AMERICAN ACADEMY *of* ACTUARIES

Recommended Changes to Risk Based Capital Requirements for C-3a (Interest Rate Risk)

Presented by the American Academy of Actuaries' Life Capital Adequacy Subcommittee to the National Association of Insurance Commissioners' Capital Adequacy Task Force

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The American Academy of Actuaries' (Academy) Life Capital Adequacy Subcommittee (LCAS) proposes two changes to the current C3a capital requirements. Both of these changes can be implemented by instruction changes with no diskette programming needed.

The first change we recommend is to exclude equity indexed annuities and insurance from the exposure included in lines 5, 15, and 16 of the "Exemption Worksheet" in the LR023 instructions, including it, instead, in lines 6 and 17. In other words, in determining the concentration of "interest sensitive" business as a part of the overall RBC, and the sensitivity of the RBC ratio to the appropriate capital requirements on interest sensitive business, we will remove equity indexed products from the interest sensitive category. By "equity indexed products" we mean the equity indexed portion of such products, not to the liability for the "fixed" option, if any.

It seems appropriate to exclude these products from the tests that may trigger mandatory scenario testing, since the use of scenario testing to set the capital requirements for these products is not allowed. Without this change, a large block of these products might require testing; yet these very products would be prevented from entering into the testing.

Equity indexed products were excluded from testing in this section, since we plan to recommend a specific approach for them in the future.

The second change we recommend has to do with the eligibility for scenario testing or for use of factors. We believe companies should be allowed to set their capital requirements by following the scenario testing method, even though the concentration and sensitivity tests do not require it. However, we also believe that a company that makes this choice must continue doing so in the future and can only revert to factors with regulatory approval. This change is consistent with the original LCAS recommendation and with the current "Phase 2" recommendation. It reflects the developing experience with scenario testing by industry and regulators. It also supports the long-term direction the Academy's Life Practice Council recommends for replacing formulaic standards with models.

We believe both of these changes could be implemented for year-end 2004, and that both would improve the measurement of interest rate risk.