AMERICAN ACADEMY *of* ACTUARIES

June 6, 2014

Mr. Dave Sandberg, Chair
Insurance Regulation Committee
International Actuarial Association

Re: Comments on IAIS Global Insurance Capital Standard (ICS) Memo

On behalf of the American Academy of Actuaries' Solvency Committee, I appreciate this opportunity to provide comments to the Insurance Regulation Committee of the International Actuarial Association (IAA) as it develops a response to the International Association of Insurance Supervisors (IAIS) on its request for input concerning the proposed approach for a global insurance capital standard (ICS). Our input on each of the questions identified in the IAIS's May 28, 2014 *Memorandum to Observers* (the ICS Memo) is offered below.

***Q1. Do you have any comments on the proposed approach to the development of ICS?***

Given the variety of risks across jurisdictions (and even within a single national boundary), we question whether a single global approach that does not take into account localized jurisdictional capital requirements (that reflect localized risks, cultures, corporate governance and legal regimes) is advisable. We suggest instead that any ICS be developed to attempt to leverage as much as possible existing local capital requirements.

In addition, paragraph 11 of the ICS Memo notes that the "ICS will define a consolidated group-wide globally comparable risk-based measure of capital adequacy." However, it is unclear to us what is meant by "comparability" in this context. Any comparison of risks between different products and different jurisdictions will be difficult. While we agree that it is important for regulators to be able to assess the risks faced by Internationally Active Insurance Groups (IAIGs), we question whether a single capital ratio or a single risk factor for a similarly labeled product can result in true comparability across national boundaries or different products. For example, the risk in auto insurance in a non-litigious country with national health care is different from the risk in auto insurance in a litigious country without national health care. Instead, the ICS should be designed in a way that identifies the risks to which IAIGs are sensitive and ensures that all IAIGs can survive certain prescribed stress scenarios.

Finally, we note that the ICS Memo does not address non-insurance affiliates. This is an important concern, particularly with respect to affiliates that may be unregulated.

***Q2. With regard to implementation steps and potential transition arrangements (referred to in paragraph 17 above), do you have comments on the intended implementation timeline for ICS, bearing in mind that it is expected to take place from 2019 onwards?***

If complex models are used, the conversion may take an extended time, particularly since many insurers impacted also will likely be implementing International Financial Reporting Standards (IFRS) and Solvency II. This needs to be carefully examined in field testing.

In addition, we are concerned that the data collected to date on the field testing project might not be sufficient to properly evaluate the risks to which IAIGs are subject. Collecting and analyzing experience data regarding risks is often time consuming, requiring multiple steps and continued refinement as the research progresses. The project steps and timeframe should incorporate this consideration.

***Q3. Do you have any comments on the proposed aims for the development of the ICS?***

As noted above, comparability across jurisdictions and products is not likely to be feasible using a simple factor approach.

We support the stated goal of minimizing opportunities for capital arbitrage; however, it is important to keep in mind the potential for arbitrage opportunities across different types of financial institutions. Presumably capital standards applicable to IAIGs will reflect the risks inherent in insurance (versus, for example, banking) but it is unclear, for example, how bank-like activities within insurers will be treated  Also, how will capital arbitrage be dealt with for unregulated institutions?

***Q4. Valuation has long been a contentious subject based on the different approaches adopted in different jurisdictions. Comparability is at the centre of the aims for the ICS. As stated in paragraph 24, a working assumption is that most of the exposure measures will come from the balance sheet and it is necessary that the balance sheet is comparable to give a comparable measure of qualifying capital resources. A number of statements have been made with respect to the ICS and also in development of the BCR that existing jurisdictional approaches to valuation should be used.***

***What are your views on the development of a balance sheet valuation approach for the purposes of comparability in supervisory reporting and capital adequacy assessments, as mentioned in paragraph 24? In particular, what would be the best way to develop an ICS which is based on comparable capital requirements and resources?***

Any valuation methodology developed for use in connection with the ICS will have shortcomings. As evidenced by the fact that the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have been unable to converge on accounting standards for insurance contracts, developing a common balance sheet across jurisdictions is fraught with considerable difficulties.

Note that the valuation issues vary drastically for life and non-life liabilities. For life insurance, the largest valuation issues have generally included whether to lock in assumptions, how much margin to include and what discount rates to use. For non-life these have not been major issues, but instead the principal issue has been whether or not to discount future cash flows. Thus, we recommend that the IAIS acknowledge the differences by industry segment when addressing valuation issues.

In considering valuation issues, we urge the IAIS to consider the following:

- Given the diversity of products and markets across the globe, it is crucial that the IAIS adopt a jurisdictional approach. One size does not fit all. A balance sheet methodology that makes sense in certain markets and for certain products may be harmful in other contexts. The IAIS should account for these jurisdictional differences to avoid unintended harmful consequences.

- The IAIS should evaluate methods of assessing capital adequacy that do not rely on a balance sheet valuation. Stress testing is a prime example of such a methodology. Such an approach can be constructed in a way that does not require a single international valuation basis, yet allows the regulator to understand under what circumstances each IAIG might come under stress and potentially be unable to meet its obligations. We would be happy to be to discuss with you how such an approach could be constructed.

- Cash flows should be based on a best or central estimate, with no margins. These cash flows will be readily available, with little or no additional work effort required, for insurers using: IFRS, U.S. GAAP, U.S. statutory claim liabilities (life, health, and P&C), U.S. cash flow testing (life and health), and economic value.

