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LETTER TO THE EDITOR

By Carol Marler

This letter represents my own personal opinion, and it does not necessarily reflect the views of my employer.

I am writing about some concerns I see with the C3 Phase 3 initiative to update the calculation of Risk Based Capital (RBC) for life insurance.

First, when the principle-based approach was introduced, the emphasis was on using each company's own risk assessment to drive the process. Somehow along the way, we have veered off that desirable path. Instead of looking at all of a company's risk factors and prioritizing them, we have focused very narrowly on the interest rate and financial market risk. In addition, instead of a principle-based approach, we are now doing what some have characterized as a really complicated rules-based approach.

I think that one of the factors behind this narrowing has been the unfortunate and long-standing adversarial relationship between companies and regulators in the United States. I remember many years ago reading a humorous piece, perhaps it was in *The Financial Reporter*, which parodied a typical discussion between two actuaries, one from each camp. Instead of a dialogue, it was more like two parallel monologues. In effect one actuary kept saying, "You want to make the reserves too high," and the other responding, "You want to make the reserves too low." The same messages could be updated today by replacing the word **reserves** with the word **capital**.

The approach being taken by Solvency II is an interesting way to get around this impasse. A key element of the overarching structure of Solvency II is that companies are required to use the risk analysis and models in day-to-day management of the company. They must demonstrate that this is not just an exercise in compliance, but that the company has a culture which sets strategy and manages the business accordingly. This aligns the interest of company management with the goal of accurately assessing risk in ways that reflect the company's own risk profile, and making appropriate provisions for it.

Second, it appears to me that it is now time for a change from looking at capital ratios to asset ratios. We have already moved in the direction of analyzing Total Asset Requirements (TAR) in C3 Phase 2. Because the associated reserves were generally calculated in a homogeneous way, it was relatively easy to convert the TAR into a capital requirement. That situation is definitely not the case with C3 Phase 3.

For example, some of the early analysis for the Principle-Based Reserves (PBR) project showed that C3 Phase 3 would generate a lower TAR than existing RBC plus reserve balances for business currently reserved under Actuarial Guideline 38, also known as XXX. The discrepancy was so great that the calculated contribution of this business to the C3 Phase 3 capital was negative. On the other hand, similar products issued in earlier years and reserved under the unitary method could produce much larger capital requirements than current rules prescribe. Although different levels of conservatism in reserves will also have an indirect impact on a TAR ratio, it will be much less extreme than if a required capital ratio continues to be used.

Regarding the lack of homogeneity in reserves brings me to my third point. Although an expanded field test is underway for the PBR project, it still focuses on new business—i.e., products currently being issued. It seems obvious to me that the C3 Phase 3 process needs more field testing than that. There are many products in company portfolios which are no longer being issued. A broader brush is needed to be sure that due consideration is given to these products. Moreover, I understand that the change to reserve requirements for PBR will be phased-in over a number of years. Once the RBC instructions are changed, there will be no opportunity at all for phase-in. To me, this suggests that field testing needs to be much more thorough than for PBR. It needs to begin, as was done for PBR, with a "final" version of C3 Phase 3. After testing, there will likely be a few iterations, depending on what each round of field testing identifies as significant inconsistencies.

At this time, the Solvency Modernization Initiative (SMI) work group is giving careful consideration to the future of RBC, and I am pleased to see this happening. Some have suggested that the current proposal for C3 Phase 3 might be merely an interim step on the way to the SMI version. Others suspect that the whole C3 Phase 3 approach is more of a distraction than a forward step. Perhaps it is time to stop further work on C3 Phase 3 and focus on work being done by SMI toward a more truly principle-based approach.

It's food for thought. ■

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