

May 2015
DISCUSSION DRAFT—For Illustrative Purposes Only
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● **DISCUSSION DRAFT** ●

Capital Adequacy Assessment for Insurers

Developed by the
Enterprise Risk Management Committee
of the
Actuarial Standards Board

May 2015
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TO: Members of Actuarial Organizations Governed by the Standards of Practice of the Actuarial Standards Board and Other Persons Interested in Capital Adequacy Assessment

FROM: Enterprise Risk Management Committee of the Actuarial Standards Board (ASB)

SUBJ: Discussion Draft regarding Capital Adequacy Assessment

This document contains a discussion draft of potential language that could ultimately be included in a proposed actuarial standard of practice (ASOP), *Capital Adequacy Assessment for Insurers*. The purpose of this discussion draft is to collect input from interested parties as the Enterprise Risk Management (ERM) Committee of the ASB continues drafting the standard. Please note that since this is a work in progress, many changes and additions are likely.

The ASB has neither reviewed nor approved this discussion draft. This is not an exposure draft, and there is no particular deadline for comments. However, the ERM Committee is proceeding apace on this project, so earlier comments are more likely to affect the contents of the eventual exposure draft. Interested parties will have an additional opportunity to comment once the formal exposure draft is issued.

The ERM Committee expects to create an exposure draft that will draw on the ideas in this discussion draft, modified by discussions with and comments received from interested parties and unfolding events. If approved, the exposure draft will go through the normal ASOP process:

1. The ERM Committee will submit the Exposure Draft (ED) to the ASB.
2. The ASB will revise the ED and release it to all actuaries and other interested parties for comment.
3. Following the end of the exposure period, the ERM Committee will revise the ED based on comments received and produce a proposed ASOP or a second ED, depending on the extent of changes. This document will follow the same process as the original ED (and even if submitted as a proposed ASOP may be changed to a second ED by the ASB).
4. The ASOP will take effect only after final approval by the ASB.

Background

When the ERM Task Force (now Committee) started work on ASOP Nos. 46, *Risk Evaluation in Enterprise Management*, and 47, *Risk Treatment in Enterprise Management*, it was intended

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that those standards would, in addition to providing general guidance to actuaries performing ERM work, provide support as building blocks for a standard on actuarial opinions regarding the developing Own Risk and Solvency Assessment (ORSA) process. The ORSA is a part of global insurance regulatory standards (see Insurance Core Principles 16 of the International Association of Insurance Supervisors). An ORSA requirement has been adopted by the National Association of Insurance Commissioners (NAIC) and is now in effect in many states. In Europe, a version of the ORSA, called the Forward Looking Assessment of Own Risk, is also in effect. In addition to regulatory requirements, risk-taking enterprises will on occasion want to assess their capital adequacy. The purpose of the proposed standard on capital adequacy assessment is to provide additional guidance specifically to actuaries preparing an assessment of capital adequacy, whether for a specific regulatory requirement or for general management purposes.

Request for Comments

The ERM Committee of the ASB appreciates comments on all areas of this possible standard and would like to draw the readers' attention to the following areas in particular:

1. Does the discussion draft provide sufficient guidance for an actuary performing or reviewing the capital adequacy assessment needed for an ORSA filing with an insurance regulator?
2. Is the scope of this discussion draft broad enough to cover all practice areas (e. g., life, health, and P&C)? If not, please suggest modifications.
3. Does this discussion draft give sufficient guidance for regulatory actuaries? If not, please suggest alternatives.
4. Does this discussion draft give sufficient guidance for users of the actuarial work product to understand and comfortably rely upon actuarial work prepared under this guidance?
5. Does this discussion draft provide enough guidance for actuaries addressing complex arrangements such as holding companies with multiple subsidiaries and jurisdictions?
6. Should the discussion draft in any way follow the form or outline of NAIC regulatory ORSA guidance? If so, why?
7. Should the discussion draft be written to acknowledge, refer to, or in any way include other regulatory methods of solvency measurement (Solvency II, Basic Capital Requirement [BCR], etc.)? If so, which methods?
8. Are there items referred to in ASOPs Nos. 46, *Risk Evaluation in Enterprise Risk Management*, and 47, *Risk Treatment in Enterprise Risk Management*, for which the disclosure requirement in ASOP Nos. 46 and 47 is not sufficient with regard to an ORSA?

