January 16, 2014

Dave Sandberg, Chair
Insurance Regulation Committee
International Association of Actuaries

Re: Comments on *Basic Capital Requirements (BCR) for Global Systemically Important Insurers (G-SIIs)*

On behalf of the American Academy of Actuaries'[1] Solvency Committee, I appreciate this opportunity to provide comments on the International Association of Insurance Supervisors' consultation document regarding the Basic Capital Requirements (BCR) for Global Systemically Important Insurers (G-SIIs).

Sincerely,

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Chairperson, Solvency Committee
American Academy of Actuaries

[1] The American Academy of Actuaries is 17,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policy-makers on all levels by providing leadership, objective expertise and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice and professionalism standards for actuaries in the United States.

Paragraph Reference	BCR text	Academy comments
General	BCR for Global Systemically Important Insurers (G-SIIs)	The BCR is designed for a very specific purpose—to regulate a limited number of G-SIIs—but the committee is concerned that the proposal may be applied more generally. The IAIS should make it clear that the BCR proposal is designed only for G-SIIs. The BCR can inform the development of the global insurance capital standard (ICS), but it should not become the ICS. The BCR is a basic approach and may not be appropriately risk-sensitive for a larger group of entities and for the expected limited number of internationally active insurance groups (IAIGs) under ComFrame. Given the approach underlying the BCR, we also suggest considering serious consideration of other more risk-sensitive approaches and methodologies to develop the ICS. Furthermore, the BCR would not be appropriate for consideration as a capital standard for locally-licensed insurance entities, primarily because the BCR as proposed may not be sufficiently risk sensitive to meet the expectations of the insurance core principles. As such, the BCR would not have relevance outside the intended nine G-SIIs. Also, recognizing that the BCR is designed for the current nine G-SIIs only, if any new G-SIIs are designated, the BCR would need to be re-evaluated to ensure it meets the objectives for the new group of G-SIIs. Finally, as suggested in paragraph 12 of the consultation draft, we concur that once the ICS is developed, the role of the BCR should be reassessed.
General	Calibration	The document does not include a discussion about calibration of BCR. For example, will it be intended to cover a 1-in-100-years event over the course of a year or some other threshold? A simple factor approach (as proposed for the BCR) would not be a precise measure of solvency. As such, it may generate a high level of false positives if calibrated to a stringent capital standard. The calibration or safety level chosen should include consideration of this risk of false positives versus false negatives. A false positive means capital would appear deficient when a more risk-focused approach might suggest capital is sufficient.
10	"The lack of comparability of insurance liabilities between different jurisdictions is a major issue..."	This may not be an issue for property/casualty claim liabilities because nearly all jurisdictions currently require the use or disclosure of undiscounted claim liability estimates without risk margin. The larger issue for such liabilities is the relative reliability (e.g., different optimism and different assumptions) of such estimates among companies, not the accounting basis.

13, 22, 82, 91 and 113	Required capital is the sum of four risk measures	This lack of covariance or risk diversification impacts increases the risk of false positives and may result in companies employing lower-risk activities than otherwise would be economically warranted to avoid such false positives. Not all risks are highly (or at all) correlated with overall financial market risk (e.g., natural catastrophe risk and many other non-financial hazard risks). Mere summing of individual risks assumes perfect correlation of all risks with financial market risk. The formula as written disregards interactions between risk measures. As such, we suggest including an adjustment to recognize that claims and financial risks are not correlated.
14, 50 (principle 2) and 57	"comparability of outcomes across jurisdictions"	The decision to not use local jurisdictional capital requirements implies that a risk measure means the same thing across jurisdictions, which is not the case with regard to many non-life non-financial hazard risks. For example, the risks associated with motor insurance in Mexico with national health care are very different from the risks associated with motor insurance in the U.S. without national health care. Similarly, the risk from commercial property business written on the coast of Australia may not be "comparable" to commercial property business written in an inland location like the U.S. Midwest. As such, comparability may not be directly achievable in the manner envisioned in this paper for non-life non-financial risk. This could be mitigated by choosing the proper driver thus reflecting such differences. This is an issue for groups in which financial market risk may not be material.
17 and 6th bullet of 105	"Current estimates are the proposed proxy measure for insurance liabilities" whereby these are defined as the expected present value without risk margin	While such estimates are not currently readily available for property/casualty claim liabilities in many jurisdictions, most if not all G-SIIs and IAIGs will have to do this calculation for much of their business for the purposes of IFRS and Solvency II. However, some companies may not have such estimates and will have undiscounted central estimates. As such, a more achievable measure would be undiscounted central estimates currently recorded or disclosed in nearly all jurisdictions for non-life.
18 and 87	"...operational and liquidity risk, will require future consideration, but that work is beyond the scope of the	Both operational and liquidity risks can be material. Operational risk at large organizations, such as G-SIIs, may be difficult to quantify and control. There are factor-based approaches developed in certain solvency jurisdictions and they could be used as a starting point for a more focused identification of these risks. Alternatively, consideration for operational risk could be built into other factors that will be applied. A case could be made that the lack of diversification and the non-use of covariance compensate for this.

