March 2, 2016

Mr. David Altmaier
Director, Property & Casualty Financial Oversight
Florida Office of Insurance Regulation
Chairman, Group Capital Calculation (E) Working Group
Via email to JGarber@naic.org

Dear Mr. Altmaier:

The attached document is submitted on behalf of the American Council of Life Insurers (ACLI) and the American Insurance Association (AIA). The ACLI is a Washington, D.C.-based trade association with 284 member life insurance companies representing more than 90 percent of U.S. industry assets and premiums, and operating in the United States and abroad. The AIA is the leading U.S. property-casualty insurance trade organization, representing more than 325 insurers that write more than $127 billion in premiums each year. Both the ACLI & AIA appreciate the opportunity to offer our input to the Group Capital Calculation (E) Working Group.

The member companies of the ACLI and AIA play a vital role in our economy and provide critical financial and insurance protection to American consumers. Any new state-based approach to assessing the solvency of insurers—and their ability to provide economic security to millions of Americans — must be bench-marked against the current long-standing, well-tested approach. The process for constructing any new approach must be deliberate, and it must incorporate ample impact analyses, field testing, and feedback channels.

We are encouraged by the Financial Condition (E) Committee's decision to explore an RBC aggregation approach to a state-based group capital calculation. This approach has deep roots in the existing state risk-based capital system and is consistent with our advocacy in other domestic and international fora. The attached document summarizes our thinking to date on an RBC aggregation approach.

We believe that state regulators, their staffs, and NAIC staff must continue to work with and within Team USA as strong and active partners. Every effort must be made to ensure that any new state-based group capital assessment not duplicate or conflict with the Federal Reserve Board's approach and that U.S. capital standards not be eclipsed by the development of international capital standards proceeding at a faster pace. Any other outcome would be disastrous for our industries.

American Council of Life Insurers
101 Constitution Avenue, NW, Washington, DC 20001-2133
(202) 624-2340 t (866) 953-4083 f carolyncobb@acli.com
www.acli.com

American Insurance Association
2101 L Street, NW, Washington, DC 20037
(202) 828-7175 t szielezienski@aiadc.org
www.aiadc.org

We appreciate the transparency of NAIC process on this topic, look forward to further discussion, and anticipate remaining actively engaged as the deliberations proceed.

Very truly yours,

Carolyn Cobb
Vice President & Chief Counsel,
Reinsurance & International Policy
American Council of Life Insurers

J. Stephen Zielezienski
Senior Vice President & General Counsel
American Insurance Association

CC: Superintendent Eric Cioppa (Maine), Chairman, NAIC Financial Condition (E) Committee
Dan Daveline, Director, Financial Regulatory Services, NAIC

An Aggregation & Calibration Approach to Insurer Group Capital

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101 Constitution Ave., NW, Washington, DC 20001-2133

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Submission Outline

- Background of the Aggregation and Calibration Approach
- Overview of the Aggregation and Calibration Approach
- Key Issues Addressed in the Aggregation and Calibration Approach
- Policy Issues Raised by the NAIC Group Capital Calculation Project

Background of the Aggregation and Calibration Approach

Attachment Two

Background

For the past year, the industry has been constructively engaged to develop an approach to a group capital calculation based on existing statutory regimes.

Termed *Aggregation and Calibration* (A&C), the approach provides a framework for aggregating available capital and required capital across an insurance group's entities, with adjustments as appropriate, to produce a group-wide solvency ratio.

The Life and P&C industries are represented in the effort, with coordination through ACLI in partnership with the American Insurance Association (AIA).

