



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

September 10, 2003

Mr. David Deacon
Head of Unit - Insurance
European Commission
Internal Market Directorate-General
Rue de la Loi 200
B-1049 Brussels, Belgium
Email: david.deacon@cec.eu.int

Dear Mr. Deacon,

Re: Considerations on the design of a future prudential supervisory system

Further to our letter to you of February 23, 2003 forwarding the International Actuarial Association's (IAA) draft comments on the EC document Markt/2535/02-EN, I am pleased to confirm that the IAA's due process is now complete. The draft comments, with minor editorial amendments, have been approved by the member associations for release as an IAA public statement and are enclosed for your files.

Yours sincerely,

W. James MacGinnitie
President

cc: Stuart Wason (Email: Stuart.Wason@mercero.com)
Jukka Rantala (Email: Jukka.Rantala@etk.fi)

**A COMMENTARY ON THE DRAFT EC DOCUMENT MARKT/2535/02-EN
“CONSIDERATIONS ON THE DESIGN OF A FUTURE
PRUDENTIAL SUPERVISORY SYSTEM”**

Released by the European Commission: November 28, 2002

International Actuarial Association

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our fifty Full Member actuarial associations represent more than 95% of all actuaries practising around the world. The Full Member associations of the IAA are listed in an Appendix to this statement. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries.

Due Process

This is the final version of the IAA’s comments that have been prepared by the Working Party on Insurer Solvency Assessment, a subcommittee of the Insurance Regulation Committee. The members of the subcommittee are listed below by name and association.

Members of the Working Party on Insurer Solvency Assessment

Stuart Wason	Chairperson
H.W.M. Van Broekhoven	Vice-Chairperson
Hans-Peter Boller	Association Suisse des Actuaires
Allan Brender	Canadian Institute of Actuaries/Institut Canadien des Actuaires
Anthony Coleman	Institute of Actuaries of Australia
Jan Dhaene	Association Royale des Actuaires Belges
David Finnis	Institute of Actuaries of Australia
Marc J. Goovaerts	Association Royale des Actuaires Belges
Burton D. Jay	American Academy of Actuaries
R Kannan	Actuarial Society of India
Toshihiro Kawano	Institute of Actuaries of Japan
Sylvain Merlus	Institut des Actuaires
Glenn Meyers	Casualty Actuarial Society
Teus J. Mourik	Het Actuarieel Genootschap
Harry H Panjer	Canadian Institute of Actuaries/Institut Canadien des Actuaires
David Sandberg	American Academy of Actuaries
Nylesh Shah	Institute of Actuaries
Shaun Wang	Casualty Actuarial Society
Hans Waszink	Het Actuarieel Genootschap
Robert F. Wolf	Casualty Actuarial Society

IAA Comments

The Working Party on Insurer Solvency Assessment of the International Actuarial Association appreciates this opportunity to comment on this draft paper and welcomes any request for elaboration in respect of any of its comments or inquiries regarding other aspects of this topic.

On behalf of the Insurance Regulation Committee of the International Actuarial Association (IAA), the WP is developing a paper for the International Association of Insurance Supervisors (IAIS) to explore the elements needed for an international capital standard for insurers and to provide a “best practices” approach available to all supervisors. The paper will deal with methods the supervisor might use to assess the current financial position as well as understand the range of possible future financial positions of insurers. Its primary focus will be on capital requirements for insurers. This paper is expected to be released in the fall of 2003.

We believe that there is considerable interest in developing a global framework for insurer supervision and solvency assessment. In this age of globalization, international ownership of insurance businesses and instant communications worldwide, it is in the public interest that they continue to have confidence in the risk and income protection solutions provided by the insurance industry. We commend the EC for its Solvency II initiatives. The WP objectives are very much aligned with those of the EC at this time and we look forward to being of further assistance to the EC as requested.

In general, the WP is most pleased and supportive of the direction and specific contents of the document. Our specific comments are as follows:

1. **Paragraph 64** The WP suggests that the words “risk-adjusted prudential regime” may have different meanings for different audiences. It may be beneficial to clarify their meaning. For example, the words could be understood to refer to the risks faced by the supervisor. On the other hand, they could mean that the supervisor will focus its efforts on those insurers exposed to the greatest risk. The WP trusts that the EC is focusing on this latter interpretation.
2. **Paragraphs 74-76** The WP believes that formulaic approaches can serve as a basic foundation upon which more advanced approaches can be built. Specifically, we suggest that:
 - a) Formulaic approaches are not intended to cover all risks – they must also be used in combination with supervisory oversight and proper disclosure / market discipline.
 - b) Formulaic approaches are not intended to be complete predictors of insolvency; the criticism contained in paragraph 74 appears unduly harsh.
 - c) The purpose of solvency assessment is to define an appropriate amount of capital that will enable a supervisor to take control of a troubled company and have sufficient assets to protect the financial interests of policyholders. This must recognize the time horizon as the time it would take to successfully arrange for continued policyholder protection and the settlement of incurred claims.

