AMERICAN ACADEMY of ACTUARIES

January 28, 2014

Commissioner Michael F. Consedine, Chair
International Insurance Relations (G) Committee
National Association of Insurance Commissioners

Via email: Ryan Workman (rworkman@naic.org)

Dear Commissioner Consedine,

On behalf of the American Academy of Actuaries'[1] Solvency Committee, I appreciate this opportunity to provide comments to the National Association of Insurance Commissioners (NAIC) on its initial draft response to the International Association of Insurance Supervisors (IAIS) consultation document on the Basic Capital Requirement (BCR) for Global Systemically Important Insurers (G-SIIs). For convenience we have provided our comments in the attached document annotating the initial draft response prepared by the NAIC, although we have comments on only certain points in the initial draft.

Sincerely,

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

CC: Commissioner Kevin M. McCarty, Vice Chair
International Insurance Relations (G) Committee
National Association of Insurance Commissioners

Commissioner Thomas B. Leonardi, Immediate Past Chair
International Insurance Relations (G) Committee
National Association of Insurance Commissioners

[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.

NAIC Draft Comments on the IAIS BCR Consultation Paper

1. **Simplicity vs. Risk sensitivity for the BCR (various paragraphs including 16, 34, 88, 89, 98 and 110):**
   The tension between simplicity, comparability and risk sensitivity are mentioned a number of times in the paper. As a uniform base for HLA, the BCR should be skewed toward simplicity in its measurement of risk. Paragraph 110 expresses a desire for between 5 and 10 risk exposure proxies. Limiting the BCR to approximately 10 proxies seems reasonable if that level of granularity provides sensible results across all designated G-SIIs.

   Academy comments: The Basic Capital Requirement (BCR) should be focused on identifying Global Systemically Important Insurers (G-SIIs) that are in or heading toward a vulnerable financial condition, rather than comparing 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. A simple factor approach is not a precise measure of solvency and 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 a 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.

2. **Impact of Field Testing on Design of the BCR (Paragraph 17):**
   Paragraph 17 suggests that data drives the design (granularity) of the formula. However, given the short timeline to develop a BCR recommendation, it is necessary that the design of the BCR drives the organization of the data and that the IAIS should identify and articulate the design and granularity of the BCR before or during the data collection period, not after it.

   Academy comments: We suggest 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.

3. **Consolidated balance sheet as the starting point (Paragraphs 19, 48 and 49):**
   Given that financial risk in the banking segment of the group will be brought forward separately via use of a Basel III measurement (per paragraph 65), the paper should be clearer on how the use of the Basel III metric will impact calculation of a BCR that is based on a consolidated balance sheet. In addition, the extent and materiality threshold at which the BCR brings in non-financial (e.g. industrial risk) should be made more explicit.

   Academy comments: Also, it should be noted that while most G-SIIs will prepare GAAP financial statements, some IAIGs may not prepare such statements. As such, the economic capital approach may be useful for IAIGs and should be recognized when discussing the development of the consolidated balance sheet.

4. Role of BCR on its own or with HLA (Sections 2.3 / 5.5; Paragraphs 56 /57; and 38/126):

- Given that the consultation paper states in several places that the primary purpose of the BCR is as a uniform base upon which to apply HLA for G-SIIs, the examples shown in Section 2.3 and again in Section 5.5 should be modified to include HLA so as to adequately illustrate that the BCR will be calculated in conjunction with HLA for G-SIIs. In addition, paragraph 56 stating that the BCR is not expected to be breached infers that in the short run the BCR will have a limited role on its own. This combined with its primary purpose being to provide a comparable base for HLA uplift for G-SIIs would indicate that it is a capital standard only in combination with HLA.
- The 2nd bullet point in paragraphs 38 and 126 notes that a decision is pending on whether the BCR will apply to IAIGs. Since the goal is to have the ICS replace the BCR with the implementation of ComFrame, and the ICS will apply to all IAIGs including G-SIIs, the rationale for applying the BCR to IAIGs at this time is unclear.

