REGULATORY GUIDANCE ON THE MISUSE OF RBC IN RATEMAKING

Adopted by the NAIC's Casualty Actuarial and Statistical Task Force
August 12, 2008

The Casualty Actuarial and Statistical Task Force wishes to re-emphasize its previous statements that capital levels indicated by the Risk-Based Capital (RBC) formula should not be used as, or assumed to be, measures of adequate capital. This would be an erroneous and therefore inappropriate use.

There seems to be a common and persistent misconception that the upper end of the Company Action Level, that is, the capital level that is 200% of a company's Authorized Control Level Risk-Based Capital requirement published in the Annual Statement, is somehow a measure of "adequate" capital. The logic of this appears to be that since, in most cases, no regulatory action is triggered under the Risk-Based Capital Model Law when an insurer's policyholders' surplus exceeds this amount, that this amount is considered by the NAIC to be the lowest level that is still "adequate". This misconception appears to be surfacing most commonly in a rate regulation context, where this surplus level (200% of Authorized Control Level) is frequently misconstrued as an "adequate" surplus level that can be used to establish limits on permitted profit levels, surplus accumulation, or leverage ratios.

It is appropriate to think of the capital level of 200% of the Authorized Control Level RBC requirement as the minimum capitalization level above which an insurer can operate without regulatory intervention (unless it is triggered by the Trend Test) as defined in the RBC Model Law. Below this level, regulatory intervention is explicitly authorized under the RBC statute. It cannot reasonably be concluded, however, that this minimum level of capital is "adequate", because a very small decline in surplus could be enough to trigger regulatory intervention. There is no evidence that companies that are consistently operating at or near this surplus level are sound or that consumers would be well served by having this level as a regulatory goal. In fact, it would seem logical, in theory, that an adequate level of surplus would be one that would ensure that there would be a very low probability of insurer insolvency, and a relatively low probability that an adverse event or events could result in a reduction in a company's surplus to a level that would put it in an RBC action level.

The drafters of the original Property-Casualty Risk-Based Capital Formula shared this perspective. In June 1993 the NAIC Property/Casualty Risk-Based Capital Working Group exposed for comment a proposed RBC formula. At that time the Working Group stated that: "The primary objective of the NAIC's Risk-Based Capital initiative is to raise the safety net that statutory surplus provides for policyholder obligations. The formula will not compute, nor was it designed to compute, the precise amount of capital a property/casualty insurer needs to operate in a competitive, dynamic and uncertain marketplace. … Accordingly, insurers will generally maintain capital well above the requirements established by this formula." The Working Group goes on to also say: "Since the formula is intended to identify insurers that require regulatory attention and does not purport to compute a target level of capital, the Working Group does not believe the results of this formula should be used in setting or reviewing premium rates or in determining the rate of return for an insurer."

To our knowledge the NAIC has never attempted to define what a theoretically adequate or optimum level of capitalization would be for an insurance company, nor has it attempted to establish financial strength ratings for companies. The RBC formula and model law were devised for the sole purpose of establishing risk-based, company-specific minimum capital requirements that specify the point at which regulatory intervention is necessary and provide statutory authority for such intervention based solely on the insurer's capital level relative to the standard. The RBC formula and statute were never intended to serve any purpose other than solvency regulation, as has been so clearly stated in the 1993 quotation above. Risk-Based Capital was originally, and continues to be, a minimum capital standard. The task of evaluating the optimum capitalization of insurers is separate and distinct from the task of evaluating minimum capital standards for solvency regulation.

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