Overview of the Aggregation and Calibration Approach

Attachment Two

Overview of the Aggregation and Calibration Approach
Building Blocks

The approach consists of two major building blocks:
Aggregation of local solvency measures and Calibration across measures to ensure comparability

Aggregation

- Aggregates local available and required capital to determine a group solvency ratio, leveraging existing regulatory solvency rules and audited financials, and specifying a suitable regime where necessary
- Reflects the group's activities and risks, including those not captured by insurance regulatory standards
- Applies adjustments where needed to appropriately aggregate across the group's entities and activities

Calibration

- Applies scalars across regimes to produce comparable measures of risk which can be aggregated into a group-wide measure

A Group Solvency Ratio measures the capital adequacy of the group, reflecting adjustments and scaling as appropriate

Overview of the Aggregation and Calibration Approach
A&C is a principles-based approach

The A&C approach is guided by overarching principles which ensure comparability and transparency, regardless of a group's structure, activities or regimes

Aggregation	**Calibration**
Guiding principles dictate the identification of regimes and adjustments in order to ensure appropriate reflection of capital across the group	Guiding principles ensure comparability when aggregating capital across regimes

← Transparency underlies all aspects of the framework →

Overview of the Aggregation and Calibration Approach
A&C's Guiding Principles

The following five principles guide A&C:

Principle		Application
1	**Reflects appropriate regime – insurance vs. non-insurance**	• All entities differentiated between insurance and non-insurance – Insurance entities under existing solvency regime – Non-insurance entities under Basel III if material
2	**Minimal adjustments to existing regimes**	• Existing solvency measures should be preserved where appropriate • Apply regime at highest level of existing consolidation where appropriate
3	**Indifferent to corporate structure**	• The location of an entity within the group structure should not impact capital at the aggregated level • Intragroup transactions should not impact capital at the aggregated level
4	**Comparable across regimes**	• The group level aggregation must reflect comparable levels of risk, achieved through scaling of capital ratios across regimes
5	**Transparent**	• The company should produce: – A full inventory of all entities listed with corresponding regime – A full inventory of intragroup transactions and related adjustments – A full inventory of company specific practices (e.g., permitted practices) and their treatment within the framework

Overview of the Aggregation and Calibration Approach
Steps in the A&C approach

Steps are guided by the five principles

1 Identification and Assignment

- Identify all legal entities
- Identify insurance and non-insurance entities
- For insurance entities, identify whether regime is scalar compatible
- For non-insurance entities, apply Basel III as appropriate

2 Inventory

- Inventory of all:
  - Entities and applicable regimes
  - Intragroup transactions (e.g., loans and guarantees)
  - Affiliated reinsurance transactions
  - Permitted and prescribed practices

3 Quantification and Adjustment

- Calculate available and required capital under the appropriate regime
- Calculate adjustments for
  - Material scalar incompatible regimes
  - Intragroup transactions
  - Affiliate reinsurance
  - Permitted and prescribed practices

4 Scaling and Aggregation

- Apply cross-regime scalars for comparability
- Consider diversification recognition in aggregation

Principles which guide the process

		1	2	3	4
1	**Reflects appropriate regime**	✓		✓	✓
2	**Minimal adjustments to existing regimes**	✓		✓	
3	**Indifferent to corporate structure**		✓	✓	
4	**Comparable across regimes**	✓	✓	✓	✓
5	**Transparent**	✓	✓	✓	✓

✓ Applicable principle

Key Issues Addressed in the Aggregation and Calibration Approach

Attachment Two

Key Issues Addressed in Aggregation and Calibration Approach

STEP	ISSUE	APPROACH
1. Identification and Assignment	Determining the Appropriate Regime	▪ Defined insurance or insurance related entities ▪ Established a materiality threshold ▪ Apply local insurance solvency regime (subject to scalar compatibility - see below) or Basel III for non insurance entities
	Universe of Scalar Compatible Regimes	▪ Relied on pre-existing assessments by third parties (NAIC, Solvency II Equivalence, IMF Insurance FSAP) • Currently Includes eleven regimes • RBC covers the majority of insurance assets and revenues of US-based insurance groups • Scalar compatible regimes cover the majority of insurance assets and revenues of US-based insurance groups ▪ For all non scalar compatible regimes • If material, restate to a scalar compatible regime that uses a similar accounting basis • If immaterial, treat as a subsidiary under U.S. RBC.
2. Inventory	Permitted and Prescribed Practices	▪ Captives treated under affiliated reinsurance treatment -- see Step 3 below ▪ Restate NY-domiciled entities to NAIC SAP ▪ Provide inventory of remaining permitted and prescribed practices to the supervisor • Shortlist of residual practices • Supervisor to apply company-specific adjustments, if needed