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9. Are there areas where the discussion draft is too restrictive or too prescriptive?
10. Are there areas in the discussion draft where more specifics would make the discussion draft more useful to users, without violating the fact that ORSA is by definition an “Own” risk assessment?
11. Are there areas in the discussion draft that should be reworded so as to be specifically appropriate for P&C, life, or health insurers?

Please review this discussion draft and give the ERM Committee the benefit of your comments and suggestions. Comments will not be posted to the ASB website and will not receive individual responses; however, they all will receive appropriate consideration by the Task Force in preparing the exposure draft for approval by the ASB. Comments can be sent to discussion@actuary.org. Comments will be reviewed as they are received, but it is suggested that they be sent by July 15, 2015.

If you wish to use conventional mail, please send comments to the following address:

Capital Adequacy Discussion Draft
Actuarial Standards Board
1850 M Street NW, Suite 300
Washington, DC 20036

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ERM Committee

David N. Ingram, Chairperson
Karen Adams Max Rudolph
Wayne Fischer David Sandberg
Joan Hentschel John Stark

CAPITAL ADEQUACY ASSESSMENT

STANDARD OF PRACTICE

Section 1. Purpose, Scope, Cross References, and Effective Date

- 1.1 Purpose—This actuarial standard of practice (ASOP) provides guidance to actuaries when performing professional services with respect to the assessment of capital adequacy.
- 1.2 Scope—This standard applies to actuaries involved in the preparation or review of capital adequacy assessment work for life or health insurers, including fraternal benefit societies and health benefit plans, property and casualty insurers, and similar entities.

The scope also includes capital adequacy assessment work related to the following:

- a. design of a capital adequacy assessment process;
- b. performance of the analysis that forms the basis for the capital adequacy assessment;
- c. construction of models that are for the primary purpose of assessing capital adequacy;
- d. capital adequacy assessments and review of capital adequacy assessments for a regulator, rating agency, or other party that is not directly affiliated with the insurer; or
- e. other comparable situations.

There are many reasons why an actuary might be asked to perform or review an assessment of capital adequacy, including but not limited to the satisfaction of a regulatory requirement to perform an Own Risk and Solvency Assessment (ORSA).

If the actuary departs from the guidance set forth in this ASOP in order to comply with applicable law (statutes, regulations, and other legally binding authority), or for any other reason the actuary deems appropriate, the actuary should refer to section 4.

- 1.3 Cross References—When this ASOP refers to the provisions of other documents, the reference includes the referenced documents as they may be amended or restated in the future, and any successor to them, by whatever name called. If any amended or restated document differs materially from the originally referenced document, the actuary should consider the guidance in this ASOP to the extent it is applicable and appropriate.

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- 1.4 Effective Date—This standard is effective for work performed on or after [four] months after adoption by the Actuarial Standards Board.

Section 2. Definitions

The terms below are defined for use in this actuarial standard of practice.

- 2.1 Capital Event—A modeled or actual event that either a) causes capital to be significantly above or below the **risk capital target** or b) causes capital to be below the **risk capital base**.
- 2.2 Risk Capital Target—The preferred amount of capital. This could be a range.
- 2.3 Risk Capital Base—A minimal acceptable amount of capital.

