American Academy *of* Actuaries

Issue Brief

Dividend Limitation—Affiliated Transactions

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Key Points

- A possible method for altering the dividend restriction could involve mandating that the company must possess a sufficient amount of positive net gain from operations (NGO) to fully offset any accumulated negative NGO before distributing any dividends.
- The dividend limitation does not take into account the prior negative NGO or the weakened capital position when the subsequent year shows positive NGO. When the owner receives 100% of the positive NGO as a dividend, the company's capital position does not improve during the positive NGO years, thus failing to offset the impact of the negative NGO years on the capital position.

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Insurers have faced regulatory limitations on shareholder dividends for many decades. The limitation is objective and based on data items available on the annual statement as described in Model Law 440 Insurance Holding Company System Regulatory Act, Section 5.B, "Dividends and other Distributions," and Section 5.A, "Transactions Within an Insurance Holding Company System." At times, insurers may experience a large loss one year and then experience modest gains in subsequent years. Based on the guidance from Model Law 440, Section 5.B, it is possible in those instances for insurers to provide dividends to shareholders from most or all the modest gains even if the gains sum up to less than the prior year's loss. In addition, the increasing use of affiliated transactions, as regulated from Model Law 440, Section 5.A, may serve to pull amounts out of an insurer while directly or indirectly avoiding the limitation on shareholder dividends.

Out of 4,647 insurers analyzed for the 10-year period of 2012 to 2021, 786 (17%) insurers paid more in total dividends than total net income over the period. Of these 786 insurers, 173 (22%) are health insurers, 144 (18%) are life insurers, and 469 (60%) are property & casualty (P&C) insurers. For these 786 insurers, total dividends paid were 149% of total net income. There are only slight variations by type of insurer with health at 156%, life at 151%, and P&C at 147%. A number of insurers in each category experienced negative total net income over the period while paying a total dividend amount in the same period.

Purpose

This issue brief focuses on two issues: 1) review of the existing dividend limitation and 2) review of the effects of affiliated transactions as they relate to the dividend limitation. Insurers have a variety of ways to affect capital positions other than by shareholder dividends and affiliated transactions. All those methods are outside the scope of this issue brief. The purpose of this issue brief is to discuss the two issues and describe potential actions that could be taken by regulators to address the issues.

We will use the following definition of a dividend limitation, which is aligned with regulatory requirements and industry practices. Dividend limitation is also known as "dividend capacity." It is the maximum dividend that an owner may collect from the insurance company unilaterally without requiring approval by an insurance regulator. The objective of the regulation is capital preservation and policyholder protection.

Dividend limitation is the lesser of (excerpt of Model Law 440, Section 5.B):

1. Ten percent (10%) of the insurer's surplus as regards policyholders as of the 31st day of December next preceding; or

2. The net gain from operations of the insurer, if the insurer is a life insurer, or the net income, if the insurer is not a life insurer, not including realized capital gains, for the twelve-month period ending the 31st day of December next preceding, but shall not include pro rata distributions of any class of the insurer's own securities.

For the purposes of this issue brief, we will use the term "net gain from operations" (NGO), and this will mean net income if the insurer is not a life insurer.

The impact of the dividend limitation varies depending on the state of an individual company's NGO.

The ERM/ORSA Committee, which authored this issue brief, includes Charlie Ford, MAAA, FSA—*Chairperson*; Dana Hunt, MAAA, FSA—*Co-Vice Chairperson*; William Jones, MAAA, FCAS—*Co-Vice Chairperson*; John Aprill, MAAA, FSA; John Blocher, MAAA, FSA ; Lesley Bosniack, MAAA, FCAS; Tamara Burden, MAAA, FSA; David Heppen, MAAA, FCAS; Kathy Huong, MAAA, FSA; Kayne Kirby, MAAA, FCAS; Clifford Lau, MAAA, FCAS; Xin Liu, MAAA, FSA; Stephanie Lynn, MAAA, FCAS; Sandra Schrader, MAAA, FCAS; David Schraub, MAAA, FSA; Joel Steinberg, MAAA, FSA; Matthew Trettin, MAAA, FSA; Ariel Weis, MAAA, FCIA, FSA; and Jon-Zeu Wu, MAAA, FSA.

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State: NGO Is Consistently Positive

When NGO is consistently positive, 100% of the NGO may be a dividend (subject to not being more than 10% of the insurer's surplus). The formula achieves the desired goal (i.e., capital protection) in this case, as the company has positive NGO and the owner removes it through a dividend, leaving the company in a similar capital position after the NGO and dividend as it was before.

State: NGO Is Consistently Negative

When NGO is consistently negative, no dividend is allowed. After the negative NGO with no dividend, the company is in a worse capital position than it was previously. If negative NGO continues, the company may eventually deteriorate its capital position enough to require actions to continue operating. The dividend limitation eliminates the dividend but does nothing else to protect capital.

When NGO is sometimes positive and sometimes negative, the dividend limitation currently varies between the two states shown above, one of which applies in any given year. When NGO is positive, 100% of it may be paid to the owner as a dividend with the company left in a similar capital position, and when NGO is negative a dividend is not allowed with the company in a worse capital position due to the negative NGO.

Over time in the current dividend limitation, if there is a series of positive and negative NGO years *and* the owner collects the maximum available dividend, the company will start to experience a deteriorating capital position because positive NGO years will not offset negative NGO years.