Key Issues Addressed in Aggregation and Calibration Approach

STEP	ISSUE	APPROACH
3. Quantification and Adjustment	Affiliated Reinsurance	▪ If reinsured to an affiliate within a scalar compatible regime, no adjustments. ▪ Otherwise, restate assets, liabilities and required capital to framework applicable to ceding insurer • If immaterial, treat as a subsidiary under ceding insurer's regime • Special case for Term, UL and VA Captives – see below
	Term Life / Universal Life Captives	▪ Asset Valuation: Use SAP ▪ Liability Valuation: Set reserves to "Required Level of Primary Security" under AG 48 (replace with PBR when adopted) ▪ Required Capital: Use RBC ▪ Applies to Captives and non-Captives
	VA Captives	▪ Asset Valuation: Use SAP ▪ Liability Valuation: Reserves set at TAR (per SAP C3P2) less Required Capital ▪ Required Capital: TAR (per SAP C3P2) x [1-1.5%] • Creates a stable boundary between capital and reserves • Subject to NAIC revisions to current framework • Applies to Captives and non-Captives
	Adjustments for other Intragroup Holdings and Transactions	▪ Application of 5 principles to make adjustments comparable to those required in consolidation ▪ Ensures there is no capital impact of intragroup transactions when capital is aggregated across entities, e.g. (1) Investments in Affiliates: o Exclude impact of investment in affiliates, including surplus notes, from available and required capital of investing company (2) Affiliate Loans: o Exclude any capital charge associated with the loan asset from the entity providing the loan (and adjust Group capital to eliminate any difference in carrying values of loan asset and obligation) (3) Affiliate Guarantees o Exclude any capital charge associated with the guarantee

Key Issues Addressed in Aggregation and Calibration Approach

STEP	ISSUE	APPROACH
4. Scaling and Aggregation	Regime Calibration	▪ Calibrate all regimes to US RBC • Calibration of P&C to Life to be determined ▪ Use regulatory intervention levels and average capital ratios for similar companies under different regimes to establish "book-ends" to scalar ▪ Scalar equals ratio of excess capital to required capital in each regime $\text{Excess Ratio} = \frac{\text{Avg. Capital Ratio} - \text{Regulatory Trigger}}{\text{Regulatory Trigger}}$ $\text{Scalar} = \frac{\text{Foreign Regime Excess Ratio}}{\text{RBC Excess Ratio}}$
	Diversification	▪ "Intra-entity" Diversification is embedded in local regimes ▪ Proposed incorporating "intra-group" sources of diversification • Cross line of business (P&C vs. Life) • Geographical • Correlations to be determined

Policy Issues Raised by the NAIC's Group Capital Calculation Project

We support state regulators' participation in national and international discussions on group capital. We believe, however, that a state-based group capital calculation raises a number of policy issues which need to be addressed as this project moves forward – a dynamic we believe the NAIC recognizes.

These policy issues include:

- The necessity and appropriateness of a group capital calculation for all insurance groups;
- How would state regulators implement & coordinate assessment of such a calculation;
- The basis and scope of an insurance commissioner's authority to adopt and act on the calculation.

We believe these questions must be answered before final development and adoption of an insurer group capital calculation by the NAIC. The ACLI and AIA are willing to work with the NAIC on addressing them in a constructive and collaborative manner.

