt, equity has the advantage of not increasing financial stress because, unlike the payment of interest on debt, the failure to pay dividends is not considered a default**.

**Long-Term Debt**

Although insurers generally use less debt as a source of capital than do companies in other industries, debt still is an important source of capital. Debt holders have priority claim on the assets of the issuing company ahead of stockholders. Appropriate use of debt can produce higher returns for equity shareholders. **Debt issued by insurers can be in the forms of bonds or surplus notes.**

A surplus note is a type of unsecured debt instrument, issued only by insurers, that has characteristics of both conventional equity and debt securities and is classified as policyholders’ surplus rather than as a liability on the insurers’ statutory balance sheet.

Like bonds, surplus notes are issued with a fixed schedule of principal and interest payments. In addition to the operations benefit of additional capital, **surplus notes have a regulatory benefit: the proceeds received from the issuance of surplus notes are included in the insurer’s adjusted capital for calculating its risk-based capital ratio. In effect, the issuance of surplus notes strengthens the ratio, as opposed to the issuance of conventional bonds, which weakens the ratio**.

**Mutual insurer Reorganization**

The inability of a mutual insurer to use the financial markets to raise capital can limit its strategic options such as expansion of business or potential mergers and acquisitions (M&A). Therefore, a mutual insurer may determine that the stock form of ownership will provide more flexibility and alternative for raising capital.

If the policyholders of a mutual insurer determine it is in their best interest to be acquired, regulatory requirements make it difficult for a mutual insurer to be acquired by any company other than another mutual. Therefore, if it were to merge or be acquired, it would have to be with or by another mutual company.

**A mutual insurer can demutualize in two ways. It can go through a complete demutualization process into a stock company, or it can go through a mutual holding company conversion**. In full demutualization, the mutual company becomes a stock company. In either case, the final approval of the plan for demutualization must come from the policyholders, based on the mutual’s bylaws and state regulations.

**Full Demutualization**

In a full demutualization, a mutual insurer’s surplus is usually distributed to policyholders a s stocks, cash, and policy enhancements. Regulators must find the conversion must be fair and equitable to its members, is not prejudicial to their interests, and is not detrimental to the public.

As a result of the demutualization process, the policyholders’ membership (ownership) rights are extinquished, but their coverage and contractual rights under their policies remain unchanged. At the time of conversion, the company may sell additional stock in the capital markets using an initial public offering (IPO) to replenish the capital it distributed to the policyholders, raise more capital, and establish a market value and liquidity for the stock.

Full demutualization can create several positive results. Policyholders as owners of the original mutual insurer receive compensation for giving up their membership rights. In most cases, the become shareholders in the reorganized company, so they can continue to participate in the company’s success. Demutualization also provides financial flexibility. The reorganized company can issue stock and debt and can obtain bank credit facilities. It provides maximum access to capital to finance future growth, and it creates a source of payment that the company can use for mergers and acquisitions.

**There are, however, disadvantages that must be considered. The demutualization process is very expensive. A large company might spend tens of millions of dollars on the professional services needed to go through the process. Ongoing administration is also expensive, because of the increased financial reporting requirement of publicly traded companies. The process is also time consuming; it can take from 18 – 24 months to complete.** During this time, management’s attention can be distracted from other duties.

**Mutual Holding Company Conversion**

In a mutual holding company conversion, the original mutual insurer becomes a stock insurer that is wholly owned by a mutual holding company. In most cases, a stock holding company is interposed between the mutual holding company and the insurer to provide greater flexibility. Other subsidiaries can be owned directly by the mutual holding company or, more often, by the stock holding company for the insurer.

The policyholders’ contractual rights remain with the stock insurer, and their other membership rights are transferred to the mutual holding company.

After the conversion, the mutual holding company may decide to raise equity capital by selling the stock holding company, the stock insurer subsidiary, or other subsidiaries, but it must always retain a majority (51 percent) of the voting stock of the stock insurer subsidiary. The mutual holding company may choose to proceed with a full demutualization later.

