AMERICAN ACADEMY *of* ACTUARIES

MEMORANDUM

To: Barbara Lautzenheiser

President – American Academy of Actuaries

From: Jim Reiskytl

Chairperson – Risk Management & Solvency Committee

Subject: Proposed comments on IAA comment letter regarding IAIS "Draft Supervisory Standard on Suitable Forms of Capital"

Date: 7/1/2004

Dear Barbara:

As you know, the Academy must vote by July 8 on the International Actuarial Association's comment letter on the International Association of Insurance Supervisors' (IAIS) "Draft Supervisory Standard on Suitable Forms of Capital." We understand that the IAIS draft may change considerably following the recent IAIS meeting in Oslo, Norway, but the Academy must work with the current IAA response regardless of any forthcoming changes. The Risk Management & Solvency Committee has reviewed the IAA comment letter, and we recommend that the Academy vote in opposition of the letter. We cannot recommend supporting the letter because of the large number of revisions and corrections that we would consider mandatory to accepting it as an accurate critique of the IAIS draft. However, we feel there is value in sharing the following comments with the IAA so that we can illustrate the reasoning behind our stance:

<u>General Comments</u>

We believe the March 12 draft of the IAIS paper is generally well written. However, the draft's intent may be further clarified to identify suitable **forms** of capital. Capital is defined as "...assets in excess of those needed to satisfy the insurer's liabilities," so presumably defining suitable forms of assets defines suitable forms of capital. Also, it appears the terms "forms" of capital and "sources" of capital are used interchangeably.

We agree with the IAA comments on the importance of the time horizon. We also feel the comment referencing Paragraph 30 of the draft is a needed improvement. However, it is unclear to us if the other comments improve the draft. In some cases the comments seem to be incomplete, inaccurate, or reflect a misinterpretation of what we feel is the author's intent within the IAIS draft. In other instances the comments are correct but seem inconsistent, in our opinion, with the stated objectives.

Below are specific comments to further address our reasoning for not supporting the comment letter:

Introductory Paragraph

We suggest deleting the proposed introductory paragraph because we feel the IAIS paper does a reasonable job of introducing the scope, as we understand it. Given that scope, we also feel the definitions of capital within the IAIS paper are appropriate and more accurate than the definitions within the IAA's proposed paragraph. We think the IAIS document makes it clear that they are dealing with the sources or forms of capital and do not intend to quantify the levels of capital. Pointing out differences in various standards, such as economic, accounting, and regulatory capital, seems to focus on differences in amounts that are purposely excluded by the drafters. Are there other differences in form or sources of capital among these definitions? These terms are also not defined in the IAA comments. We also believe the third sentence, beginning "Thus economic capital…", refers to regulatory capital, not economic capital. There are other changes we would suggest if it were to be included, but we ultimately feel this comment is better removed than improved.

Paragraph 5

- If the introductory paragraph is deleted, this comment is no longer needed.

Paragraph 10

- This comment may not be necessary, but if retained, we would recommend the following modified language: "…investor equity, many **publicly traded stock** insurers aim to maintain capital **so as** to maximize return on equity."

Paragraph 13

- We disagree with the comment and feel the IAIS draft makes the point well. We think the second sentence of the IAIS draft is clear. There are certain comments in the IAIS draft related to the level of potential capital in the event of wind-up events, such as subordinated debt and the priority of policyholder claims. While accurate, these comments are not relevant to the IAIS' stated foundation of regulatory capital as being related to a going concern foundation.
- As to the IAA suggestion, we believe regulatory capital is generally based on a going concern until the company becomes weakly capitalized. At this point, the supervisor must become increasingly aware of the significant changes in capital that can occur in a run-off scenario. There are certain comments in the IAIS draft related to the level of potential capital in the event of wind-up events, such as subordinated debt and the priority of policyholder claims.

Paragraph 15

- It is not clear to us what the "relative strength of methods and assumptions" in the IAA comment means. We also think the IAA comment is incomplete. It does have the potential to affect results but this will not occur if the capital requirements reflect these differences (this needs to be clarified).

- There appears to be typo in the first sentence of the proposed language. The word “different” should be replaced with “difference.”

Total Balance Sheet section

- The comments here seem to support our previous point that one must reflect differences in asset liability assumptions in determining capital requirements. We feel the last sentence is too limited. We would prefer modifying the paragraph to read “…of its total balanced sheet on an integrated basis under a system that is consistently determined.” Delete the rest of the original paragraph from that point on. This would allow many systems to be used – it achieves a common definition of total capital as long as the latter is clearly defined (such as a 95% standard or 90% CTE standard).

Reinsurance section

We feel this comment is unnecessary because for the purposes of this paper, differentiating between insurance and reinsurance is inappropriate as to the forms or sources of capital. We would also note that arbitrage occurs when a set of cash flows have different prices in different markets. Arbitrage opportunities arise from economic and tax conditions, not because of accounting standards.

Based on the above concerns, we recommend the Academy vote in opposition of the IAA comment letter. We would also ask that these comments be forwarded directly to Stuart Wason, Chairperson of the IAA’s Solvency Subcommittee, to share the reasoning behind our opposition to the letter. The Risk Management & Solvency Committee appreciates the opportunity to aid in the Academy voting process, and we hope our comments have been helpful.

Sincerely,

Jim Reiskytl

Jim Reiskytl
Chairperson, Risk Management & Solvency Committee
American Academy of Actuaries