INTRODUCTION

Although commonly thought of as one industry, the insurance industry actually consists of several distinct industries. Each distinct industry is based on the type of insurance written, for example, property/casualty, life/health, health maintenance organizations, title, and disability[1]. Each functions in its own way, has distinct financial attributes and operates differently. OTS-chartered thrifts are owned by a variety of these different types of insurance entities.

The insurance industry is comprised of several different types of businesses:

- Insurance companies, also called insurance underwriters – those that take on insurance risk by underwriting and issuing policies to customers.
- Reinsurers – insurance companies that insure portions of the business underwritten by other insurance companies.
- Agents – sales staff, either employees or independent contractors that sell on behalf of the companies they represent.
- Brokers – sales staff that is independent of insurance companies, they bring together insurance buyers and sellers. They work on behalf of the buyer.

State insurance departments regulate each type of insurance business listed above in a different way and to a different extent[2].

As with any holding company, you need to start with the administrative program and then move onto the CORE program (or abbreviated program if applicable).

[1] Information about insurance industries is presented in Appendix A.

[2] Regulation by state insurance departments is discussed in Appendix B.

PROGRAM GUIDANCE

Capital

Information presented in Capital Section 300 is just as relevant to insurance entities as to other types of organizations. However, you should consider the information presented below before drawing firm conclusions about a holding company enterprise that is engaged in insurance activities within the structure.

Capital Sufficiency

Capital levels for insurance companies are typically relatively high. This is due to strong investment performance during the 1990's and significant investment regulation[3]. In addition, due to the risk of catastrophes and the long-term nature of life insurance policies, higher capital levels are typically held. Recent events may result in a reduction of capital for certain companies. However, the industry overall is expected to remain strong.

Risk-based capital (RBC) is the major tool used by insurance regulators to evaluate the adequacy of an insurance company's capital level on a statutory accounting basis.

Insurance companies are part of a highly regulated industry. This level of regulation may result in restrictions against providing capital to the thrift. Evaluate the existence and/or adequacy of holding company capital in support of the thrift. This evaluation of consolidated capital should exclude the capital related to regulated insurance companies and any other regulated entities such as state banks. The remaining amount of capital should then be evaluated for its adequacy in support of the subsidiary thrift.

An evaluation of capital would also include a determination of any existing capital restrictions by

[3] Capital regulation of the insurance industry is discussed further in Appendix A.

another regulator. For affiliates that are regulated by another state or federal agency, determine if there are any agreements or conditions imposed that would require the holding company to devote financial resources (including capital contributions) to that entity. If such agreements or conditions exist, determine the extent to which they could ultimately have an adverse effect on the subsidiary thrift.

RBC is calculated at the individual insurance company, rather than enterprise level. Distinct RBC formulas are available for property/casualty, life and health maintenance organization companies.

The calculation involves applying risk factors to various asset, premium and reserve items. The factors are higher for items with greater underlying risk and lower for items with lower underlying risk.

As noted above, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital. Results of 200 percent or above typically indicate little concern. Results below 200 percent may result in insurance department actions.

OTS' approach to holding company supervision provides for the evaluation of capital on a case-by-case basis. Holding companies that underwrite insurance will prepare Statutory Accounting Statements either in addition to, or instead of GAAP statements. In those instances, SAP capital can be used as a measure of capital similar to tangible capital.

Risks

Capital Section 300 of the Handbook discusses various types of risk that organizations must address. The insurance industry also must deal with Underwriting Risk.

Insurance is a unique product in that the ultimate cost is sometimes not known until long after the product is sold. Underwriting risk is the risk that premiums will be inadequate to cover the cost of claims that occur during the policy periods. Insurance prices are established based on estimates of expected claim costs as well as estimates of the costs to issue and administer the policy. The estimates and assumptions used to develop policy pricing may prove to ultimately be inaccurate. This inaccuracy may result from poor assumptions, changing legal environments, increased longevity, higher than expected weather catastrophes and research breakthroughs as to the causes of disease[4]. The total cost of the policy may not be known until many years after the coverage has been provided. Factors that were unknown at the time the policy was issued may result in increased claims and claims costs.

