



# AMERICAN ACADEMY *of* ACTUARIES

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March 25, 2004

Mr. Stuart Wason  
Chairperson  
Insurer Solvency Assessment Working Party  
International Actuarial Association  
360 Albert  
Ottawa, Ontario  
Canada

Dear Mr. Wason:

The American Academy of Actuaries' Risk Management and Solvency Committee appreciates the opportunity to review and comment on the International Actuarial Association's (IAA) Insurer Solvency Assessment Working Party's report entitled "A Global Framework for Insurer Solvency Assessment." We commend the IAA on its commitment to developing a forward-looking global solvency assessment standard. We believe this draft, version 44, represents a substantial improvement over version 16, the draft report on which we previously offered comments.

The Academy Board of Directors has asked our committee to review the draft and offer our recommendation on voting to approve the document. This committee has also been encouraged to provide feedback directly to the IAA. The Risk Management and Solvency Committee recommended that the Academy approve the IAA's draft subject to the following two qualifications:

## Qualifications

1. For the property/casualty insurance industry, the 99<sup>th</sup> percentile placeholder is not an appropriate goal for claim reserves or for a 12-month-horizon capital standard as it may not be measurable, achievable, or represent an appropriate use of capital. The report should clearly identify that a lower level of confidence may need to serve as the basis for a regulatory capital standard for this industry segment.
2. We think that though the case studies within the appendices may not be appropriate for many products sold within the United States, they may be useful for products in other countries. As such, we believe the case studies should be clearly identified/qualified as being possible examples or illustrations. For example, each of the case studies is a hypothetical advanced model example of a possible application of this framework that was created to illustrate some of the concepts discussed in the report. The Life Insurance Company Case Study (Appendix

A) is described as an illustration of some of the concepts. The other studies in Appendices B & C also need appropriate qualification.

We do think, however, that the case studies serve as valuable points of reference for beginning a dialogue on the possible application of this framework. We would be happy to participate in such a dialogue in the future.

In addition to these qualifications, we offer several general comments:

### General Comments

We are in general agreement with many of the framework principles articulated in this paper, including the following: a three pillar approach for evaluating capital adequacy that places regulatory emphasis on “minimum capital” to identify weakly capitalized companies and “target capital” to allow certain companies the opportunity to take corrective measures; TVaR or some other specific universal standard measure of calculating capital requirements; and the desirability for converging to such an international standard measure for assessing total capital needs. We do, however, regard the framework as useful but theoretical and thus consider it a work in progress. We recognize that the framework may not be practical or plausible in every country and for every line of business.

The relative roles of regulators and company management in evaluating capital strength must be thoughtfully considered and generally defined. The framework identified within the report suggests a further blurring of these roles beyond that which currently exists in the United States. Clarification on the distinction between the regulators’ primary focus on minimum capital and the actions intended to prevent takeovers for weakly capitalized companies, and a company’s management responsibilities and decisions as to how much additional capital to hold, would enhance this framework with the “blurring” limited to those occurring between these two primary functions.

We recognize the value of solvency measures tailored to an individual entity for weakly capitalized companies as well as for certain selected risks such as variable annuity guarantees for all companies. Any expansion of such an approach may not be practical or necessary. If adopted, it would require a political commitment to support regulators with a qualified staff to evaluate individual approaches and assure that consistency among companies, and consistency at one company over several years, is retained. In addition to regulatory needs, many companies may not have, or need, the level of sophistication that this approach requires. Thus we question whether this should be a current goal; rather it may be a goal whose potential for improving the possible identity of weakly capitalized companies should be reexamined in the future.

Most U.S. insurers invest in rated securities. The credit risk measurement approach suggested within the framework would essentially replace the capital requirements already implied by the ratings assigned to these securities. It seems that this measurement approach is more appropriately applied to the credit risks associated with non-rated securities.

The report refers to an "optimal" approach to determining capital that is "most appropriate for that company" (Paragraph 4.30.) We do not believe sufficient research or consensus has been reached to describe any approach as optimal, and therefore while we agree with the qualifying

sentence within this paragraph that suggests the approach may require "a degree of technical sophistication that may be beyond many companies' abilities and resources..." we would suggest that the word "preferred" be substituted for the word "optimal."

Finally, we have the following specific comments:

- o "Absolute" language appears in several areas where we believe it is not intended. For example, Paragraph 6.76 seems to imply that a frequency/severity based calculation or possibly a projected loss ratio method "are the recommended" methods for estimating the expected loss in each LOB. The wording might be changed to state that, "The expected loss for each LOB might be calculated either by adopting a frequency-and severity-based calculation based on actual exposures or, if data adequate to support such a calculation is not available, by using a projected loss ratio applied to premium earned, or other methods as specified by the supervisor." Also, when referring to the amount of capital needed by companies to avoid failure (Paragraph 3.20), the report states that such failures "*cannot* be eliminated through a high capital requirement" when in fact they cannot be "practically" eliminated.
- o The report refers several times to the need to balance efficient use of capital and risk solvency requirements and refers to adequate returns on capital (e.g. Paragraph 3.5.) Clearly these concerns are to be considered in setting management goals, but the minimum regulatory portion of the framework should focus on the primary goal of providing protection to policyholders.
- o We recommend that Paragraph 2.30 in the executive summary be rewritten as follows: "Simple regulatory risk measures may be appropriate 1) to identify possible weakly capitalized companies; 2) to assess many risks where there is reasonable and sufficient data (such as credit risk for rated bonds;) 3) when there does not exist a generally accepted view of how the risk should be assessed; or 4) if the risk is of minor importance."
- o The indexing of the report as a whole seems confusing.

We intend to forward an addendum to this letter that contains a series of chapter-specific comments for your additional consideration. We appreciate the opportunity to participate in the review and approval of the IAA's report. If you have any questions or would like additional rationale regarding our comments, please feel free to contact me or Ethan Sonnichsen, the Academy's policy analyst for risk management and financial reporting, at (202) 785-7866. We look forward to continued dialogue on this very important issue.

Sincerely,



James F. Reiskytl  
Chairperson  
Risk Management and Solvency Committee  
American Academy of Actuaries