Academy comments: We suggest that the IAIS make it clear that the BCR proposal is designed only for G-SIIs. The BCR is a basic approach and may not be sufficiently risk-sensitive for a larger group of entities. The BCR can inform the development of the Insurance Capital Standard (ICS), but it should not become the ICS. Given the simplified approach underlying the BCR, serious consideration should be given to more risk-sensitive approaches and methodologies in developing the ICS.

In addition, 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. Furthermore, the BCR would not be appropriate for consideration as a capital standard for locally-licensed insurance entities, because the BCR as proposed may not be sufficiently risk sensitive to meet the expectations of the insurance core principles.

5. Segmentation (Paragraphs 28/103; 27/102):

- Given the desired level of simplicity in the BCR, it is unlikely that asset / liability mismatch (ALM) can be more fully explored for the ICS.
- Separate proxy(ies) should be identified for systemic NTNI activities in the BCR in order to facilitate the calculation of HLA which is intended to address such activities.

6. **Paragraph 47**, referencing the BCR as a "going concern" standard should be deleted as extraneous, inconsistent with other aspects of the paper, and unclear in its meaning.

Academy comments: Most regulatory capital work has focused on minimum capital levels and not a "going concern" basis. In addition, as noted above, we believe the BCR should be focused on identifying G-SIIs that are in vulnerable financial condition, rather than comparing strong G-SIIs.

7. Impact of discount rates on best estimates (Paragraph 59):

- The paper correctly implies that use of different discount rates can reduce comparability across companies. However, use of a single prescribed discount rate (especially a risk free rate) can lead to unintended consequences regarding the availability and cost of some insurance products should it become a target benchmark. If a prescribed discount rate is desired, it seems sensible to collect data using more than one prescribed discount rate.
- Any conclusion or impression that the ICS will be bound by the same valuation approach and parameters (e.g. adjusted GAAP + defined discount rate) as those used for the BCR is premature. That BCR and the ICS will serve two different purposes, thus assumptions made for the BCR may be different for ICS. The assumptions for developing the ICS may well be informed by the evolving state of affairs in valuation and by the role of the ICS and its underlying granularity and methodology.

8. **Fungibility of Capital (Paragraph 64 and 2nd bullet point in paragraph 1 of Annex A):** The issue of location of capital should remain independent from the calculation of capital requirements or capital resources in the BCR. Evaluation of location of capital should be left to the supervisory colleges, noting the resolution protocol briefly reference in Annex A of the BCR Consultation paper. The paper should state that the measurement of capital resources against the BCR will be made on the consolidated group level for the BCR, and not adjusted for location of capital. The calculation of a BCR ratio should not impact nor be impacted by existing jurisdictional entity based capital requirements.

9. **Composition for the BCR (Paragraph 65):** We support the use of the Basel III leverage ratio for banking financial activities as described in paragraph 65. However the methodology for applying an HLA uplift to the Basel leverage ratio will need further discussion and development.

10. **General Comments:**

- As factors are developed for testing, consideration should be given to the lack of diversification credit in the BCR, and the fact that HLA will be added to the BCR. Therefore during testing, the factors for the BCR alone should be designed to generate a result that is at the low end ("minimum capital") compared to existing group capital requirements. It is reasonable to assume that significant regulatory judgment may be required for the risk factors used for the BCR and that the BCR should be targeted in relation to current industrywide capital requirements or capital resources when establishing the risk factors. Calibration of BCR will require increased attention and specificity when HLA is added.
- The notion of a second consultation once the proposed design and initial factors for the BCR have been completed is strongly supported.

Academy comments: The lack of a covariance or risk diversification credit 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. Mere summing of individual risks assumes exact 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 underwriting and financial risks are not correlated.

Paragraph 31 contemplates the use of pre-calibrated factors from already established capital and solvency frameworks, but does not mention U.S. Risk-based Capital (RBC). U.S. NAIC RBC formulas should be included. RBC allows for more granularity than Solvency I, and thereby reflects risk-sensitivity better than Solvency I.