The mutual holding company structure greatly increased the mutual company’s ability to raise equity capital, make acquisitions, and diversity its operations, while retaining the mutual aspect of policyholder membership. The reorganization into a mutual holding company system avoids some of the costs and delays associated with full demutualization. However, there is some controversy surrounding the use of mutual holding company conversions.

Critics of mutual holding company conversions say that policyholders are disadvantage, because they lose part of their company without compensation. However, advocates say that a well drafted mutual holding company plan will retain policyholder control of mutual company interests and allow the company to access the capital markets to raise capital for growth.

**Reinsurance**

Reinsurance has several uses in the management of an insurer’s capital. It can increase capital through a loss portfolio transfer, and it can allow the insurer to avoid a reduction in capital by providing surplus relief. Reinsurance can also reduce the need for capital by reducing the insurer’s exposure to risk. It includes ceding commission.

**Loss Portfolio Transfer**

LPT’s are used more often as a way for an insurer to withdraw from a segment of business than as a source of capital. I the losses ceded are expected to be unprofitable, a loss portfolio transfer may actually be unprofitable and result in a decrease in capital. However, an LPT can reduce the need for capital by reducing the insurer’s risk that payments for the losses transferred would have exceeded the reserve amounts.

**Surplus Relief**

Statutory accounting mandates that all expenses associated with the acquisition (sale) of an insurance policy be recognized at the time the policy is sold. Because the premium revenue of a policy is earned over the policy’s life, this immediate recognition of expenses causes a temporary reduction of surplus.

However, if an insurer reinsures loss exposures, it may receive a ceding commission from the reinsurer. **The ceding commission is an amount paid by the reinsurer to the primary insurer to cover part or all of the primary insurer’s policy acquisition expenses**. Proceeds from surplus relief is included into the risk-based capital ratio. It may also include a provision for profit on the ceded business. The ceding commission offsets the reduction in surplus caused by immediate recognition of expenses. The effect is called surplus relief.

**Reduce Exposure to Risk**

As an alternative to increasing its capital, an insurer can reduce its need for capital by reducing its exposure to risk. Reinsurance reduces an insurer’s risk by transferring ii to other entities. Alternatively, reinsurance can be thought of as a way to rent additional capital from reinsurers.

**Reinsurance is especially valuable in enabling insurers to avoid maintaining capital to cover the potential cost of serious, but unlikely, losses.**

**Catastrophe Bonds**

**Catastrophe bonds are securities structured to provide funds to help offset an insurer’s catastrophe losses. They work by transferring the risk of loss from a catastrophe directly to the investor in the bond**.

Insurers issue catastrophe bonds to the bond investor with the provision that the payment of interest, repayment of principal, or both are reduced or even eliminated in the event of a specified catastrophe. Therefore, the investor in the bond assumes the risk that a catastrophe will occur. The insurer uses the reduction or elimination of interest payments and principal repayments to offset its losses from the catastrophe. In summary, the insurer’s risk of incurring catastrophe losses is transformed into investment risk, represented by the potential loss in value of the catastrophe bond linked to those catastrophe losses.

To facilitate the insurance of catastrophe bonds, an insurer creates an entity called a special purpose reinsurance vehicle (SPRV) to exclusively write the specific coverage for the insurer’s risk to be covered. The SPRV issues a catastrophe reinsurance agreement to the insurer and issues catastrophe bonds to capitalize its reinsurance obligation. The catastrophe bonds are sold to investors directly through the capital markets.

Catastrophe bonds are often rated by an agency such as T&P, Moody’s or Fitch Ratings.

**\*\* Shareholder Dividends**

A company’s initial dividend policy decision regarding earnings is to either pay dividends to shareholders or retain them for investment within or outside the company. Earnings retained for investment can constitute an internal source of capital.

An optimal dividend policy maximizes a company’s market value. Whether this is accomplished through a no-dividend, low dividend, or high dividend policy depends on the company’s circumstances.

**Reasons for Dividends**

The company’s access to external sources of capital. The first factor that a company may use to determine what dividends to pay its shareholders is the extent of its access to **external sources of capital.** A company with limited free cash flow that can secure external capital (debt, or equity) can pay dividends without forgoing investment projects. **However, the cost of raising external debt or equity capital generally excess the cost of retaining earning (in other words, forgoing dividends), so any benefit derived from paying dividends-as measured through a higher stock price- needs to more than offset the additional cost of raising the external capital**.

