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Best Practice Capital Management

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There has been a lot of talk recently about computing a single number that is the "proper" level of capital in an insurance company. These calculations assume what will happen in the future, using normalized historical experience, and then generate statistics based on the resulting distribution.

While historically it is hard to go back even 50 years and say all the data is consistent, some practitioners consider it relevant to hold capital at the 1 in 2,000 (or greater) level. What does this even mean? Since the extreme data is ignored, failing in in 2,000 what? Certainly not years.

Today's market is unique in history. Rates are low, but have been manipulated by central banks engaged in a currency war. It will be hard for the Fed to raise rates due to implications on the price of oil, exports, and the economy in general. Assumptions based on historical data may not be realistic either. Do we really think bonds will continue to earn rates similar to the last 50 years when they are starting from today's low rates?

I prefer to use a common sense method to holding capital. I look at historical stresses, such as the 1918 pandemic or 2008 liquidity trap, along with principle based stochastic methods and other deterministic scenarios. I am likely to hold the worst result, but I may also look at made-up scenarios or interactions between scenarios. For example, I might consider a scenario where I consider hyperinflation, not Weimar but more like Brazil levels, reaching into the low 20s. From today's environment this would increase default rates on bonds considerably and lead to an illiquid market. This would be tough enough, but for life insurers I might add a pandemic with a .5% mortality spike over 3 months and an earthquake to boot. I am always surprised that regulators don't require some type of stress scenario like this to compare across companies.

I have collected a couple of near-quotes on this topic, showing the importance of common sense risk management.

- From Seth Klarman talk in Oct 2013 (Grant conference) "Risk management at Baupost is just people sitting around a table thinking"

- "There's no sense in being precise when you don't even know what you're talking about."
  John von Neumann (1903 – 1957), the father of modern game theory.

The key is to build resilience into a firm's financials; bend but don't break. Those firms that can survive the initial thrust of an event and have thought about it in advance can thrive in the aftermath.

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