Preparing for Principles-Based Capital

As our industry moves towards a principles-based approach to valuation, many life insurers have focused on its potential effect on reserves. However, work is currently under way to apply similar principles to required capital, with similar expected results. But whereas plans for principles-based reserves will initially apply to new business only, proposals for principles-based capital (PBC) are currently targeting both new and inforce business.

As with principles-based regulations for reserves, PBC recommendations are still works in progress. However, information currently available points to several implications that life insurers will need to address.

Background

The American Academy of Actuaries originally directed the Life Capital Work Group (LCWG) to evaluate the interest-rate and market risk (C3) component of the current RBC framework in the context of a principles-based approach. Their work is part of the C3 Phase 3 project. The focus eventually expanded to include a portion of C1 (asset market and credit) risks. The LCWG is currently targeting C3P3 implementation for year-end 2009.

Efforts on PBC mirror general efforts of the Life Reserve Work Group to establish rules for principles-based reserves. Current RBC rules are formula-driven, but it is expected that the principles-based approach will incorporate a stochastic-based methodology, which will include updated modeling assumptions as they emerge and become credible.

NAIC RBC and Volatility

Changes in RBC have been, and will most likely continue to be, applied by line of business (i.e., life, annuities, etc.) regardless of issue era. Therefore, it is reasonable to expect shifts in RBC when converting from a formulaic to a principles-based NAIC capital requirement.

Once PBC requirements are implemented, larger swings in required capital may occur from year to year. This is due to the inherent stochastic modeling volatility, which is compounded by frequently updated modeling assumptions. And, unlike principles-based reserving that affects only prospective new business, volatility in capital requirements may affect all inforce business for the given line.
Current Pricing Considerations

Business issued today is priced based on well defined capital requirements. But required capital for today’s new business will change as PBC is implemented. Therefore, PBC may present a “current” pricing risk. If changes in underlying modeling assumptions and stochastic variances result in increased capital requirements not factored into current pricing, then today’s new business could be underpriced. Consider also that unforeseen increases in policy lapsation may result in elevated mortality rates on the remaining business, further increasing per-unit capital requirements above original pricing assumptions.

As details emerge on the direction for PBC, we look forward to working with our clients on evolving implications and how we can work together to ensure continued success.