



AMERICAN ACADEMY *of* ACTUARIES

August 4, 2014

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

Re: Comments on the IAIS Public Consultation Document on the Basic Capital Requirements for Global Systemically Important Insurers

On behalf of the American Academy of Actuaries'¹ Solvency Committee, I appreciate this opportunity to provide the attached comments on the International Association of Insurance Supervisors' second public consultation document regarding the proposed Basic Capital Requirements for Global Systemically Important Insurers. The Academy will also be sending a copy of these comments to the National Association of Insurance Commissioners.

If you have any questions or would like to discuss these comments further, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Elizabeth K. Brill, MAAA, FSA
Chairperson, Solvency Committee
American Academy of Actuaries

¹ The American Academy of Actuaries is 18,000-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.

American Academy of Actuaries' Solvency Committee

Comments on July 9, 2014 IAIS Consultation Draft on the Basic Capital Requirements for Global Systemically Important Insurers

Item	Paragraph Reference	Comment	Alternative Approach	
1	General	<p>The consultation draft indicates that a Market Adjusted Valuation Approach will be taken to develop the balance sheet.</p>	<p>A market-based approach would not be appropriate for many insurance products—such as long term life and annuity products—and could have adverse consequences for insurers in many jurisdictions, including the U.S.</p> <p>Fundamentally, both market value and amortized cost approaches are well suited to certain products and environments, but not in others. For long-duration, illiquid insurance, a market value approach does not work. Evidence of this can be seen in the history of U.S. insurance accounting. Prior to the great depression, the U.S. used a market-based approach to valuing life insurance. However, during the Great Depression regulators decided market-based valuation requirements should not apply to insurers with illiquid liabilities, which allowed insurers to continue to invest in the economy and stabilize markets.</p>	<p>An approach that either allows long-duration, illiquid products to be valued on an amortized cost basis or an approach that does not rely on a balance sheet valuation is necessary for an effective capital requirement.</p>
2	General	<p>The draft does not reflect all major risk factors.</p>	<p>There does not appear to be any charge for catastrophic risk.</p>	<p>Add a charge for catastrophic risk.</p>

Item	Paragraph Reference	Reference	Comment	Alternative Approach
3	General	Field testing captures a point-in-time state.	Volatility is not captured when examining a static state and can only be captured when examining several points in time, with particular need for stressed periods.	Field testing should look at multiple points in time and real stresses—such as the 2008 financial crisis—with regard to asset risk, several underwriting cycles with regard to property/casualty pricing risk, and years with large natural disasters—like Hurricane Sandy in 2012—with regard to catastrophe risk.
4	1.1, par 2 Annex C, par 44	<p>The development of the international capital standards (ICS) will be informed by the work on the basic capital requirements (BCR).</p> <p>The initial approach for BCR does not pre-empt future development of alternative approaches to discounting.</p>	<p>The consultation document clearly states that the development of the ICS will be informed by the BCR and implies (via the reference in Annex C to alternative discounting approaches) that future work also will use a current estimate approach.</p> <p>The current estimate/factor-based approach to the BCR should not form the basis of the ICS. For the reasons described in Item 1 above, the current factor-based approach is not effective and does not appropriately reflect local differences. In addition, the focus on Global Systemically Important Insurers (G-SIIs) has not allowed for sufficient investigation of risks in areas other than life insurance, including health and property and casualty (P&C). Such risks generally are not a concern for the G-SIIs, which are the focus of the BCR.</p>	<p>In connection with the ICS, the International Association of Insurance Supervisors (IAIS) should evaluate methods of assessing capital adequacy that do not rely on a balance sheet valuation. There are two approaches that have been discussed—using internal models and leveraging local requirements. Stress testing is a prime example of an approach that uses internal models rather than relying on a balance sheet valuation. 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 group might come under stress and potentially be unable to meet its obligations.</p> <p>We suspect that some combination of local requirements and models using internal risk exposure data will be required to sufficiently reflect local differences in risk.</p>

