



ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION

FAXED

May 31, 2001

The Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Morris W. Chambers
President

c/o London Life Insurance Co.
255 Dufferin Avenue
London, Ontario N6A 4K1
CANADA

Tel: (519)435-7075
Fax: (519)435-7210
E-Mail:
mo.chambers@londonlife.com

Dear Sirs,

RE: The New Basel Capital Accord Consultative Document

The International Actuarial Association (IAA) appreciates the opportunity given to comment on the Consultative Document on the proposals for a new Basel Capital Accord.

At this stage these comments represent the views of the members of the Committee on Insurance Regulation only. The comments have not been approved formally by the member associations of the IAA. We intend to submit these comments for due process and formal approval by the IAA membership and, in due course, will provide that formal response. In the meantime, these comments should be regarded as an informal commentary on the Consultative Document, rather than as a formal policy statement of the IAA.

If, upon reading these comments, you identify any points that you would wish to pursue, please do not hesitate to contact the chairperson of the Committee on Insurance Regulation, Nigel Masters, or any of the other members of the Committee. The IAA will be pleased to develop these ideas further with you.

Sincerely,

Morris W. Chambers
President

cc: Nigel Masters (E-mail: nigel.masters@uk.pwcglobal.com)

**A COMMENTARY ON THE CONSULTATIVE DOCUMENT PUBLISHED BY THE
BASEL COMMITTEE ON BANKING SUPERVISION
'THE NEW BASEL CAPITAL ACCORD'**

The International Actuarial Association

The International Actuarial Association (the "IAA") represents the international actuarial profession. Our member actuarial associations exceed forty in number, and represent more than 95% of all actuaries practicing around the world. The 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. The IAA's interest in the Consultative Document on the New Basel Capital Accord is to assist the Basel Committee in developing a high quality standard on this very important topic. The IAA appreciates the opportunity to provide comments on this Consultative Document.

Due Process

These comments have been prepared by a committee of the IAA, the members of which are listed below by name and association. It is now intended that the comments will be circulated for approval to the member associations of the IAA as part of our due process procedures. Accordingly, these comments do not constitute a formal response by the IAA. The final copy of this draft statement will be transmitted to the Basel Committee as soon as this draft statement has passed through the IAA's due process.

Members of the IAA Insurance Regulation Committee

Nigel Masters	Chairperson
David Hartman	Vice-Chairperson
Félix Arias Bergadá	Col.Legi d'Actuaris de Catalunya
Morris Chambers	Canadian Institute of Actuaries
John Allan Feyter	New Zealand Society of Actuaries
Rainer Fürhaupter	Deutsche Aktuarvereinigung e. V. (DAV)
K S Gopalakrishnan	Actuarial Society of India
Thomas Karp	Institute of Actuaries of Australia
Won How Lo	Actuarial Institute of the Republic of China
Helge-Ivar Magnussen	Den Norske Aktuarforening
Ryoichi Nakamura	Institute of Actuaries of Japan
Gennaro Olivieri	Istituto Italiano degli Attuari
Thierry Poincelin	Institut des Actuaire Français
Jukka Rantala	Suomen Aktuaariyhdistys
Angus John Robertson	Faculty of Actuaries
Richard Roth	Casualty Actuarial Society
David Sandberg	American Academy of Actuaries
Simon Van Vuure	Het Actuarieel Genootschap
Robert E Wilcox	Society of Actuaries; Conference of Consulting Actuaries
Gyula Horvath	Hungarian Actuarial Society

The Convergence of the Financial Services Industry

The actuarial profession has historically been more associated with insurance and its prudential supervision than with banking. However, with increasing numbers of actuaries working in the banking sector and for financial conglomerates, the IAA recognises the continuing convergence of the financial services industry and the consequent need for consistent accounting and prudential supervision regimes that operate across banking, insurance and investment management. Accordingly, the Insurance Regulation Committee of the IAA regards the proposals set out in the Consultative Document as being of great importance to all financial services enterprises.

The comments that follow are made on the expectation that the regulators of the banks and insurers will seek, in the near future, to harmonise the prudential supervision of financial institutions. This reflects, in part, the emergence of financial conglomerates and, in part, the importance of regulatory coherence and financial stability. We recognise that the degree of harmonisation may, of necessity, be restricted but the starting point for our comments is that regulators will move towards the greatest level of harmonisation possible.