Section 3. Analysis of Issues and Recommended Practices

- 3.1 Capital Adequacy Assessment—An actuary may be called upon to assess capital adequacy or review an assessment, using various tools such as economic capital models and stress and scenario tests. In performing services related to capital adequacy assessment, the actuary should consider, or may rely on others who have considered, the following:
- 3.1.1 Scope of the Review—The actuary should state the scope of the review upon which the conclusion is based.
- 3.1.2 Limitations of the Opinion—The actuary should state any limitations associated with the opinion formed. The actuary should reference any reports relied upon from the insurer to form the opinion. For example, the conclusion may state that adequacy is dependent upon management’s ability to execute certain mitigating strategies under certain stress scenarios such that capital can be maintained above the **risk capital base**.
- 3.1.3 Variation of Results—The actuary should state that the conclusion is not a guarantee of future results. Actual results can and will vary from projected capital adequacy results due to differences in actual versus assumed experience.
- 3.1.4 Trends—The actuary should consider trend analysis in forming an opinion. Industry-wide historical trends and insurer-specific trends can provide the actuary with valuable insight for assessing capital adequacy, tempered by analysis of the drivers of changes in trends.
- 3.1.5 Other Considerations—The actuary may also consider the following:

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- a. Risk Definition—The appropriateness of how the insurer defines risk and the appropriateness of the primary risk metric(s) used in the risk management system of the insurer.
- b. Risk Identification—The appropriateness of the risk identification process, the risks identified by the insurer, and the risk classification system of the insurer.
- c. Risk Profile—The existence and appropriateness of management reports, if any, that discuss all risks across all exposures, subject to materiality, taking into account the specific risk exposures of the insurer.
- d. Resources of the Insurer—The adequacy of current resources and capabilities plus the effect on adequacy of any significant changes, or projected changes, in the risk profile, the level of surplus, and the insurer strategy.
- e. Risk Culture—The appropriateness and consistency of the firm’s attitude toward risk, including how this attitude is incorporated into the risk appetite and how it impacts risk modeling.
- f. Risk Quantification—The appropriateness of the analytical tools and processes that will be used to evaluate risk.
- g. Published Financial and Filed Regulatory Reports—Consistency between the capital adequacy assessment and publicly released reports of loss and expense reserves, unearned premium reserves, or premium deficiency reserves. The actuary should consider the reserve amount(s) publicly reported by the insurer and, if available, any actuarial analysis or reports provided to management related to estimation of reserves.
- h. Risk Appetite—See definitions and ASOP No. 46, *Risk Evaluation in Enterprise Risk Management*. The potential for inconsistency between the risk profile and the risk appetite.
- i. Time Sensitivity of Analysis—The appropriateness of the timeframe over which the analysis is valid.
- j. Prior Capital Adequacy Analyses—Differences between prior capital adequacy assessments and the current analysis and explanations of such differences, if applicable.
- k. Applicable Law—Adherence to laws applicable to the content and/or form of this document.

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3.2 Basis of Capital Adequacy Assessments—The actuary may be called upon to recommend the basis for the capital adequacy determination. The actuary should include a description of the analysis method used to assess capital adequacy. The degree of analysis performed by the actuary should also be stated. In some cases, extensive analysis of confidential and proprietary information may be used to separately model capital adequacy for the insurer. In other cases, the review may be based upon more limited analysis or publicly available data. An actuary should consider the impacts to capital relative to the **risk capital base**. In forming that recommendation, the actuary should consider three primary aspects of capital adequacy: the valuation basis for assets and liabilities used to determine the amount of capital, the basis for the **risk capital base**, and the level of severity of the adverse conditions that are used as the test of capital adequacy.

3.2.1 Valuation Basis—In selecting the valuation basis, the actuary should consider the following:

- a. the criteria used by management for making risk and other financial decisions;
- b. valuation basis mandated by principals, regulators, or others;
- c. the time frame(s) considered by management in decisions;
- d. the advantages and disadvantages of the different assumptions used;
- e. the unique characteristics of the selected and alternative valuation base;
- f. mitigation of material disadvantages associated with the valuation basis selected;
- g. the effects of the selected and alternative valuation basis on any results;
- h. historical behavior of selected and alternate valuation basis;
- i. projections of future economic conditions; and
- j. management and stakeholder expectations.