Item	Paragraph Reference		Comment	Alternative Approach
5	2.2.2, par 20	The calculation of current estimates requires taking the present value of all relevant future cash flows.	Since cash flows must be calculated anyway, we question why it is necessary to then overlay an accounting basis in determining the BCR.	Take a more streamlined, straightforward, and comparable approach by stress testing the cash flows directly rather than creating a market-adjusted balance sheet and then stress testing. (Note that simpler approaches may be sufficient for shorter tail lines for which the timing of the flows has less of an economic impact. In such cases, stress testing the nominal amounts may be sufficient.)
6	2.2.4, par 24	The calibration level of the BCR will account implicitly for some degree of diversification.	This implicit reflection of diversification by adjusting the factors creates an unlevel playing field. It reduces the otherwise calculated factors for all companies rather than directing the credit to those that achieved the diversification. Hence, those companies with no or less diversification gain a benefit at the expense of those with higher levels of diversification.	If the desire is to keep the overall formula simple, then use a simple formulaic way of reflecting diversification, such as through a simple square root of the sum of the squares covariance formula.
7	2.2.5, par 25	The calibration level of the BCR will account implicitly for the absence of an assets and liability management (ALM) factor.	Similar to the diversification argument for paragraph 24, this implicit approach creates an unlevel playing field by reducing the charge for those with ALM risk and overstating the charge for those without this risk.	Investigate simple ways to reflect ALM risk, at a minimum, in order to create appropriate incentives.
8	3.4, par 36	BCR segment: "Annuities"	Are these deferred or income-paying? Deferred and income-paying annuities have entirely different risk profiles.	Add clarification.

Item	Paragraph Reference		Comment	Alternative Approach
9	3.4, par 36	Proxy measure for risk exposure: current estimate for non-life non-property	It is not clear if this is meant to be a value net or gross of reinsurance. Subsequent discussion of “current estimate” versus reinsurance recoverable implies that “current estimate” is gross of reinsurance, yet the charges in the same paragraph for reinsurance recoverables imply low collection risk, and the proxy for property risk is a value net of reinsurance.	Clarify that the proxy measure for non-property, non-life is current estimates net of reinsurance.
10	3.4, par 36	The risk factor applied to “other non-traditional” current estimates is 1.29 percent. This compares to the lowest risk factor applied to traditional non-life current estimates of 6.25 percent.	The use of a lower risk factor for “other non-traditional” P&C lines than for “traditional” P&C lines implies that non-traditional risks are not a risk issue for the BCR. Additionally, this creates an incentive to call everything “non-traditional” for a P&C company.	If the “other” non-traditional lines for non-life receive a lower risk charge than traditional lines, then the non-traditional/traditional distinction should be eliminated for non-life.
11	4, par 46	Capital resources are determined on a consolidated basis.	There is no discussion regarding transferring needed capital across jurisdictions.	Add a sentence that states fungibility is not addressed by this document.
12	5.1, par 60	Key difference between the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP) is margin over current estimate (MOCE).	This statement ignores that the differences in discount rates are significant for U.S. GAAP reporters.	Add a sentence noting the importance of discount rates for life/annuity insurance.

Item	Paragraph Reference		Comment	Alternative Approach
13	Annex C	Length and prescriptive level of the guidance.	The length and prescriptive nature of this Annex appears to create both a separate accounting standard and new actuarial guidance. We have significant concerns with creating a new accounting standard and creating such detailed actuarial guidance in a “principle-based” framework. In particular, the extent to which this would be applied (given the low number and geographic spread of G-SIIs) is unlikely to result in a level of “generally acceptable” and common practice in application.	It is better to leverage existing accounting frameworks or use an approach that does not rely on a balance sheet valuation, and provide the general objectives for the actuarial estimates, rather than providing prescriptive statements on estimation methodology.
14	Annex C, par 25	Discounting... occurs with a yield curve relevant to the particular currency.	Both Greece and Germany use the same currency, but it does not make sense that they would use the same discount rates.	Add “and jurisdiction” to the sentence in question.
15	Annex C, par 49	Only 40 percent of the actual corporate bond spread is used for the adjustment.	This seems like it is adding a MOCE to the current estimate. If the investments are at market, they will already reflect credit-worthiness.	

Item	Paragraph Reference	Reference	Comment	Alternative Approach
16	Annex D, par 3	Financial instruments will be classified as Core Capital only if they do not have a fixed maturity and have distributions that can be cancelled.	Will surplus notes be classified as Core Capital pursuant to Annex D, par 6? Will senior debt held at the insurance holding company be classified as Core Capital, if cash cannot be upstreamed from the operating company to the holding company to pay such debt without supervisory approval?	Specify that surplus notes (as well as debt at the holding company level) will be classified as Core Capital whenever regulatory approval is required to remove funds from insurance entities to pay such debt in a distressed situation.
	Annex D, par 6	Core Capital includes surplus funds and contributed surplus.	We believe that surplus notes (and proceeds from holding company debt contributed to the operating insurer) are categorized appropriately as surplus under the U.S. statutory accounting framework and believe they should be similarly classified as Core Capital for purposes of the BCR (and under ComFrame generally).	
17	Annex F, par 26	Net Amount at Risk (NAAR) is equal to sum of the insured minus current estimate, net of reinsurance recoverables.	All the current estimates are gross of reinsurance (page 25, par 10). Reinsurance recoverables are calculated and recognized separately. So, the preparer will have to pull out any protection reinsurance recoverables from this calculation. That may not be easily done.	Have NAAR be gross of reinsurance.