AMERICAN ACADEMY *of* ACTUARIES

February 4, 2009

National Association of Insurance Commissioners (NAIC)
International Solvency and Accounting (E) Working Group
Via email: kdefrain@naic.org

Re: *Non-Accounting Issues for Consideration in the Solvency Modernization Initiative*

On behalf of the American Academy of Actuaries'[1] Risk Management and Solvency Committee, I am pleased to share the following comments with the NAIC International Solvency and Accounting (E) Working Group. We appreciate the breadth of topics noted in the Solvency Modernization Initiative and have organized our comments by section:

1. Framework & Principles
    a. We support the recommendation to consolidate the principles into one framework document. We note that the initial effort to do so may identify areas within the current framework where principles are either incomplete, in conflict with principles used elsewhere in the framework that will need to be reconciled, or are different because the business line has a different operating framework/objective from another business line. This means a process to review and recommend the appropriate way to resolve the conflict(s) will need to be in place. The process will also need to flag possible needed changes to regulatory requirements.
    b. It would be helpful if this effort also clarified the role and responsibility of the regulator towards the financial statements. At one possible end of the spectrum, the regulator only "audits" the statements prepared by the company and the company is responsible for the statements it files. At the other end of the spectrum is the view that the state commissioners are receiving a set of financials prepared under their specifications and direction. The answer may likely be somewhere between these two viewpoints, but the principles underlying the decision needs to be articulated.
    c. We think it would be helpful to have a statement of the objectives and goals of the modernization effort so that it will be clear how to evaluate whether the objectives are met by existing principles or practices as well as for any proposed or implemented changes.
    d. We also recommend that the Working Group impose deadlines on itself to assure that the project moves on an expeditious track.
2. Study of International Solvency Initiatives
    a. Our tracking of U.S. and International initiatives suggests that there are several, topically different, items that we recommend considering:

[1] The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to assist public policymakers by providing 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. Academy members are highly trained practitioners in mathematical and statistical approaches to quantifying risk, practicing in the insurance industry as well as the broader financial services industry.

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i. The actual requirements for calculating and reporting reserves and capital.
ii. The priority, purpose and balance between reserves, capital and risk management procedures. For example, the Canadian regulators, the Office of the Superintendent of Financial Institutions Canada (OSFI) have stated that risk management is the first and most important element for effective solvency and that risk management is then supported by reserves and capital.
iii. The amount of discretion, if any, for reporting, dialogue and discussion between the company and the regulator.
iv. The legal and regulatory process for making future changes and modifications. For example, must they be approved by a legislator, a commissioner, group of commissioners, etc.? Is there a formalized review process that includes the regulator and the companies to review what is working well and what needs improvement in the reporting process?
v. Finally, the feedback/governance process in place to review the impact of requirements on actual practices of reporting risk and designing product offerings.

3. Tools in the Solvency System
   a. We note that under the ERM section, it is not mentioned that even though the NAIC is requiring the use of a risk focused examination process, there is currently no requirement for a common format for risk focused financial reporting for life insurers. This includes both the measurement of risk as well as the use of actual to expected analysis. While both the life and P&C annual statement contains exhibits addressing some risk measurement issues in varying degrees, they are at high aggregation levels and may represent limited transparency for the risks assumed. Effective ongoing access to best reporting practices could tie into efforts to streamline and enhance the statutory reporting requirements as well as be used for desired regulatory data collection at times of newly emerging or unusual risk events.
   b. Also lacking explicitly in the risk exam requirements is a comprehensive and uniform way to address and report on systemic risk issues. This may be done through uniform risk reporting and/or some centralized or consolidated review process. The NAIC could assist in this process or individual states could support it. This would then be a platform for managing the feedback loop review process, assessing risks that may be missing or misrepresented in the reporting process, and allow dialogue with other US and/or international regulators about the aggregate risk exposures and possible concerns for the U.S. industry as a whole or in part. We note two possible additional tools to assist in this.
      i. Create accountability within the U.S. state-based system through a systemic risk identification function, led, perhaps, by a "risk officer" to carry out and execute the above responsibilities. For example, we note that the recent NAIC review of possible year-end modifications to capital and reserve requirements ended with the expressed desire to "know when and if there is a financial crisis." This change would create the capacity for someone or a group to speak to the risk status of the industry (or segments of the industry), whether to the public, or to other U.S. and international regulators.
      ii. Require documentation of risk flows between policyholders, insurers and reinsurers. This documentation could parallel the effect of double entry accounting so that risk spreading functions can be more easily traced within the insurance system, and can be aggregated at company or industry levels as needed. This allows regulators to trace the genealogy of risk in a company.

4. Use of Internal Models and Regulatory Capital Requirements

   The emerging view on these items points to the need to use an appropriate mix of internal models, capital requirements, and stress testing. Over reliance on any of these three to the exclusion of the others can significantly weaken or distort the strength of the overall solvency of the industry.

If you would like to discuss any of these points further, feel free to contact us. Again, thank you for the opportunity to share our comments with the Working Group.

Sincerely,

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