3.2.2 Selecting Risk Capital Base—If the actuary is asked to provide professional advice for selecting the **risk capital base**, the actuary should consider the following:

- a. the valuation basis;
- b. reasons for the selections of valuation basis. The actuary may wish to

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provide lists of advantages and disadvantages of possible selections and the reasons for the particular selection (such as conservatism, stability, ease of understanding, accuracy, realistic value in a crisis situation);

- c. management’s objectives for capital (such as return on equity, insurer stability, acquisition plans, infrastructure investment);
- d. the definition of capital adequacy or redundancy;
- e. the point in time at which capital is assessed;
- f. the time horizon over which the capital base is determined;
- g. the purpose of the capital;
- h. how the ERM framework defines various levels of required capital adequacy in relation to the liabilities;
- i. the method that is used to determine the “sufficient” level of required capital (such as factors, historical averages, internal capital models);
- j. the relative significance of using reasonable ranges versus a single number;
- k. the various regulatory and management triggers, targets, and criteria; and
- l. the manner in which the insurer will be able to access additional capital if and when needed, including the fungibility and liquidity of sources of capital that are internal to a group of insurers.

The level of severity of adverse conditions is addressed in section 3.3.1(b).

3.3 Selecting Stress Tests—An actuary may be called upon to propose or review stress testing for a **risk capital target** or **risk capital base**. The actuary should follow applicable guidance for stress test in ASOP No. 46 and ASOP No. 47, *Risk Treatment in Enterprise Risk Management*, in this work. In addition, the actuary should consider the following:

3.3.1 Stress Testing—The classification/anticipated action plan of each existing and new stress test, describing selection rationale and when anticipated actions may not be possible in all environments.

- a. Types of Stress Tests—The actuary may include forms of stress tests such as the following:

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1. Reverse Stress Tests—The actuary can reverse engineer a scenario that creates a **capital event**.
 2. Deterministic Stress Tests—The actuary can design a scenario to challenge the insurer in specific ways based on its unique exposures. Emerging risks may be considered using deterministic stress tests.
 3. Combination of Stress Tests—The actuary can design a scenario where multiple events that were tested in other scenarios happen simultaneously or sequentially.
 4. Combinations of Events—The actuary can design a scenario that combines multiple events and their interactions.
- b. Level of Adversity—Scenarios and stress tests may be insurer-specific or systematic. They should consider several levels of adversity, with the severity of each level defined, such as
1. periods of normal volatility;
 2. a scenario representing a plausible disaster; and
 3. a scenario representing an extremely unlikely adverse scenario.
- c. Sensitivity Testing—Sensitivity testing may be used to determine the applicability of the results of the stress tests under changing conditions, including the passage of time.
- 3.4 Consistency with Risk Appetite and Tolerance—A risk appetite statement may or may not be stated in terms of capital or capital adequacy. If an actuary is called upon to propose or review a proposal for a **risk capital target** or **risk capital base**, the actuary should consider the **risk capital target** or **risk capital base** closely related to a risk appetite and therefore include the considerations from ASOP No. 47 in this work. The actuary should also take into account the following additional considerations in forming or reviewing a **risk capital target** or **risk capital base**:
- a. the historical level of capital in relation to the risks of the insurer;
 - b. the historical level of capital in relation to capital targets from outside bodies, such as rating agencies, as well as regulatory capital requirements;
 - c. the implicit acceptable level of volatility of capital under the risk appetite; and

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- d. the level of security that is needed to satisfy important stakeholders and constituencies.

When performing this step, one or two of the considerations is often assumed to be much more significant than the others. The actuary should verify that a prior assumption in that regard is still valid and disclose such assumptions.

3.5 Special Management Reactions—An actuary may be called upon to incorporate management reactions to **capital events** into the determination of **risk capital targets** or minimums and stress tests for the insurer in a projection of planned or stressed future operation of the insurer. These reactions are sometimes extreme actions, such as capital raising, divestitures of blocks of business, major changes in distribution or pricing, employee layoffs, or other major changes in insurer operations. Thresholds may also be triggered by slower-moving trends. An actuary should use professional judgment in determining which of the following, or other, considerations apply:

3.5.1 Management Actions Used in the Past—If the proposed management actions were used in the past, the actuary should consider the following:

- a. the magnitude of the impact of the prior action compared with the impact needed in the projection;
- b. the prior effectiveness of the reaction compared with the projected effectiveness;
- c. the risk environment at the time of the prior action compared with the risk environment in the projection;
- d. differences in the ERM program and risk profile between the time of the prior action and the projection period;
- e. the degree to which the people who were directly involved in the past action may be involved in future similar actions; and
- f. differences in the insurer's financial strength between the time of the prior action and the projection period.