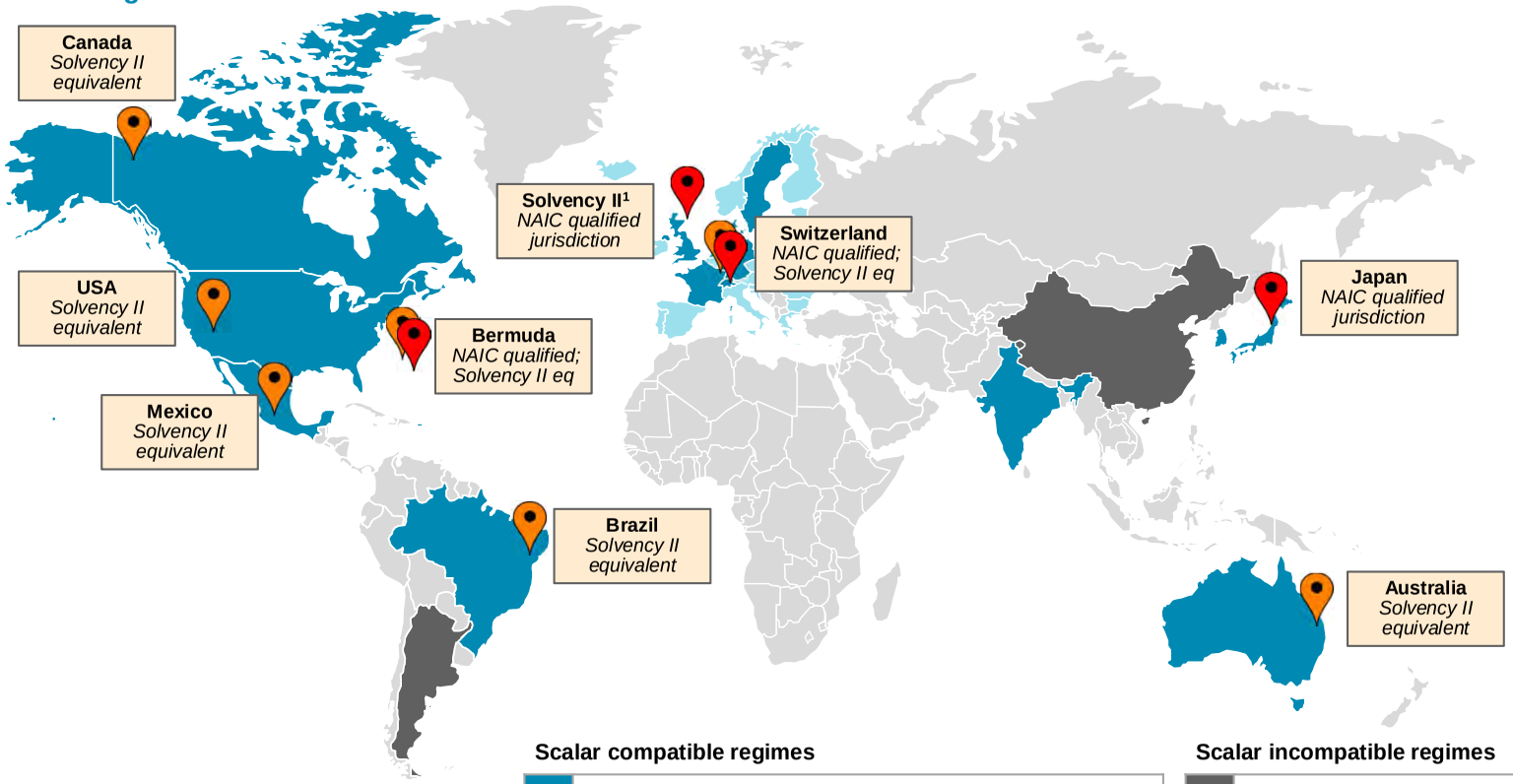
Appendix

Attachment Two

The provisional list of scalar compatible regimes

Principle 1: Reflects appropriate regime
Principle 2: Minimal adjustments to existing regimes
Principle 4: Comparable across regimes
Principle 5: Transparent

Global Regime Classification



Scalar compatible regimes

	IMF assessed ("Observed" or "Largely Observed")
	Other SII jurisdictions not assessed – scalar compatible
	On NAIC list of qualified jurisdictions
	Solvency II equivalent