Further the WP is concerned that these paragraphs in the paper seem to assume there are no quantitative methods between a strict formulaic approach and internal models. The Basel approach to credit risk belies this. There can be a variety of approaches, moving along the spectrum from formula to internal. The WP believes that the method of determining the capital requirement (once it is appropriately defined by bounding principles) can range from a factor-based approach, to a customized factor approach, to a standardized risk model approach and finally (in terms of insurer complexity but perhaps also in terms of a preferred approach where the appropriate technical capabilities exist) to internal risk models. Depending on local circumstances and the capabilities of the insurers and the supervisor themselves, the supervisor can permit the capital requirement to be determined from within a continuum of approaches. An insurer would require permission to use these more advanced approaches; as the methods become more company-specific, the supervisor would have to be satisfied to a greater degree as to the company's risk management and technical competence.

3. **Paragraphs 79-82** The WP believes that the concept of a causal chain, as introduced in these paragraphs, as well as the use of both quantitative and qualitative approaches to risk assessment are most important. We concur that supervisors need to have available a range of risk analysis tools. No one tool is satisfactory by itself. Their assembly into a coherent system of prudential supervision is vital. However, even a coherent system will fail if it does not incent insurers to exercise sound risk management.
4. **Paragraphs 83-86** We agree that it is very important to define properly and clearly the function of the capital requirement in the overall supervisory framework. Our work to date suggests that the concepts of confidence level and time horizon require definition. There may be a tendency to think of a capital requirement as the result of a mechanical process with fixed factors. There may even be a tendency to associate with a particular approach when using the phrase "risk based capital" (RBC). These tendencies need to be recognized and addressed directly. The WP is working to define, from our own perspective, the key principles that should underlie a capital requirement.
5. **Paragraphs 83-95** The WP believes it is important to point out the relationship between capital requirements and risk management: risk management is in place to prevent trouble, capital is required to pay for trouble if it should occur in spite of best risk management practices having been applied. The amount of capital required may be influenced by the quality of the risk management.
6. **Paragraph 111** The WP supports the use of a single financial reporting basis for both statutory and GAAP purposes. The WP has no opinion in regard to the specifics of the proposals currently being put forward by the IASB; however any move towards a common international accounting standard for insurers will make the task of developing a global framework for insurer solvency assessment much easier. In order to allow concurrent development of international insurance accounting standards and the EC insurer supervisory framework, without hindrance of one on the other, the EC may need to consider the development of some quantitative measures (like best estimate liabilities or liabilities computed at an appropriate confidence level etc.) to enable European-wide insurer comparisons to be made.

7. **Paragraph 118-119** Continuing with our remarks related to Paragraph 111, the WP believes that it is preferable to determine the design of all three Pillars of Solvency II at the same time since they are each part of one coherent system of prudential supervision.
8. **Paragraph 159** The WP agrees that the varying levels of prudence in the mathematical provisions in Europe make the task of solvency assessment complex. It is for this reason that the WP prefers a total balance sheet approach to solvency assessment and the WP looks forward to sharing the details of its approach with the EC by this fall.
9. **Paragraph 185** The WP agrees that investment coverage rules and capital rules should be considered simultaneously. The WP notes that if the capital rules will take asset risks appropriately into account, the method of reducing the asset values for coverage purposes discussed in this paragraph may be superfluous.
10. **Paragraph 188** The WP is surprised that the EC considers asset/liability management risk to be a Pillar 2 risk. This is an important type of risk faced by insurers – primarily life insurers – and the techniques to model this type of risk are readily available to all insurers.
11. **Paragraphs 189-192** The idea of extending the coverage rules to the minimum margin requirement sounds logical; especially if the present prudence margins in the technical provisions will be shifted more and more to the capital requirements.
12. **Paragraphs 206-220** The WP thinks that the principle of a multi-layer system with an Absolute Minimum Margin and Target Capital is a very good starting point. With such multi-layer systems it is possible to more easily adapt the supervisory measures to the changing risk of failure than in a system with one trigger level only. Such a multi-layer system is not too complicated to build up if the same type of data (but maybe different time horizons or confidence levels) is used in the formulas to determine the different layers. From the actuarial perspective, the same types of formulas for all layers could be appropriate but the legal practice in some countries may require that the layer triggering serious measures (e.g. withdrawal of license) be based on quite robust methods.
13. **Paragraph 270** A very useful Pillar 2 tool that is used in some countries is a future financial condition analysis whereby the insurer is required to prepare a projection of its earnings, balance sheet and capital ratios for the next few years under a variety of adverse but plausible scenarios. This information required by the supervisor is kept confidential to the insurer and the supervisor.