Liquidity risk is typically less likely to be of concern in an insurance organization due to the extensive structure of investment regulation. Often 75 percent or more of an insurance company's assets are concentrated in the investment portfolio. Insurance investments are heavily weighted in bonds rather than stock.

Insurance company investments are typically structured to focus on providing for adequate diversification, liquidity and quality. The primary objective of an insurer's investment strategy is to preserve capital. Insurers invest largely in long-term bonds with fixed interest rates and predictable cash flows.

Life insurance companies present a unique aspect in evaluating capital. Variable life insurance and variable annuities are accounted for through the use of separate accounts. Policies accounted for in this way require no supporting capital. Capital calculations for companies with separate accounts

[4] Medical research may find the cause of a disease relates to a product thereby creating insurance claims outside of health insurance. For instance, several serious lung conditions have been traced to asbestos exposure resulting in large volumes of claims to manufacturers of asbestos. Lead paint has been linked to mental and physical impairment in children resulting in claims against paint manufacturers and landlords.

should be made excluding the amount recorded in that category[5].

Debt

Due to the strong capital levels and large investment portfolios most insurance organizations carry little debt. Procedures presented in Capital Section 300 related to debt may not be needed when evaluating many insurance holding companies.

Most insurance companies have negotiated terms for substantial letters of credit. These agreements are in place, available to activate in the event of a catastrophe. This type of agreement is not drawn on for operating funds or to finance growth, rather only for those infrequent, major events that require large amounts of immediate cash. The existence of these prenegotiated agreements provides the company the ability to obtain cash quickly without liquidating portions of the investment portfolio. The agreements help to minimize the impact that the sale of investments in a poor investment market would have on a company's operating results.

Dividend Policies

State insurance regulation typically includes restrictions on dividends from the underwriting company to the parent holding company. Dividends that do not require prior insurance department approval are limited to the current years earnings and ten percent of surplus as of the beginning of the year. Dividends in excess of that must receive prior insurance department approval.

As part of evaluating the financial condition of the holding company, the examiner should determine the impact reduced earnings (limiting dividends) would have on the cash flow needs of the holding company.

Accounting Methods

You may find that companies that underwrite insurance may not have their financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP). Instead, companies that underwrite insurance must file their financial statements with state insurance departments using what is referred to as statutory accounting principles (SAP). Publicly traded insurance underwriting companies must file GAAP statements with the Securities and Exchange Commission in addition to the SAP statements filed with the state insurance departments. Mutual or closely held companies typically only prepare SAP statements.

When reviewing financial statements, you should determine if the company prepares both SAP and GAAP statements or if only SAP statements are prepared.

If the holding company itself is not engaged in insurance underwriting activities and only controls or has investments in insurance companies, financial statements would be prepared using GAAP, SAP would not be used.

Ratio results calculated using SAP numbers would appear less favorable than those prepared using GAAP numbers. You should not automatically evaluate this more conservative result harsher than a GAAP result.

Companies that underwrite insurance often have diverse affiliates and subsidiaries within the structure; therefore, the statements at the ultimate parent may be complex. Because of this complexity it is not practical to simply benchmark results. Rather, a thorough understanding of the company and its various components will provide a comfort level that examination procedures are adequate.

Organizational Structure and Relationship

As noted above, OTS has approved applications for thrift charters for several different types of insurance companies. The thrift has been used by these organizations as a means to fill product line gaps and cross sell related products to existing in-

[5] Information about Separate Accounts is included in Appendix A.

surance clients. The types of products and services they offer reflect the overall organizations broader marketing strategy.

Several life insurance companies were granted thrift charters to provide trust services to consumers. The companies, whose insurance operations focus on life insurance and retirement and estate planning, use the thrift to provide trust services that complement these activities. Life insurance policies can be used to fund trusts. Retirement funds may be direct deposited into checking accounts. Certificates of deposit may be incorporated into asset diversification plans for retirement or estate planning purposes.