3.5.2 Management Actions Not Used in the Past—Where the proposed management actions have never previously been taken by the insurer, the actuary may consider the following:

- a. feedback from board members or other officers;
- b. any experience of other insurers with similar actions;

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- c. experience of other non-insurance firms with similar actions; and
- d. other experience that the insurer has had implementing similar actions.

3.6 Relation to Other ASOPs—The actuary should also comply with other ASOPs, including the following:

3.6.1 Modeling, Data Quality, and Actuarial Communications—The actuary should refer to [proposed ASOP on modeling], ASOP No. 23, *Data Quality*, and ASOP No. 41, *Actuarial Communications*, for guidance in the consideration of models used for capital adequacy assessments.

3.6.2 Risk Evaluation and Treatment—The actuary should refer to ASOP Nos. 46 and 47 in the following circumstances:

- a. When performing the following assessments, the actuary should refer to ASOP No. 46 for guidance:
 - 1. using an economic capital model to assess the value of the **risk capital target** or **risk capital base**;
 - 2. using stress tests to assess the value of the risk capital standard; and
 - 3. performing stress tests to assess the resilience of an insurer.
- b. When considering risk tolerance and appetite of the insurer, the actuary should refer to ASOP No. 47 for guidance.
- c. When considering the adequacy or appropriateness of an ERM program, the actuary should refer to ASOP Nos. 46 and 47 for guidance.

3.6.3 Other ASOPs—Many other ASOPs provide specific modeling requirements, including setting assumptions. The actuary designing, developing, modifying, or using models to assist with assessing capital adequacy should satisfy not only the requirements of this ASOP, but also any specific modeling requirements from an applicable ASOP. If such specific modeling requirements from an applicable ASOP are inconsistent with this ASOP, the requirements of such other guidance supersede the guidance of this ASOP. However, the guidance in this ASOP applies to the extent it is not inconsistent with such other guidance.

3.7 Reliance on Data or Other Information Supplied by Others—When relying on data or other information supplied by others, the actuary should refer to ASOP Nos. 23 and 41 for guidance. When relying on projections or supporting analysis supplied by others, the

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actuary should disclose both the fact and the extent of such reliance, and the actuary should refer to ASOP No. 23, deeming such projections or supporting analysis as data covered by ASOP No. 23. Similarly, the actuary should refer to ASOP No. 41 (including paragraphs 4.2 and 4.3) with respect to the disclosure of responsibility for data, assumptions, and methods.

- 3.8 Documentation—The actuary should consider whether documentation of modeling aspects mentioned in this ASOP should be prepared and retained, given the intended purpose of the model. Where appropriate to the intended purpose of the model, the actuary may retain documentation or other file material, pursuant to section 3.8 of ASOP No. 41. The actuary should also prepare and retain documentation to demonstrate compliance with the disclosure requirements of section 4.

3.8.1 Substance of Documentation—All documentation required by this ASOP should

- a. contain enough detail for a technically competent person with no previous knowledge of the particular model being documented to understand the matters involved and assess the judgments made;
- b. include a statement of the purpose of the documentation; and
- c. be clear, unambiguous, and complete for that purpose.