	BCR."	
20	"A sole focus on capital requirements does not provide a full picture when assessing the financial condition of G-SIIs."	This proposal would not present a full picture to assess the financial condition of G-SIIs. Rather, it seems to overstate the importance of capital when evaluating financial condition. In general, external rating agencies (and analysis of past insolvencies) place the greatest emphasis on the quality of management and the quality of earnings, with lower emphasis placed on capital ratios. Hence, this project may be over-emphasizing capital ratios.
21	"This can be expressed in terms of a ratio, which provides a metric that is comparable between G-SIIs."	The focus should be the identification of G-SIIs that are in vulnerable financial condition, rather than the comparison or ranking of strong G-SIIs. A focus on comparing strong G-SIIs is a different goal than the identification of weak G-SIIs and may lead to a different BCR.
27	Non-traditional and non - insurance (NTNI) risks	This discussion is largely silent on non-insurance, non-financial risks. If it is material for G-SIIs then this appears to be a gap in the proposal with no guidance suggested. (Paragraph 65 specifically mentions "non-insurance non-financial entities," but provides no guidance.)
30	"It is desirable to have 10 or less factors used…"	This threshold may be too low. To gain accuracy, the IAIS should increase this level due to the complexity of local cultures, products, and risk environments in the many subsidiaries of the IAIGs.
31	"...apply pre-calibrated factors from other already established solvency and capital frameworks,	It is not clear why the pre-calibrated factors from the U.S. NAIC RBC formulas were not included here. That delineation is factor based and allows for more granularity than Solvency I, which the committee opposes given its lack of risk sensitivity.

	such as Solvency I and Basel III…"	
37	"selected expert input sought as and when deemed appropriate by the IAIS"	There is risk associated with a closed process and the use of selected experts, especially in cases in which there are multiple views among experts from multiple areas and/or scopes of expertise. This concern is best addressed via an open process. The committee urges that this part of the process be open and allow for various viewpoints to be heard.
38	"Decide in 2014 whether the BCR will also apply to IAIGs and, if so, when"	A goal of establishing whether insurers that create systemic risk to global financial systems seems to be very different from identifying whether an IAIG exposes the world to systemic risk, because many IAIGs may not create material risk to financial systems due to an entirely different set of risk exposures. In particular, some IAIGs will be largely or wholly non-life insurers, with little if any exposure to financial risks or impact on the global financial system. As such, it may not be prudent to extend a tool for G-SIIs to all IAIGs, especially given the limited timeframe.
45	"The BCR is intended to provide a more comparable foundation for the HLA than local capital requirements…"	This implies that the risks being faced are comparable across jurisdictions, which is more probable for financial risks than non-financial and specific product risks. Otherwise, the committee would suggest using local capital requirements as the base due to the greater capability of leveraging local analyses of local non-financial and product risks. It may be more likely that the major risks are comparable across jurisdictions for G-SIIs than for IAIGs.
47	"The BCR will be developed with the goal that G-SII's continue as 'going concerns.' "	Most regulatory capital work has focused on minimum capital levels. The regulators should be expecting much higher needed capital should the focus remain on being a "going concern." The capital the BCR is utilizing going concern capital is not revealed until paragraph 47 and should be addressed earlier in the document.

47	"The BCR will be developed with the goal that G-SII's continue as 'going concerns.' "	It is not clear what this means given that nearly all capital requirements focus on being able to meet policyholder claims, not on survival after a critical event. This may lead to a high BCR level from the "simple" formula, which could lead to a high level of false positives. The committee suggests that this goal is best handled by other aspects of G-SII supervision rather than the BCR. (In general, simple formulas result in higher levels of false positives, and a high standard from a simple formula will result in high levels of false positives. This could lead to market disruptions).
48	"...the starting point is the consolidated group balance sheet."	This assumes fungibility of capital, which does not currently exist across jurisdictions or in some jurisdictions across sector boundaries.
49	"The BCR should only reflect the aspects of NTNI risks that impact on the group's insurance operations."	If the IAIG designates supporting capital and holds capital at the parent level for its subsidiaries' possible use, then all non-traditional, non-insurance (NTNI) activities would impact the group's insurance operations as this capital could be used to support NTNI needs.
50, BCR Principle 4	"The form of presentation of the BCR… should be simple… yet sufficiently granular for the results to be fit…"	This is a laudable objective but having dual, equal targets of accuracy and simplicity will be a challenge to achieve. (Note: IAIS seems to address this in paragraphs 51, 52, 54, 58 and 59).