The drive for harmonisation is seen most clearly in the changing organisational structures of the regulators themselves. There are now many territories with integrated regulators such as Australia, Canada, Japan, Korea, Malaysia, Norway and the UK. Also, of course, BIS shares facilities with its insurance counterpart, the IAIS. Accordingly, our comments suggest ways in which the current proposals might be enhanced so that the chances of a single prudential system are optimised.

Overview

The Insurance Regulation Committee of the IAA welcomes the Basel Committee's proposed approach to the supervision of capital and risk in the banking sector. A capital requirement that reflects the level of risk in the operations of a financial institution leads to efficient pricing of capital and its effective use in concert with economic reality. We see the New Basel Accord as moving in the right direction and, subject to our comments below on risk diversification, transfer and exposure, we are pleased to support the concepts behind its introduction.

The Impact of Fair Value Accounting

The impending introduction of fair value accounting, notably in the European Union, is driving a fundamental reappraisal of traditional insurance provisioning techniques. An immediate consequence is that the prudential capital system for insurers needs to be overhauled. A risk-based approach to prudential supervision, if implemented in an effective manner, has many advantages. As well as providing a system consistent with other parts of the financial services industry, it extends the provisioning techniques required under fair value accounting into an integrated financial management system.

Ideally, a fair value accounting regime needs to be complemented with a regulatory regime that takes into account the fair value provisions and how they are determined when setting regulatory capital requirements. In this way the appropriate overall level of prudence can be determined. If fair values are targeted at anticipated outcomes, the regulatory capital needs to be targeted at an appropriate level of extreme loss. For meaningful reporting, it is better if the regulatory requirements are clearly additional to the fair value provisions even if the capital for regulatory purposes is calculated independently of the fair values.

The IAA has commented favourably on the International Accounting Standards Board's proposals for fair value accounting for financial instruments in general and for insurance contracts in particular. We believe that a realistic view of an enterprise's financial progress is the clearest indicator of whether that enterprise is strengthening or weakening its financial condition. Given this support for fair value reporting, it is a natural next step to support the direction of the Basel Committee's proposals.

The Three Pillar Approach

The 'three pillar approach' set out in the proposals has much to commend it, in that it provides a core of financial strength and the flexibility to adapt to changes in assets, liabilities and the economic and consumer environments. Provided that the Accord is not so prescriptive in respect of the base elements of its standard capital requirements that it becomes irrelevant to insurers, it should be relatively straightforward to adapt the general concepts to other financial services enterprises, many of which already use comparable approaches. Further, the flexibility offered in the supervisory response, the second pillar, accommodates the diversity of products prevalent in the insurance industry.

The flexible, interactive and risk-based approach to supervision proposed in the second pillar will be familiar to insurers in those countries where the appointed actuary system is utilised. Under this system, the regulator is able to rely on an experienced professional, working under a framework of principles and guidance, to report to management and the regulator on the financial condition of the enterprise. The report will be informed by a detailed inside knowledge of the enterprise. The individual is responsible for elements of the day-to-day prudential supervision of the insurer, advising both the board of directors of the insurer and the regulator of the steps necessary to operate the enterprise soundly and prudently. This extension of prudential supervision is discussed further below.

We note the heavy reliance in the third pillar on disclosure. In many cases disclosure is essential for public confidence and understanding. For example, disclosure of changes in assumptions and the reasoning behind the changes can be very beneficial. Similarly, tracking changes, such as can be done for general insurance loss reserves and health insurance, is one way of assessing the refinements required to amend statistical models of the risks.

However, some experience suggests that the power of disclosure is diluted by the need, in practice, to limit the level of detail provided. This, in turn, may lead to bland statements that can obscure important details of assumptions or approach. This may be avoided by adopting a targeted approach to disclosure and focusing on material assumptions.

An alternative is a greater emphasis on audit, review and certification by independent, external bodies. Such bodies might include the regulators, the audit firms and consulting practices from a range of disciplines. The important factors in assessing the suitability of such bodies to provide the certification are their objectivity, independence and competence to undertake the reviews required.