The current dividend limitation has no memory: The dividend limitation does not "remember" the negative NGO from the negative year or the deteriorated capital position when the next year is a positive NGO year. When 100% of the positive NGO is collected by the owner as a dividend, the company's capital position does not improve during the positive NGO years to offset the effect on capital position of the negative NGO years.

To add memory: A potential way to modify the dividend limitation would be to require the company to have enough positive NGO to 100% offset accumulated negative NGO before paying any dividend. For example, if the NGO from one or multiple years was ($20 million), the company must earn $20 million prior to the owner collecting a dividend. This calculation would start when a negative NGO occurs. It is not an accumulation from the foundation of the company—merely an offset to any negative NGO until it is fully offset, then dividends start again upon further positive NGO.

An offset less than 100% is also possible. For example, the dividend limitation could be modified to require the company to have enough positive NGO to X% offset accumulated negative NGO before paying any dividend. If X = 75, then 75% of a positive NGO is applied to offset any negative NGO until it is offset, and there would be some dividend allowed before the negative has been completely offset. For example, if the NGO from one or multiple years was ($20 million) and 75% of positive NGO is applied to offset the negative first, then when $20 million NGO occurs, a dividend of $5 million is available while leaving ($5 million) to be offset by future positive NGO.

These alternative approaches to establishing dividend limitations are illustrated by the simple numerical examples below:

Form	% Offsetting negative	Accumulated Negative NGO: Example	Subsequent Positive NGO: Example	Dividend Payment	Remaining Accumulated Negative NGO ($)
Current	0%	(20mm)	20mm	20mm	(20mm)
Memory	50%	(20mm)	20mm	10mm	(10mm)
Memory	75%	(20mm)	20mm	5mm	(5mm)
Memory	100%	(20mm)	20mm	0mm	0mm

Form	% Offsetting negative	Accumulated Negative NGO: Example	Subsequent Positive NGO: Example	Dividend Payment	Remaining Accumulated Negative NGO ($)
Current	0%	(20mm)	12mm	12mm	(20mm)
Memory	50%	(20mm)	12mm	6mm	(14mm)
Memory	75%	(20mm)	12mm	3mm	(11mm)
Memory	100%	(20mm)	12mm	0mm	(8mm)

By adding "memory," if there are any positive NGO years in the future, the accumulated negative NGO is effectively worn off over time, returning the company to a similar capital position as it was prior to the initial negative NGO (all else being equal). The percentage used will determine how quickly or slowly recovery occurs, with 100% as the quickest recovery.

Alternative Dividend Limitation Approach: Accumulated Earnings vs. Paid Dividends

An alternative approach that insurance regulators could consider is based on each insurer's accumulated earnings over time relative to the dividends it has paid. The concept would be to limit cumulative dividends to cumulative accumulated earnings. Alternatively, cumulative dividends could be limited to a percentage of accumulated earnings. Conceptually, the approach "gives credit" to each insurer's earnings history. The approach limits the insurer's ability to pay dividends that were not earned through its operations. Insurance regulators could choose any timeframe over which to consider accumulated earnings and cumulative dividends, such as five to 10 years. Transition rules may be appropriate as well if an approach along these lines is adopted in the future.

Amounts paid under affiliated transactions are not considered dividends: Affiliated transactions and amounts paid under them are disclosed. Any amounts paid under affiliated transactions are not counted as dividends and therefore not subject to the dividend limitation described above. However, amounts paid under affiliated transactions may limit dividends to the extent they reduce the NGO. Consequently, under current rules, payments under affiliated transaction agreements may continue even if the NGO is negative and dividends are not allowed to be paid.

The example below illustrates a metric that could be considered by insurance regulators in establishing limits to the amounts paid under affiliated transactions: the "Affiliated Transaction Coverage Ratio." The example below assumes the current dividend limitation remains in place.

NGO: Example	(1) Affiliated Transactions Reducing NGO: Example	(2) Dividend Capacity	Affiliated Transaction Coverage Ratio = [(1) + (2)] / (1) – 1
20mm	5mm	20mm	400%
10mm	5mm	10mm	200%
5mm	5mm	5mm	100%
2mm	5mm	2mm	40%
1mm	5mm	1mm	20%
0mm	5mm	0mm	0%
Negative	5mm	0mm	0%

The affiliated transaction coverage ratio indicates how much the amounts paid under affiliated transactions is affecting the dividend capacity. A high ratio indicates that the affiliated transaction payments are not having a significant effect, and a low ratio indicates that the affiliated transaction payments are having a significant effect. The dividend capacity can change depending on any dividend limitation changes and the Affiliated Transaction Coverage Ratio will still be available as a metric for regulators to consider in potentially establishing limits to affiliated transactions. When this ratio drops below a certain level, it may indicate an owner is overly relying on amounts paid under affiliated transactions to remove capital from the insurer. This might be informative for taking further steps or developing further guidelines.

Transition Issues

If any changes are implemented to the dividend limitation, insurance regulators may wish to consider transition rules, such as only considering negative NGO that occurs or is reported after implementation date. In such a scenario, insurers would not start with a negative NGO from the outset.

Similarly, if any changes are implemented for affiliated transactions, insurance regulators may wish to only consider amounts paid under affiliated transactions after the implementation date. In such a scenario, if an Affiliated Transaction Coverage Ratio concept were adopted, it would apply only to amounts paid after implementation.

Conclusion

Adding "memory" to the dividend limitation and more formal tracking of affiliated transactions can be done many different ways. This issue brief is designed to start discussions in these areas. Those discussions may lead outside of this concise description of the issues.

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