Scalar incompatible regimes

	IMF assessed ("Partially Observes" or "Not Observed")
	No assessment

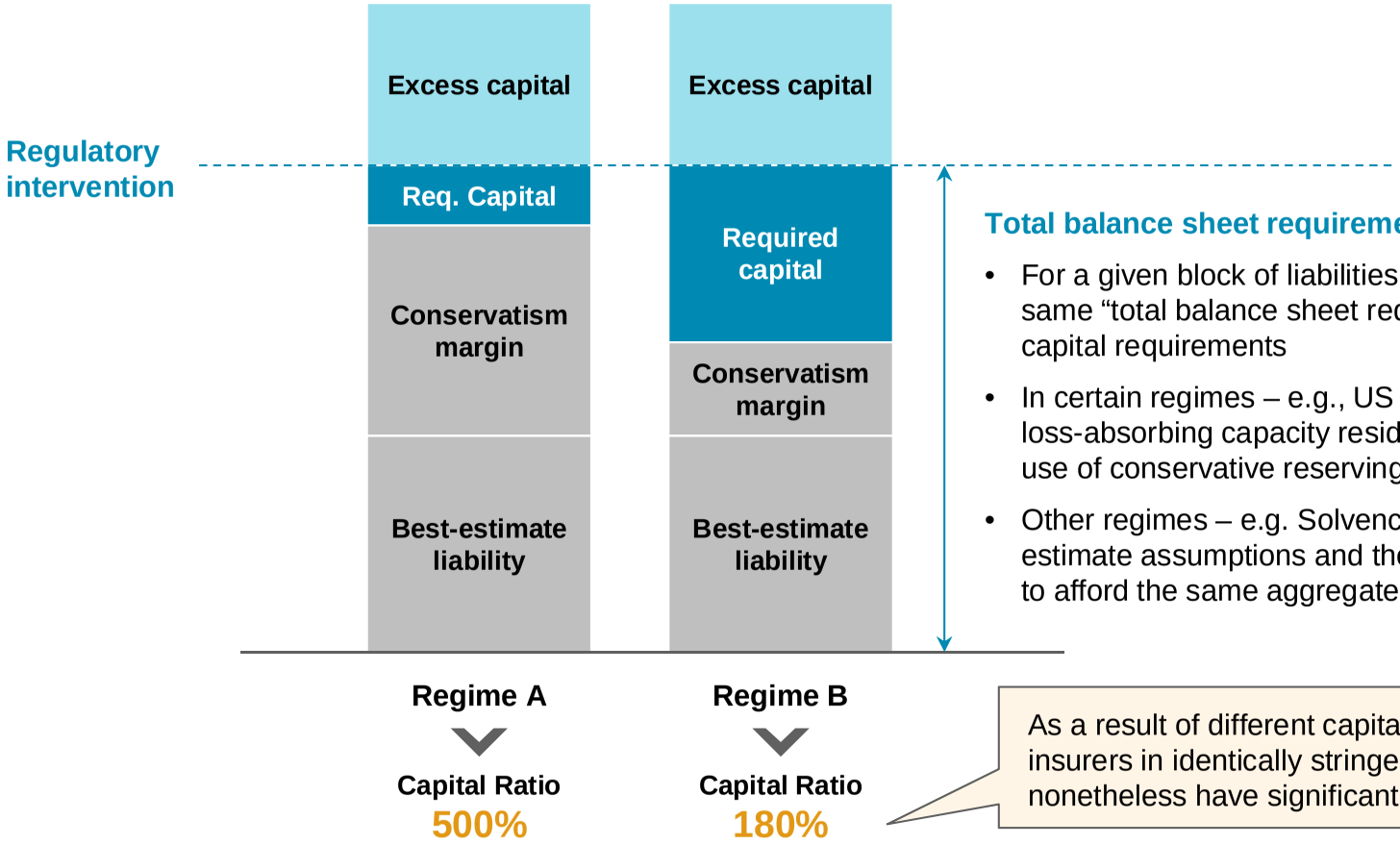
1. France, Germany, Ireland and UK are included in the NAIC list of qualified jurisdictions; A&C extends scalar compatibility designation to all countries compliant with Solvency II.