Standardised and IRB Approaches

The insurance industry is diverse in scale, product and geography. It is important that an international regulatory system is relevant to and operable by both the most and the least sophisticated of organisations. For this reason we support the use of a two tier approach with standard factors allowing the less sophisticated to operate a straightforward but capital intensive system while the largest, most diverse operations can gain real advantage by developing strong risk management techniques and measurement models.

The diversity of the insurance industry makes it particularly open to regulatory arbitrage and any regulatory system must recognise the need for consistent standards between large and small organisations and across territorial borders. This necessitates strong codes of international practice. The IAA sees, as one of its main purposes, the promotion of standards of best practice for the international actuarial profession.

The actuarial profession has a core role in the risk management and measurement of insurance business. In particular, the actuarial profession has evolved many methods for the measurement of risks and its actuarial models of risks and risk measurement are large and sophisticated. We believe that certain of these techniques have relevance to financial services entities outside the insurance industry where large portfolios of 'retail' assets or liabilities are aggregated. We would welcome the opportunity to present to the Basel Committee the techniques and principles under which actuaries carry out this core role.

Our experience with such modelling and analysis leads us to several observations concerning the proposed standardised and IRB approaches, relative to the first pillar. These are:

- Both approaches should reflect the benefits from risk diversification, and the peril from risk concentration. While some products may lead to risk exposure in only one or a few narrow areas, in which case recognition of diversification benefits is not material, other products contain exposure to several risks. When these "several" risks are independent, the capital needed to protect against all such risks is less than the sum of the capital requirements for each individual risk in isolation. Such a finding is built in to internal capital models used by insurers today, as well as by banks. To ignore such a situation is to invite regulatory arbitrage, and the migration of exposures away from the banking world (or any regime where such diversification benefit is not recognized).
- Both approaches would need to change in their treatment of risk transfer before they could be applied to insurance. The suppliers of insurance products rely heavily on reinsurance to transfer risk and control their exposure to risk. Such a transfer is generally considered to reduce significantly the risk levels faced by an insurer, frequently replacing material insurance risk with credit risk which is generally materially lower. The

treatment of such transfers in the proposed New Basel Accord ignores the benefits of such risk transfer, and would unnecessarily discourage the beneficial use of reinsurance to lessen insolvency risk.

- The IRB approach assumes that risk exposure is linearly related to expected losses. This is often not the case. In our experience with insurance products, the variability in potential results from various insurance products is not a constant. The risk of extreme loss is not the same multiple of expected loss for all products. In general insurance, high layers of commercial liability protection contain much more risk than low limit auto liability protection, for the same level of expected losses. We would expect to find the same occurring in banking, or any financial enterprise. Therefore, a risk-based approach should reflect the volatility of the exposure in question, through reference to standard deviations, probabilities of ruin, extreme event probabilities, and the like.

Differences between Banking and Insurance

So far this paper has focused on the similarities in prudential supervision across the financial services sector. It is important to note, as well, those areas of insurance operations that are different from banking and investment management.

- **Underwriting.** The most notable difference is the wide diversity of different liabilities that insurance policies underwrite. This is in contrast to the banking emphasis on underwriting its asset portfolio (loans). The liabilities include frequency, severity and timing risks and aggregate assumptions about general policyholder behaviour. These risks may be found to a degree in banking books but not on the scale that insurers routinely underwrite.
- **Interest Rate Risk.** The long term insurance industry carries a wider exposure to interest rate risk than do the banks. The actuarial profession has considerable experience in addressing long term financial guarantees. We welcome the placing of interest rate risk under the aegis of the second pillar as interest rate risk comes in many forms. While a core capital requirement is, in our view, appropriate, it is difficult to identify one or even several measures that properly reflect the variety of interest rate exposures especially when the assets are purchased to fund policyholder liabilities to be paid far in the future. Instead, a rigorous regime of asset/liability management is an essential regimen for financial strength and risk management.
- **Non-guaranteed policyholder liabilities.** One approach that insurers have developed to counter the risk of structural change in the financial markets, which is a significant risk over the long periods that some policies run, is to allow benefits to be payable at the discretion of the management of the insurer. This discretion raises particular challenges for regulators who need to ensure that the discretion is not abused. The principles of market conduct are yet to be accepted globally. However, the appointed actuary system has, in general, been a useful mechanism that regulators have used to mitigate this potential for abuse.
- **Participating policies.** On similar lines and for broadly similar historical reasons, many long term insurance policies are written on a participating basis so that the policyholders pay higher premiums in order to share in the overall financial success of the insurer. In some