***Q5. There were a significant number of comments received in the ComFrame consultation about the approach to capital resources. Field testing will provide further information on capital resources. The IAIS will decide the approach to capital resources based on both the input from consultation and field testing over the period of development of the ICS. Are there any additional points that you wish to make about capital resources that have not already been said in previous consultation submissions?***

The determination of capital resources needs to be based on capital available to the insurance operations, which in some cases would include capital obtained at the holding company in the form of debt, yet contributed down to an insurance subsidiary in the form of paid-in capital. Such capital essentially would be equity capital from the perspective of the operating insurer, given suitable safeguards against the holding company raiding such capital from a subsidiary when inappropriate for insurer solvency purposes.

In addition, we believe that all assets and liabilities, whether they are on- or off-balance sheet, should be included in the analysis.

***Q6. What are your views on the use of an internal model-based method to determine either the entire capital requirement or part of the capital requirement for the ICS? Should this be part of the ICS developed by 2016 or part of a longer-term goal for the ICS?***

There are significant issues, both theoretical and practical, with the use of internal economic capital models. From a theoretical perspective, using internal economic capital models will hinder comparability of outcomes between companies. Some may use internal models, others may not, and the results may or may not be similar.

From a practical perspective, it will be difficult for regulators to review models to assure they are appropriate. Auditing such models can be very difficult and, as we are seeing in connection with the implementation of Solvency II, it can be challenging for regulators to review internal models.

It is important to note, however, that not all internal models are subject to the same challenges as economic capital models. For some companies and risks (particularly for natural disasters and catastrophes), the "internal model" may be, in fact, a model developed by a third party but reviewed and used by the company with its own data as input. This should be explicitly permitted under ComFrame. Similarly, cash flow testing models, which could be used in the stress testing context, have the ability to produce comparable outcomes – as long as regulators prescribe the assumptions, scenarios, and methodologies to be used (which must take into account jurisdictional differences). Lastly, any decision with regard to internal models and/or third party models (e.g., catastrophe models) needs to recognize the different position of reinsurers vis-à-vis primary insurers. Reinsurers do not have access to the same granular insurance contract exposure data that may be expected from primary insurers.

***Q7. What are your views regarding the approaches described in paragraph 32?***

For some risks such as natural disaster/catastrophe risks, factor-based approaches are inferior to the use of models. As noted above, this does not necessarily mean that internal economic capital (or catastrophe) models should be used.

***Q8. If you believe either or both internal models or other risk-based methods of implementation should be allowed, how should comparability of outcomes be ensured and evidenced?***

It will be quite difficult to assure comparability of outcomes if companies use their own internal economic capital models. However, as noted above other types of "internal" models have the potential to produce more comparable results. Regardless, as described above, standardization of assumptions, including standard yield curves and interest rate scenarios, will be critical to achieving consistency and comparability of outcomes. This will need to be done at the jurisdictional level since there are significant differences in risks across the globe.

Should the IAIS decide to allow the use of internal capital models, it should work with actuarial professional organizations to establish actuarial guidelines and standards to facilitate uniform application and review.

***Q9. What are your views on the ICS being developed as a group-wide PCR as proposed in paragraph 35? (Otherwise, how else should it be developed)?***

The focus on a group-wide capital total does not necessarily protect solvency at the operating insurer. For example, adequate capital held at the parent company level does not help policyholders if the capital cannot be moved to the jurisdiction of an insolvent subsidiary. Therefore, it is not clear how a group-wide PCR would be used in day-to-day supervision.

***Q10. Do you support the two alternative criteria on which information would be collected to enable calibration of the capital requirement?***

The two criteria specified are not sufficient to enable calibration of a prudential capital requirement because: (1) these criteria are not far enough in the tail for a capital standard; and (2) the one-year time horizon is inappropriate for insurers with long-term liabilities.

Moreover, it will be difficult, if not impossible, to reliably estimate the proposed targets for certain risks. For example, consider a major earthquake hazard that comes from the New Madrid Earthquake zone in the central U.S. Since there is no clear scientific consensus on the return period for this earthquake zone, any 1-in-200 risk metric is not subject to reliable quantification.

***Q11. What are your views on the development of the supervisory capital adequacy assessment process as proposed in paragraph 38?***

***Should there be additional elements?***

Yes, we believe this should be considered an illustrative list, rather than a complete list. For example, the performance of general-purpose financial statements also should be considered, as these are often the driver and evaluator of management performance.

***What are your views on whether the capital adequacy assessment process to be developed in parallel with the ICS should be:***

- ***One where clear enforceable supervisory actions are set out in that process which would provide some certainty regarding supervisory actions that can be expected if the ICS is breached; or***
- ***One with a more flexible approach where possible supervisory actions are articulated but application of those actions is subject to supervisors taking into account the specific circumstances of the IAIG if the ICS is breached?***

In theory, we prefer the first alternative since it enhances uniformity across jurisdictions and provides support to the regulator if the action is challenged. However, the higher the risk metric target and the more simple/broad-based the ICS approach, the more flexibility is needed to address the inevitable false-positives.

We appreciate the opportunity to submit these comments for your consideration. If you have any questions or would like to discuss these comments sooner, please contact Heather Jerbi, the Academy's assistant director of public policy at 202.785.7869 or jerbi@actuary.org.

Sincerely,

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