Section 4. Communications and Disclosures

- 4.1 Actuarial Communication—When issuing an actuarial communication subject to this standard, the actuary should consider the intended purpose of the assessment of capital adequacy and refer to ASOP Nos. 23, 41, 46, and 47 and, if applicable, ASOP No. 38, *Using Models Outside the Actuary's Area of Expertise (Property and Casualty)*. (In addition, the current Modeling exposure draft may become relevant.) In particular, consistent with the intended use or purpose, the actuary should disclose the following, as appropriate:

- a. The actuary should document and communicate the degree to which fungibility, liquidity, and emerging risks are evaluated in this report;
- b. The actuary should document and communicate the degree of consistency between the assessment of capital adequacy and other publicly available documents. Differences in projections from those shown to the same audience should be discussed;
- c. The actuary should document and communicate the past history of capital and surplus and reasons for deviations from past trends included in the capital adequacy assessment;

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- d. The actuary should document and communicate the description of any aggregation or changes in aggregation from the prior report;
 - e. The actuary should document and communicate the knowledge of management’s ability and willingness to execute documented mitigation strategies; and
 - f. The actuary should document and communicate the extent to which reported reserves from entities, their affiliates, or subsidiaries were relied upon and
 - 1. deviations from any insurer’s reported reserves and reasons for such deviation;
 - 2. the extent to which reported reserves were evaluated by the actuary; and
 - 3. reserve ranges considered and any deviations from one or more opening actuary’s ranges or point estimates (if the information is available and applicable).
 - g. The actuary should document and communicate the stress tests performed. In addition,
 - 1. The actuary should report the results of each stress test and provide a description of how the stress test shows, or does not show, insurer stability in times of stress and the level of adversity of each stress test or scenario;
 - 2. the degree to which results of stress testing are affected by expectation of a mitigation response; and
 - 3. a description of how risk margins or conservatism are included in the analysis.
- 4.2 Basis of Capital Adequacy—The actuary should document and communicate his or her role in the determination of the basis of capital adequacy and, if appropriate, the rationale for that selection. (Refer to section 3.2.)
- 4.3 Selecting Risk Capital Base—The actuary should document and communicate his or her role in selecting the **risk capital base** for the capital adequacy analysis and, if appropriate, the rationale for that selection. (Refer to section 3.2.2.)
- 4.4 Special Management Actions—The actuary should document and communicate whether his or her assessment included any special management actions.
- 4.5 Format and Content of Statement—Applicable law may specify the content of the statement of actuarial opinion and the supporting memorandum to the insurer. If the

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actuary departs materially from the recommended language or gives an adverse opinion, such departure or adverse opinion should be disclosed in both the opinion and the supporting memorandum.

- 4.6 Reliance on Others for Data, Projections, and Supporting Analysis—The actuary may rely on data, projections, and supporting analysis supplied by others. In doing so, the actuary should disclose both the fact and the extent of such reliance. Such disclosure may be prescribed in applicable law. The accuracy and comprehensiveness of data, projections, and supporting analysis supplied by others are the responsibility of those who supply the data, projections, and supporting analysis. When practicable, the actuary should review the data, projections, and supporting analysis for reasonableness and consistency, and disclose such a review. For further guidance, the actuary should refer to ASOP No. 23.
- 4.7 Additional Disclosures—In addition to the details that may be required by applicable law, the report should include disclosure and discussion of the following:
- a. identification of the intended users of the report;
 - b. the actuary’s reliance, if any, on representations of insurer management regarding subsequent events or material changes in assumptions from the prior report;
 - c. the reasonableness of any prior period data, studies, analyses, or methods; that key assumptions are still appropriate; and that no material events have occurred prior to the valuation date that would invalidate the analysis; and
 - d. the basis of any professional judgment.
- 4.8 Deviation from Guidance in the Standard—If the actuary departs from the guidance set forth in this standard, the actuary should include the following, where applicable:
- a. the disclosure in ASOP No. 41, section 4.2, if any material assumption or method was prescribed by applicable law (statutes, regulations, and other legally binding authority);
 - b. the disclosure in ASOP No. 41, section 4.3, if the actuary states reliance on other sources and thereby disclaims responsibility for any material assumption or method selected by a party other than the actuary; and
 - c. the disclosure in ASOP No. 41, section 4.4, if, in the actuary’s professional judgment, the actuary has otherwise deviated materially from the guidance of this ASOP.