AMERICAN ACADEMY of ACTUARIES

January 5, 2007

International Association of Insurance Supervisors
Via email to: karen.doran@bis.org
CC: rob.curtis@fsa.gov.uk

RE: American Academy of Actuaries comments on the IAIS *Common Structure for the Assessment of Insurer Solvency*

To the International Association of Insurance Supervisors,

The American Academy of Actuaries[1] Risk Management and Solvency Committee has completed a review of the December 4 draft of the IAIS *Common Structure Paper for the Assessment of Insurer Solvency* and prepared the attached comments.

We believe the current draft has significantly improved from the last document. The Risk Management and Solvency Committee members appreciate the opportunity to review this IAIS paper and provide comments to the IAIS. Should you have any questions or need further information on our comments, please feel free to contact us through Tina Getachew at getachew@actuary.org or at (202) 223-8196.

Sincerely,

James E. Rech
Chairperson,
Risk Management and Solvency Committee
American Academy of Actuaries

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

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Members and Observers Comments on IAIS Draft Paper
The IAIS Common Structure for the Assessment of Insurer Solvency
(Comments due by 5 January 2007)

American Academy of Actuaries' Comments

Name	Paragraph reference	Comment[1]	Resolution
American Academy of Actuaries (AAA)	18	Suggest inserting in "…raison d´être of insurance is the assumption <u>pooling</u> and spreading of risk…" "Pooling" could also be added although it is not as critical as "spreading" of risk.	
AAA	18, Footnote 6	It should be clarified that underwriting risk includes unpaid claim liability estimation risk. The attached footnote is not clear enough on this issue. In the footnote, suggest inserting "…also including claim <u>liability estimation</u> and expense risks."	
AAA	20	In the fifth sentence, "…its exposure risk as far as <u>practicable</u> into quantitative measures…", suggest changing "possible" to "practicable" if "possible" would ignore resource costs or reliability.	
AAA	20	In the fifth sentence, "…economic capital it finds <u>most appropriate</u> from its risk management perspective." Suggest changing "optimal" to "most appropriate" because some interpret "optimal" as indicating that a single solution exists. In reality, no single best solution exists, although certain considerations need to be addressed by whatever the final choice is for the situation.	
AAA	20	Suggest inserting in "these aims require prudent levels of total financial resources <u>to be held by insurers</u> and this in turn..."	
AAA	29	…." to prepare an adequate risk analysis <u>and consider premium, technical provisions and capital requirements</u>" Why should one consider capital requirements before entering into a facultative ceded reinsurance contract? A risk analysis should take place, but the extent should vary based on the materiality. Taken to the extreme, these words could imply that extensive efforts and documentation should take place before any (re)insurance transaction. We would recommend deleting the phrase underlined above.	
AAA	32, Insert footnote 12	Suggest the addition of the footnote to "average claim amount declines as the block of independent[12]…" Independence is critical to this feature. For example, insuring more properties in the same geographical area will not result in lower volatility with regard to major natural disasters, as adjacent properties are not "independent" as to such risk.	

[1] Please provide comments of a more critical nature on content, together with alternate drafting suggestions on this template, comments of an editorial nature should be provided on the first template.

AAA	3.15 Valuation and Market Consistency Cornerstone IV and 41 and 42	Further, we do not see how the current document is "an extension of, but fully consistent with, the total balance sheet concept as adopted by the IAA." The TBS approach should be an economic valuation – economic valuations are rarely equal to an observed market valuation. For example, the market introduces speculators into the pricing function and as such the price for "growth" companies will not be at the economic valuation based on an analysis of their current cash flows. Enterprise risk management is complemented under a TBS approach. Under both, solvency is dependent upon the unique risks retained within the insurer's portfolio. The technical reserves developed under marked-to-model methodologies, even using parameters consistent with market assessments, where appropriate, will not produce market valuations. It produces an economic valuation. We must always remember that insurance liabilities are more similar to "forwards" (non-standard) than "futures" (standardized) contracts; by this we mean that for insurance products, heterogeneity can dominate over homogeneity among terms, conditions, and critical cost drivers.	
AAA	41	US actuaries involved in valuing insurance liabilities, particularly those practicing in the non-life area, may find this paragraph confusing as it is unclear whether it is suggesting a change in current practice. Currently, non-life actuaries use company specific data, to the extent it is credible, as the starting point for valuing liabilities. Moreover, when actuaries use market information to supplement company data, they are expected to justify the appropriateness of that data for valuing the company specific portfolio at hand. This paragraph seems to suggest the opposite i.e. use market information as the starting point and use company information to supplement it to the extent that you can justify it. Therefore, we suggest adding on the following sentence to the end of paragraph 41. Indeed, where financial markets provide only limited information useful for valuing insurance technical risks, the solvency regime should recognize that company-specific data may provide the most relevant information for making an economic valuation of a specific portfolio.	
	43	Is the last sentence of this paragraph applicable in practice as currently written? Suggest inserting the underlined: "... information is used <u>where applicable in the model</u> to arrive at an <u>estimated</u> value for the obligations which <u>may be viewed as</u> consistent with the market price of financial assets..."	
	Structure Element #6, 48, and 49	A company's claims settlement practices can influence the value of their insurance liabilities and it is thus common practice for US actuaries, particularly those practicing in the non-life area, to reflect this in their valuations. These practices are generally considered to be a characteristic of the insurer holding the portfolio and may or may not be indicative of general market claim settlement practice. Assuming the paper is not suggesting a change in current practice, we suggest that "indicative of general market practice" be deleted from Structure Element 6 and paragraph 49. Further, we suggest that paragraph 49 be re-written as follows: ***However, it is important to note that in practice aspects of the insurer's specific business model and practices, for example with regard to property and casualty claim handling, can impact the value of their technical liabilities. Such specific characteristics should be taken into account when determining market consistent values for such obligations.***	

	48	Since insurance reserves are rarely traded, there is not an efficient market for such liability transfers. To develop such a market, insurance securitization approaches would need to be developed and expanded. The structures paper simply advocates traditional regulatory approaches to building additional conservatism (the risk loads for uncertainty) into an insurer's technical reserve provisions. It will not reduce or eliminate financial arbitrage (see paragraph 48).	
	51	Premiums differ for participating (par) and non-participating (non-par) life insurance. The non-par premiums for par insurance are established to be appropriate under most, but not all, likely adverse events, with dividends adjusting the cost to reflect current experience. Non-par premiums are established as a guaranteed cost to policyholders--nothing changes after issue. These fundamental differences are not covered in the current comments.	
	53	Since capital needs focus on events in the tail that are very unlikely, these comments seem to be appropriate for the technical provisions; not for capital events in the tail, as they are unlikely to vary with the change in current experience. It seems unlikely that current experience for possible events in the tail is likely to change much in the tail modelling.	
	Structure Element 7	We understand that the balance sheet is the regulator's financial valuation concern. Hence, the TBS approach. However under the TBS approach, the risk management of the carrier is based on the assets, current liabilities and minimum capital of the insurer. Why confuse the approach in this paper with a definition of technical reserves that introduce parameter (uncertainty) risk, but still are representative of economic values, not a market value that could be realistically be expected to be paid to a market participant to take over the obligations?	
	90	…. "´fit and proper´ standards"… What regulators can enforce and a board of directors is legally required to do varies across government entities, US and abroad. Therefore the term "fit and proper" should be further explained.	
	103	What policyholder expectations are included in these comments? If they include dividends on par policies one would hope the only expectation would be that they reflect the current emerging experience. These comments do not apply to policyholder dividends or make it clear that for dividends expectations are tied to emerging future experience of the company.	