The second factor is the expected rate of return on the company’s investment opportunities. If the company’s expected return from its investment projects is owner than that from other investment projects available to its stockholder, management should consider using its free cash to pay dividends rather than to invest in the projects with the lower return.

Another factor is the symbolic value of paying dividends. **A popular reason for increasing cash dividend payments is the belief that higher dividends will create higher market prices for the company’s shares because they indicate management’s optimism regarding the company’s prospective performance. Therefore, maintaining or increasing dividend levels is perceived as a positive signal to the market that can lead to increased share value**.

A fourth factor is the tax aspects of dividends. Shareholders are taxed on dividends when they are declared. However, if the company decided to forgo dividends and invest those funds internally, the stockholder is not immediately taxed and should receive a benefit in the form of increased stock value.

The final factor is investor attitude toward uncertainty. Shareholders might prefer current dividends over potentially higher future returns simply because of uncertainty increases with the length of the planning horizon. In terms of the risk-return relationship, retention of earnings in the company, with the prospect of high dividend payments in the future, is riskier and therefore implies that a higher capitalization (discount) rate will be applied in evaluating expected income streams, reducing the company’s market value.

**Factors Affecting Insurance Industry dividends**

**The financial management practices of insurers differ from those of other types of business, and this extends to insurer dividend policy. An insurer’s dividend decisions are complicated by these factors:**

* **Income measurement rules**
* **Cash flows**
* **Capital structure**
* **Ownership**
* **Regulatory restrictions**

**Income Measurement Rules**

No consensus exists regarding how insurers should measure income when setting their dividend policy and payout ratio. Shareholders received financial reports based on generally accepted accounting principles (GAAP). Regulators review insurers’ financial conditions from annual statements based on statutory accounting principles (SAP). Investors or management may prefer to consider factors in addition to net income, such as unrealized gains or losses, when determining dividend policy. Insurers can rely greatly on investment results to achieve their total return, and unrealized capital gains contribute significantly to the total income.

**Cash Flow**

While unrealized capital gains increase shareholder value, they do not generate cash that could be returned to shareholders as dividends. An insurer’s surplus and comprehensive income (which include unrealized gains) might be sufficient to pay dividends. However, positive cash flow from other sources of income would be needed to support dividend payments without reducing the insurer’s liquidity.

The availability of cash to pay insurer dividends is also affected by payment of certain expenses. Some expenses, such as commissions and premium tax, are paid near the inception of the policy. Although accrual accounting spreads these expenses over the life of the policy, their payment is an immediate drain on available cash.

**Capital Structure**

The capital structure of insurers can affect dividend decisions. Funds can be acquired by expanding insurance sales (insurance leverage), issuing debt (financial leverage), or obtaining additional equity. If operating profits are earned on new business, increased financial leverage will generate earning for distribution or retention. Similarly, if the return on additional debt capital is greater than its cost, the additional profits will be available for distribution or retention. However, insurers tend to use very little debt capital relative to other types of companies. Furthermore, insurer management needs to consider the additional risk associated with expanded insurance sales and/or greater financial leverage when making dividend policy decisions.

**Regulatory Restrictions**

Each state restricts insurers’ payment of stockholder dividends. These restrictions limit an insurer’s ability to release capital without approval from the state.

**Alternatives to Dividends**

Payment of cash dividends is not the only means of distributing income to company shareholders. Two common alternatives are repurchasing corporate stock and expanding available investment opportunities.

A company’s repurchase of corporate stock puts cash directly into the hands of affected shareholders. It also has advantages for the company: it results in a permanent reduction in total future dividend payments, improves flexibility by providing treasury stock for other uses (such as stock option plans), and might increase the market value of outstanding shares. A disadvantage of repurchasing shares is that it may reduce the company’s ability to generate future income, because it is effectively lowering its capital.

The second common alternative to paying cash dividends is to use funds for external investment opportunities that offer potentially greater returns then internal investment opportunities, such as acquiring an ownership interest in or merging with other companies.