53	"There is a need to ensure, in the development of capital requirements and measures for G-SIIs, that opportunities for regulatory arbitrage between the banking and insurance sectors are not increased."	The committee agrees that this is an issue for G-SIIs. The committee notes that this does not necessarily remain a concern regarding IAIGs. While many G-SIIs' activities may overlap with banking activities, there can be many IAIGs with little to no overlap.
65	"...non-material non-financial activities should be excluded from the BCR where appropriate"	What should the insurance company do when numerous non-material activities, in aggregate, represent a material risk?
68	"Field testing will gather data on valuation approaches in two key alternative ways:" GAAP and economic capital	While most G-SIIs will have GAAP financial statements, some IAIGs will not have such statements. As such, this approach may be useful for IAIGs. This should be recognized at the beginning of the document.
69	"...certain components of the balance	"Market-based" was not in the glossary. What exactly is meant by "market-based"?

	sheet… will be… market-based…"	
69,71 and 73	market-based valuation and "current estimate" (i.e., a present value basis)	This basis is not simple and not readily available for non-life claim liabilities. The committee suggests using undiscounted central estimates for these liabilities; as such amounts are reported or disclosed for nearly all jurisdictions.
71 and 75	"Technical provisions are … the main source of the lack of comparability of balance sheets among insurance groups."	While generally true, especially for life companies, this is less true with regard to non-life financial statements. The committee suggests the use of the readily comparable and available claim liability estimates on an undiscounted basis. Besides being readily available, such estimates implicitly include risk margins that are correlated with the length of the settlement tail, which usually implies the need for a higher-risk margin.
73	"The current estimate reflects the expected present value of all relevant future cash flows…"	In order to ensure comparability, the IAIS will need to be more explicit on the level of expenses it expects to employ, focusing on direct versus indirect and then again in wind-up versus going concern.
76	"It is the understanding of the IAIS that for most G-SIIs the computation of current estimate liability	For non-life companies, it is not currently common practice to report discounted claim liabilities unless or until they are reporting under Solvency II. It is also not the case for certain liabilities of life insurers reporting under U.S. GAAP or Stat or in Asia. Whether this will continue to be the case depends on the results of the current discussion at the IASB and FASB. In any event, it is likely there will be some companies that do not have this information readily available.

	valuations, for a variety of purposes, is common practice."	
83	rejecting of basing ICS on "existing local capital requirements"	If the ICS is to keep a focus solely on asset risks then this decision may be appropriate, but if the scope will include non-financial and insurance product risks then this decision should be reconsidered. The reason is that the IAIS does not have the resources to evaluate product and non-financial hazard risks for all the jurisdictions that exist among IAIS members, and these risks can differ significantly across jurisdictions. As such, a strategy focused on the asset risks that justify a G-SII designation will likely not transfer to a useful ICS for IAIGs. The best strategy for the IAIS to develop an ICS that sufficiently addresses local differences in non-financial and product risk is to leverage local expertise embedded in local capital requirements.
100	insurance liability risks	The committee recommends treating pre- and post-claim event liabilities differently in this risk assessment. The pre-event risk includes event risk, underwriting risk, and pricing risk. The post-event risks involve mostly estimation risk, but for claim liabilities with a longer settlement lag the post-event claim liability ends up with a high concentration of the more problematic claim liabilities (more so than the pre-claim liability). The easier to settle claims are normally settled faster, so the claim liability at any point in time tends to include many policy years of claim tails.
102	NTNI risks	For non-financial subsidiaries in this category, it will be a challenge to derive factors.
102	NTNI risks - no mention of non-insurance, non-financial here	There may be some non-insurance risks that are not covered by existing financial sector capital requirements (e.g., aircraft leasing businesses).
105 (last bullet) and 112	This ratio provides a metric that is comparable between entities.	Two insurers with the same ratio of held capital to required capital may have different financial strength; as such, the metric may not be useful for comparisons. The reason is that the risk of events larger than the required capital is a function of the various risks faced. One insurer may not have much risk of events beyond the required capital amount, while another may have great risk of events beyond the required capital amount. The committee is concerned that this statement focuses on the percentile and not the tail beyond a given percentile.
110	desirable to have 10 or less factors	This decision makes it less likely that the result will be useful for application to IAIGs, due to the greater diversity in risks for IAIGs versus G-SIIs.

116-123	Field testing process	The committee suggests including a team of contributors that can simulate the historical results of a known failure of an IAIG or G-SII. This would provide an illustration of the viability of the BCR's ability to indicate a pending failure.
125	March to May 2014 - field testing	Efforts should be made to avoid overlap of the testing with the close of financial results (for a fiscal year or quarter).