SENATE TAXATION
EXHIBIT NO. 5
DATE 3-21-07
BILL NO. SB-556

Overview of Risk Based Capital

Prepared by Chris Manger, BCBSMT

March 21, 2007

What is Risk Based Capital?

- Risk Based Capital (RBC) is a tool created by regulators to objectively and uniformly measure the financial strength of insurers relative to the degree of risk assumed by them within their business operations.
- It determines if the capital accumulated by the insurer is sufficient.

Premiums Must Pay the Claims....

- In a perfect world, premiums would be set at the perfect level to cover all costs
- It's not a perfect world!
- An insurer needs to maintain sufficient capital to protect its policyholders during those "rainy days" when costs, including utilization, outpace income.

Who is Concerned?

- The insurer is concerned about its ability to continue to service policyholders and pay provider claims
- The regulators are concerned that policyholders are adequately protected
- The Blue Cross and Blue Shield Association is concerned about the financial strength of the Blue System

Objectives of the Formula

- The RBC formula analyzes financial risk by applying a statistical formula to selected risk factors
- The formula is designed to take into account that probably not all adverse events will occur at the same time

The Five RBC Risk Factors

- Insurance Affiliate Risk (H0)
- Invested Asset Risk (H1)
- Underwriting Risk (H2)
- Credit Risk (H3)
- Business Risk (H4)

The Formula .....

$$H0 + \sqrt{H1^2 + H2^2 + H3^2 + H4^2}$$

How is the Result Used?

- The result of the calculation is known as RBC after Covariance
- The Covariance is multiplied by 0.5
- The result of this calculation is the Authorized Control Level (ACL) – this is basically the minimum amount of capital required to cover the statistical risk the company is exposed to

What Does This Tell Us?

- The ACL number is divided into the statutory surplus (or capital) of the insurer to arrive at the RBC percentage
- The RBC percentage indicates how the size of the surplus or capital measures up against the minimum necessary (ACL)

The Importance of Surplus

- The denominator in this calculation is the ACL
- The numerator is the surplus – the larger this number the better in terms of the RBC outcome
- Surplus can be increased or decreased by earnings, unrealized investment income, "non-admitted assets" and surplus notes

Who cares about RBC?

- The state regulators monitor RBC for solvency concerns:
- If the RBC percentage falls between:
  - 150%-200%: A corrective action plan must be submitted to the regulators
  - 100%-150%: A financial plan must be submitted and the regulator issues corrective orders
  - 70%-100%: Regulators take control

RBC for The "Blues"

- The Blue Cross and Blue Shield Association has a number of financial strength requirements for its members, including RBC
- At 375%, the Plan is in the Early Warning Stage
- At 200%, the Association revokes the Plan's license