AMERICAN ACADEMY *of* ACTUARIES

Testimony Concerning Future of Financial Services Industry Oversight and Regulation

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Mr. Chairman and Members of the Committee:

Actuaries Can Help Solve Our Financial Crisis

What would be the consequences of packaging millions of risky mortgages into thousands of complex financial instruments and selling them to investors around the world for trillions of dollars?

It's the kind of question bankers and investors should have asked, but few did, and perhaps many didn't even know they should.

It's the kind of question actuaries ask, and one that actuaries' unique skills qualify them to answer. Actuaries pose similar questions about insurance products all the time and routinely answer them for major companies and government institutions around the world.

A model for managing financial risk

Managing risk to achieve financial security is, and has always been the keystone of the actuarial profession. Many private and government-run programs — such as insurance, pensions, and Social Security — operate based on actuarial principles.

An integral part of making these programs work and keeping them solvent is effective regulation. Much of that regulation has been developed and implemented with the guidance of actuaries, particularly the actuarial risk management tools and regulations that have protected much of the insurance industry.

While insurance regulations certainly have their own set of issues and critics, the fundamental elements of those regulations governing solvency and capital requirements are generally recognized as being effective. They protect the public from extensive failures through various preventive measures and through guarantee mechanisms that are designed to avoid or minimize government intervention.

Actuaries' experience with the designing of insurance and other financial protection systems, and with the regulations that both ensure their financial solvency and protect consumers, is invaluable in addressing the protections and safeguards appropriate for the capital markets.

Balancing government involvement and managing solvency risks

Shareholders, customers, and regulators expect understandable and transparent information about the risks financial institutions face and how they're managing those risks.

It’s not enough to address these risks one at a time, or in isolation. The key is to look at all the risks facing an institution – short-term and long-term – and see how they interact. The process of identifying, quantifying, mitigating, and managing risk, as well as identifying emerging risks that haven’t yet been considered, is called Enterprise Risk Management (ERM). Organizations with effective ERM processes are much better equipped to avoid, or mitigate, the impact of severe financial crises. ERM teams that include actuaries are even better equipped to identify and avert the kind of risks now crippling our economy.

Why? Because the involvement of actuaries in insurance solvency regulation, including risk-based capital requirements, has been instrumental in protecting most of the insurance industry from extensive failures.

There can still be risks to insurers from this current credit crisis, however. Credit default swaps, for example, were sold as a means to transfer default risk, similar to insurance, but were not protected under the insurance regulations that are designed to keep the majority of insurance companies solvent. Effective ERM processes and disclosures of these types of risks can provide some basis for confidence for insurers and the public, particularly where the insurance business has effective solvency regulation.

The actuarial profession – an experienced resource

Actuaries are subject to a formal code of professional conduct and are subject to disciplinary action if they violate that code. This commitment to professionalism, combined with the profession’s traditional experience with the long-term risks of the insurance business (and effective ways to regulate them), can be helpful in the current economic crisis. But it’s not the only thing actuaries bring to the table. Many actuaries also have significant training and experience in the financial markets.

The actuarial profession has many decades of experience in the research, development, implementation, and operation of effective risk models, with realistic representations of extreme scenarios, and deep understanding of the interaction of various kinds of risk. Robust actuarial involvement in ERM includes all major risk categories, such as credit, financial market, underwriting, operational, and strategic risks. Actuarial credentials have always included training across a broad cross section of risks, and continuing education programs in risk management topics are offered regularly.

Government officials, public policymakers, and lawmakers are trying to restore confidence in the financial markets affected by the sub-prime mortgage debacle and the resulting credit crunch. Actuaries have the knowledge, skills, and organizational support to provide significant, relevant, and important input and assistance. We look forward to working cooperatively with other professionals in finding secure long-term solutions to our current financial crisis.

The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers 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.

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