Several property/casualty insurance companies have applied for, and received full service retail charters. The products they offer, including home mortgages and auto loans, complement the auto and homeowners lines of insurance offered.

As the companies gain experience with the thrift and gain proficiency with the ability to cross sell thrift services to existing insurance clients, some have requested expanded authority. Several have acquired other thrifts or received approval to expand their authority to full service from trust only.

Approval of business plans for insurance industry thrifts often include restrictions or requirements. In many instances the insurance company plans for insurance agents to market thrift products. Agents' roles are largely marketing and information only; they are restricted from accepting deposits. In order to assure that this message is communicated effectively, agent training materials often require prior review by OTS before release.

Opportunities arise to cross sell thrift products to insurance clients. Likewise, opportunities exist to cross sell insurance products to thrift customers. Several existing thrifts have chosen to enter the insurance arena either through the creation or purchase of insurance agencies, marketing agreements with agents, or the creation of reinsurance companies.

Gramm-Leach-Bliley addressed concerns related to the sales of insurance products in a banking environment. The requirements of this law have been incorporated into OTS regulation through 12 CFR Chapter V Part 536 – Consumer Protection in Sales of Insurance.

The rule addresses anti-tying and disclosures to reduce customer confusion. A main focus of the rule is to make clear that the Federal Deposit Insurance Corporation does not insure insurance products sold on behalf of a bank or thrift. Compliance examiners review thrift activities for adherence to the rule.

Earnings

As recommended in the Earnings Section, you will consider ratings given by Moody's or Standards and Poor's. You should also review the ratings of A. M. Best for companies that underwrite insurance[6].

Although it is commonly thought that insurance companies make a profit only due to the difference between premium revenue and claim expenses, that if often not the case.

Insurance companies make a profit through their success at managing the funds available for investment. Insurance companies receive money from customers for premiums and management fees. The company has the funds available for investment, sometimes for many years, before claims are paid to policyholders and beneficiaries.

Ratio Analysis

Some of the ratios suggested in the Earnings Section use information from the cash flow statement. Typically, the cash flow statement is less informative for insurance companies than for other types of industries. The investment portfolio dominates assets and the management of it results in a significant volume of activity reported in the financing section of the cash flow statement. This leads to results that although typical for insurance may appear odd.

[6] Information about A. M. Best is included in Appendix C.

The current ratio cannot be used for most insurance organizations. The balance sheets for these entities are not usually segregated into current and long-term assets.

Operating cash flow is also of less importance for insurance companies again because of the significant impact of investing activities reflected in the financing section of the cash flow statement.

As mentioned previously many insurance entities have little to no debt resulting in either highly favorable or no result for the debt ratio.

Because of the high capital levels of many insurance companies, return on equity results are often lower for this industry than for other industries. Often investment analysts, due to their lack of understanding of the industry and their focus on maximizing return on equity for investors, shy away from these companies. Instead you should view the high capital level as a strength rather than a weakness.

Deferred Acquisition Costs

Deferred policy acquisition costs (DPAC) are referred to in the Earnings Section as an asset that does not generate cash. DPAC is comprised of the costs necessary to sell and issue a policy such as agent commissions and underwriters salaries and benefits. These expenses are paid early in the policy term. Under the GAAP matching concept items are expensed in the same period that the corresponding revenue is earned. DPAC is a prepaid expense (asset) that is amortized over the estimated life of the policy.

Property/casualty companies typically issue 6 month or 12 month policies. DPAC is expensed over the policy life. Given the short-term nature of property/casualty policies, DPAC does not typically represent a large portion of assets on the balance sheet.

Life insurance companies issue policies that are expected to remain in force for many years. DPAC is expensed over this estimated longer life of the policy and therefore is typically a larger percentage of assets.

SUMMARY

The insurance industry is comprised of a variety of different types of organizations. An understanding of these businesses and how they differ from thrifts will help you in determining the scope and methodology for conducting a holding company examination.