versions of participation, the policyholders have rights and obligations relating to their own blocks of business, while in others the policyholders share in the fortunes of the insurer as a whole, in which case they generally have obligations and rights similar to those of shareholders. In either case, the job of the regulator to protect policyholders is compromised by the need to balance the interests of policyholders as owners as well as insureds. Again, the appointed actuary system, taken as a part of the Second Pillar, can help regulators respond to the diverse challenges arising from these complex interests.

- **Time Horizon.** Perhaps the greatest difference, in terms of measurement of risk, between banking and insurance is the very long time horizons, thirty years and more, over which insurance policies operate. This means that the benchmark risk measures set out in paragraph 52 of the Overview (i.e. 0.7% PD (probability of default), 50% LGD (loss given default), over a 3 year time horizon) would need reconsideration in the context of insurance liabilities. This is an area where more work is required to achieve coherence between financial institutions. The actuarial profession is carrying out research in this area of risk frameworks and we will be pleased to share this with the Committee in due course.

Taking these differences together, we believe that any application of the Basel framework to insurers will need to incorporate the flexibility needed to address the diverse nature of insurance liabilities as the regulation of insurance and banking converges.

An Integrated Risk Framework

An important part of the research into risk frameworks mentioned above is the bringing together of insurance risks and banking risks, as articulated by the New Basel Accord, into one integrated risk structure. Our work in this area to date suggests that there is a significant overlap between the risk categories that appear in some guise in both frameworks. However, the practical impact of these risks on different financial institutions can vary significantly and the manner in which the risks are defined, managed and mitigated will vary between the two industries. Notably, as mentioned above, the importance of risk correlation and risk transfer for insurers needs to be acknowledged.

Some of the specific insurance risks, such as mortality or employer liability, to which insurers are subject, are not seen in banking. In the same way, some risks in specific banking products do not appear in insurance companies. Nonetheless, aside from these specific product risks, many risks are common and categories such as interest rate risk, counterparty risk and operational risk are present in both types of organisation. As mentioned above, the levels of the various risks, for example interest rate risk, differ between the two industries, but this is a question of identifying the right measure of exposure rather than fundamentally restructuring the risk frameworks.

Given this underlying commonality of risk, we support the development of the Basel risk structure into a wider risk model that covers both insurers and banks. The actuarial profession is carrying out research in this area.

Stochastic Modelling and Scenario and Stress Testing

There is no deep and liquid market on which portfolios of insurance liabilities can be traded and a market value established. Consequently and as a result of the complex nature of insurance

liabilities discussed above, the actuarial profession has needed to develop valuation techniques based on stochastic models. The models cover investment markets and also demographic movements, claims frequencies and claim severity, including extreme event provisions. The best of these models now recognise the importance of correlation between risks. The actuarial profession would be pleased to contribute this expertise to the Committee's thinking on the development, certification and audit of internal risk management and measurement models.

Also, the insurance industry has developed scenario modelling and stress testing techniques in some insurance disciplines that are comparable to those used by banks and we would welcome participating in further research aimed at applying such techniques to insurance operations.

One area where the Consultative Document might undertake a fuller discussion is the area of when and what supervisory action might be taken when significant but not 'terminal' issues are identified by the risk assessment and measurement process. An enterprise that is financially weak, but stable, is arguably 'an accident waiting to happen'. However, there may be no action that the regulator can take because the enterprise is not in breach of any regulation. A risk based regime is only effective if it can proactively force enterprises to manage their risks more prudently and adapt earlier than under current regimes. While we recognise the difficulty of setting general rules in this area, we believe the Consultative Document should discuss what proactive action might be appropriate. If this is not done, then risk assessment may be perceived as an end in itself.

