May 21, 1999

Hon. James A. Leach
Chairman
Committee on Banking and Financial Services
2129 Rayburn House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Re: Hedge Funds Report

Dear Chairman Leach:

The American Academy of Actuaries' (the "Academy's")[1] Committee on Banking and Financial Services has read with interest the recently-issued report of the President's Working Group on Financial Markets titled, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (the "Working Group Report"). We have also examined testimony presented to the House Committee on Banking and Financial Services by various parties during a May 6, 1999 hearing on the Working Group Report.

We agree that rigorous risk management is essential to the success of any financial enterprise, and that appropriate regulatory involvement can strengthen the risk-management systems of regulated entities. The actuarial profession has devoted substantial effort to the development of two of its core competencies: the analysis of risk and the implementation of risk management techniques. As a result, various risk management systems are being put into place by insurers as a forward-looking approach to protecting company viability.

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[1] The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

- For life insurers and property and casualty insurers, actuaries are utilizing dynamic financial analysis to support capital allocation and business strategies.

- For the property and casualty insurance area, the actuarial profession is using modeling techniques for risk assessment. For example, catastrophe models are being used to: 1) evaluate the current level of risk a company faces; 2) develop catastrophe "loads" rating property coverages; and 3) determine capital allocation and business strategies.

Actuaries are working with various committees of the National Association of Insurance Commissioners ("NAIC") to study risk management in a variety of insurance contexts.

- For life and health insurers, the Academy's Valuation Task Force is working with the NAIC's Life and Health Actuarial Task Force on a unified valuation system, including the concept of a "viability report, " an annual report involving dynamic financial analysis of a company's viability based upon its business plan.

- For managed care organizations, the Academy recently produced a set of preliminary recommendations on the development of a liquidity test to accompany the current risk-based capital formula. One element of the recommended liquidity test would be a forward-looking dynamic financial analysis of specific potential stresses to a company's financial condition as applied to the company's business plan.

- For property and casualty insurers, the Academy is actively supporting the NAIC Securitization Task Force in the measurement and evaluation of the effectiveness of insurance based hedge transactions such as insurance index options. The Academy is also working with the NAIC Catastrophe Reserve Working Group to evaluate alternative approaches in managing a company's catastrophe exposures.

The near failure of Long-Term Capital Management as described by the Working Group Report highlights the importance of sound risk management practices to better protect the financial health of hedge funds. The risk management models and techniques that are currently being applied by actuaries, although designed for use in an insurance context, may well be transferable to other financial service industries. Actuaries are expert in risk management, and we would like to offer our assistance to you and your committee as you consider the findings and recommendations of the Working Group Report.

The Working Group's recommendations to enhance hedge funds' risk management techniques appear to us to be sound in principle. However, as you observed in a May 6, 1999 press statement, "many of the details in the Working Group's recommendations remain to be filled in." We would welcome the opportunity to provide actuarial support to your committee and regulators as specific proposals to foster strong risk management practices and their investors are developed. Please contact Tom Wilder at the Academy office, (202) 223-8196 to advise us on how we may further assist you.

Sincerely,

Donald E. Sanning
Chairperson
Committee on Banking and Financial Services

cc: Members, Committee on Banking and Financial Services