The IAA Working Party on Insurer Solvency Assessment commends the EC for its Solvency II initiatives and looks forward to providing the EC with a full report upon the completion of our mandate this fall.

In quick summary, based on the WP work to date and our review of the EC document, we are strongly supportive of,

- a multi-pillar risk-based approach to insurance supervision
- a common solvency assessment method for all supervisors based on a total balance sheet approach as described in our draft report

- a continuum of possible methods of determining capital ranging from standard formulaic approaches to advanced internal risk models
- a multi-layer system of capital thresholds which enables the supervisor to take appropriate actions as the financial position of the insurer weakens.

In addition, we strongly believe that,

- supervisors require a range of risk analysis tools
- a coherent system of prudential supervision must incent insurers to exercise sound risk management.

In conclusion, the Working Party is pleased to be invited to provide comments on this EC document as the actuarial profession is deeply interested in insurer solvency assessment based on our technical expertise as well as our professional concern for actions that are in the public interest.

On behalf of the Working Party, I trust that our comments are of assistance to you and we look forward to discussing these issues with you. We especially look forward to discussing with you our final report, which is due this fall.

FULL MEMBER ASSOCIATIONS OF THE IAA

Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires (Argentina)
Institute of Actuaries of Australia (Australia)
Aktuarvereinigung Österreichs (AVÖ) (Austria)
Association Royale des Actuaires Belges (Belgique)
Instituto Brasileiro de Atuária (IBA) (Brazil)
Canadian Institute of Actuaries/Institut Canadien des Actuaires (Canada)
Cyprus Association of Actuaries (Cyprus)
Česká Společnost Aktuárů (Czech Republic)
Den Danske Aktuarforening (Denmark)
Egyptian Society of Actuaries (Egypt)
Eesti Aktuaaride Liit (Estonia)
Suomen Aktuaariyhdistys (Finland)
Institut des Actuaires (France)
Deutsche Aktuarvereinigung e. V. (DAV) (Germany)
Hellenic Actuarial Society (Greece)
Actuarial Society of Hong Kong (Hong Kong)
Magyar Aktuárius Társaság (Hungary)
Félag Íslenskra Tryggingastærðfræðinga (Iceland)
Actuarial Society of India (India)
Society of Actuaries in Ireland (Ireland)
Israel Association of Actuaries (Israel)
Istituto Italiano degli Attuari (Italy)
Institute of Actuaries of Japan (Japan)
Japanese Society of Certified Pension Actuaries (Japan)
Latvijas Aktuaru Asociācija (Latvia)
Lebanese Association of Actuaries (Lebanon)
Colegio Nacional de Actuarios A. C. (Mexico)
Het Actuarieel Genootschap (Netherlands)
New Zealand Society of Actuaries (New Zealand)
Den Norske Aktuarforening (Norway)
Actuarial Society of the Philippines (Philippines)
Polskie Stowarzyszenie Aktuariuszy (Poland)
Instituto dos Actuários Portugueses (Portugal)
Academia de Actuarios de Puerto Rico (Puerto Rico)
Singapore Actuarial Society (Singapore)
Slovensko Aktuarsko Društvo (Slovenia)
Actuarial Society of South Africa (South Africa)
Col.legi d'Actuaris de Catalunya (Spain)
Instituto de Actuarios Españoles (Spain)
Svenska Aktuarieföreningen (Sweden)
Association Suisse des Actuaires (Switzerland)
Actuarial Institute of the Republic of China (Taiwan R.O.C.)
Faculty of Actuaries (United Kingdom)
Institute of Actuaries (United Kingdom)
American Academy of Actuaries (United States)
American Society of Pension Actuaries (United States)
Casualty Actuarial Society (United States)
Conference of Consulting Actuaries (United States)
Society of Actuaries (United States)