The Contribution of the Actuarial Profession

As noted above, one of the original reasons for establishing an actuarial profession some two hundred years ago was managing the solvency of insurance enterprises. While some failures have occurred over that time, generally the insurance industry has served its policyholders well and the actuarial profession claims some credit for that.

Under the proposed New Accord, the contribution of the actuary can be retained and extended with benefit to the regulators, to the financial product consumers and to the industry.

We welcome the Consultative Document's recognition of the use of experts in maintaining and enhancing the solvency regime of financial institutions. Our members take a central role within the prudential regime for insurers. We believe this involvement allows a flexibility of control that in turn promotes innovation without recklessness and provides regulators and management with a core of professionals on whom they can rely for competence and integrity. To this end, the IAA is promoting the development of internationally acknowledged standards for actuaries working for financial institutions operating under international accounting or regulatory regimes. The standards will cover both technical skills, including ongoing education, and professional conduct.

A theme of the Consultative Document is that all those involved in the determination of provisions and solvency should take a wider view of all the risks, business as well as technical, on behalf of the investor. For individuals to be able to balance commercial and ethical pressures, membership of a strong profession is extremely desirable, if not essential. It is only the existence of a code of conduct backed by an effective disciplinary regime that can allow regulators,

working within an appropriate legislative system, to be comfortable to delegate day-to-day responsibility for policyholder interests to non-regulators, thereby achieving the beneficial gearing required for cost-effective regulation.

The Consultative Document gives importance to taking a broad view of solvency systems. We would echo this point, observing that to be most effective an actuary should not limit his attention to the narrow assessment of regulatory liabilities and solvency margins, but should actively contribute to all aspects of the financial management. The involvement of actuaries in general business planning can provide a proper balance of the interests of the various stakeholders in the business from the outset. This will support a prosperous and strong financial services industry, which is to the long-term benefit of the public, without compromising the position of current investors.

This is particularly true in the area of product design and pricing. The involvement of actuaries following a strong code of conduct can allow a regulator to have confidence that financial institutions are selling products that are sound in the context of the institution's overall financial strength. This allows regulators to dispense with, or at least reduce, the inefficient and potentially uncompetitive process of prior approval of products.

Concluding Remarks

The Insurance Regulation Committee of the IAA welcomes the broad approach to prudential supervision as set out in the Consultative Document on the New Basel Accord. We strongly support its emphasis on relating capital requirements to entity-specific risks.

The IAA recognises the convergence of the international financial services industry and the comments above should be read in the context of insurance and banking regulation possibly being brought together in the medium term future. The Insurance Regulation Committee of the IAA will be pleased to support the Basel Committee and the International Association of Insurance Supervisors as they pursue this goal. We will be happy to answer any comments or queries that you have on these comments. Further, we would welcome the opportunity to meet with representatives of the BIS on a somewhat regular basis to discuss our mutual concern for the protection of the interests of the public in the financial services sector.

Nigel B. Masters
Chairperson
Insurance Regulation Committee,
International Association of Actuaries.

FULL MEMBER ASSOCIATIONS OF THE IAA

Consejo Profesional De Ciencias Económicas De La Capital Federal (Argentina)
 Institute of Actuaries of Australia (Australia)
 Aktuarvereinigung Österreichs (AVÖ) (Austria)
 Association Royale des Actuaire Belges (Belgium)
 Instituto Brasileiro de Atuária (IBA) (Brazil)
 Canadian Institute of Actuaries (Canada)
 Cyprus Association of Actuaries (Cyprus)
 Česká Společnost Aktuárů (Czech Republic)
 Den Danske Aktuarforening (Denmark)
 Egyptian Society of Actuaries (Egypt)
 Suomen Aktuaariyhdistys (Finland)
 Association des Actuaire de Bretagne (France)
 Association des Actuaire Diplômés de l'I.S.F.A. (France)
 Institut des Actuaire Français (France)
 Deutsche Aktuarvereinigung e. V. (DAV) (Germany)
 Hellenic Actuarial Society (Greece)
 Actuarial Society of Hong Kong (Hong Kong)
 Hungarian Actuarial Society (Hungary)
 Félag Islenskra 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)
 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)
 Instituto dos Actuários Portugueses (Portugal)
 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 Actuaire (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)