Implementing the Market Cost of Capital Method for Fair Value Margins

By John Manistre

Abstract: The Market Cost of Capital approach may soon emerge as the standard for estimating margins in insurer's fair value balance sheets. This paper develops a conceptually rigorous formulation of the cost of capital method for estimating margins for mortality, lapse and other forms of underwriting risk. We show that the cost of capital method is fundamentally a regime switching model and a handful of special problems are solved in closed form. The paper then goes on to develop two more pragmatic methods which we call the explicit and implicit margin methods respectively. Both of these methods approximate the regime switching model under appropriate circumstances and can be implemented with standard actuarial platforms. Neither method requires stochastic on stochastic projections to get useful results.