On August 9, 2011, SCOR SE, a global reinsurer with offices in more than 31 countries, acquired substantially all of the life reinsurance business, operations and staff of Transamerica Reinsurance, the life reinsurance division of the AEGON companies. The business of Transamerica Reinsurance will now be conducted through the SCOR Global Life companies, and Transamerica Reinsurance is no longer affiliated with the AEGON companies.

While articles, treaties and some historic materials may continue to bear the name Transamerica, AEGON is no longer producing new reinsurance business.

Economic Capital: What It Is, and Isn’t

Editor’s Note: As the life insurance industry moves towards a more principles-based environment, related terminology increasingly has different meanings for different constituents. In this article, Larry identifies common misperceptions of economic capital and provides a more concise definition. In future publications of The Messenger, he will address more specific issues facing carriers as they move from theory to practice.

Traditionally, most insurers have determined capital requirements based strictly upon regulatory or rating agency formulas. But recently, companies have increased their use of more principles-based, economic approaches to calculate the desired level of capital. In Towers Watson’s 2010 survey of life insurance CFOs, 90 percent indicated they either currently calculate economic capital (EC) or plan to do so in the near future.

However, business leaders and risk managers have reached little agreement about what exactly EC is, let alone how it is determined. EC is often used interchangeably with various levels of regulatory capital (RBC) including principles-based approaches, rating agency capital, IFRS/GAAP capital, etc. Were you to ask a sample of executives from a number of life insurers, “What is ‘economic capital?’” responses might include:

- The level of capital at which there is less than a one percent chance of triggering the company action RBC level
- Whatever it takes to achieve an S&P “AA” credit rating
- The ability to withstand a .1 percent risk of ruin or probability of insolvency in any calendar year
- The Solvency II level of capital at a 99.5 percent confidence level
- The optimal level of capital at which shareholder value is maximized (holding too much capital can diminish returns and increase the cost of insurance to consumers; too little may increase the probability of insolvency to an unacceptable level)

The foundation for many of these various definitions of EC is a set of somewhat arbitrary yet rigid factor-based formulas (e.g., X percent of assets, Y percent of life insurance in force) or principles-based rules prescribed by regulators or rating agencies. These calculations are really constraints or inputs to developing an EC value, not necessarily the EC value itself.

This then begs the question, “What exactly is EC?” Given a defined enterprise-wide risk appetite, EC is the amount of capital determined by senior management and the board of
Economic Capital (cont.)

directors to provide a given level of safety to stakeholders while pursuing the strategic objectives of the enterprise. Like other principles-based approaches, an insurer’s EC is a dynamic number that will change as the company business profile, senior leadership and/or the macroeconomic environment changes.

With its critical role in developing the level of EC, risk appetite is a framework to determine specifically which risks and how much of these risks should be taken to achieve enterprise objectives in line with the firm’s overall corporate strategy. There is no right or wrong answer to a proper risk appetite or a proper level of EC, as long as senior management and the board are aligned and transparent with all key stakeholders of the enterprise. Stakeholders include shareholders, debt holders, rating agencies, customers, vendors, reinsurers, distribution channels, regulators, stock analysts, etc.

This is EC in theory. The emerging best practice seems to be moving toward selecting a level of EC that is the greater of management’s economic tolerance (e.g. 1 in 1000 risk of ruin), statutory solvency requirements (RBC, Solvency II) and rating agency requirements (e.g. AA, A+, Aa2), plus a moderate add-on buffer.

In summary, EC is a critical tool to holistically view the risk profile of the firm to be sure that there is adequate capital in order to achieve enterprise objectives with an acceptable probability. Regulators, rating agencies and a host of third parties are important stakeholders that can and do influence this process. As senior management and the board reflect on their ultimate responsibility to these stakeholders, they will continue to look more closely at EC as a critical risk management tool and come to a useful operational understanding of what that means for the continuing success of the enterprise.