Variation in the degree of accounting conservatism explains a large portion of differences in capital ratios across solvency regimes

Principle 1: Reflects appropriate regime
Principle 4: Comparable across regimes
Principle 5: Transparent

Total balance sheet requirement of an illustrative insurer

Illustrative



Total balance sheet requirement

- For a given block of liabilities, two regimes can have the same "total balance sheet requirement" but very different capital requirements
- In certain regimes – e.g., US RBC, a significant portion of loss-absorbing capacity resides in reserves through the use of conservative reserving assumptions[1]
- Other regimes – e.g. Solvency II – use mostly best-estimate assumptions and therefore require more capital to afford the same aggregate loss-absorbing capacity[1]

As a result of different capital requirements, identical insurers in identically stringent regimes can nonetheless have significantly different capital ratios

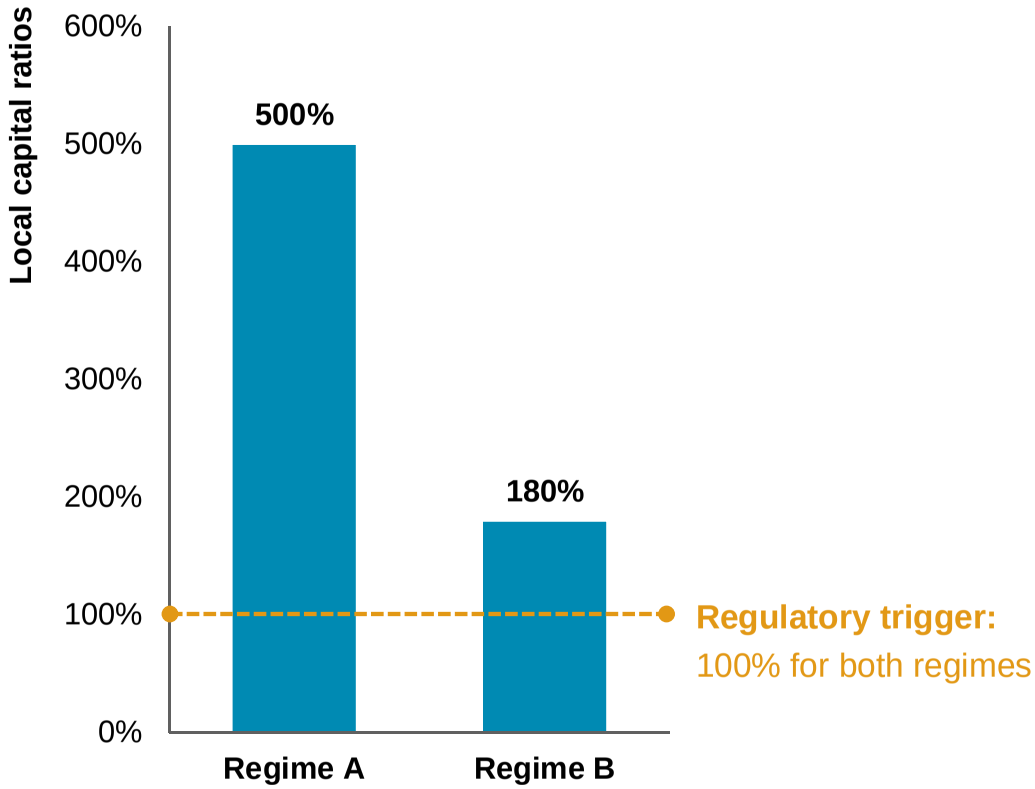
1. Additionally, certain regimes have more conservative asset valuation and admissibility rules (e.g., for intangible assets) than do other regimes; these differences would also contribute to different capital requirements that nevertheless represent similar requirements of the company's general financial health.

Calibration approaches that are based on a single point of comparison do not capture the impact of accounting conservatism

Principle 1: Reflects appropriate regime
Principle 4: Comparable across regimes
Principle 5: Transparent

Average operating ratios of sample regimes

Illustrative



- **Under the regulatory trigger approach:**
  - The insurer in regime B would have a significantly lower GSR than the insurer in regime A
  - This discrepancy may create incentives and disincentives to write in certain jurisdictions
  - Potential for capital arbitrage, even amongst scalar compatible regimes (e.g. Europe to US)
- **Under the operating range approach**
  - The scalar is calibrated by comparing 500% (regime A) to 180% (regime B)
  - As a result, a capital ratio at the regulatory trigger of 100% for regime A would correspond to a capital ratio of ~36% for regime B, which is much lower than the actual regulatory trigger of 100%
  - This may be inconsistent with actual insurer failure

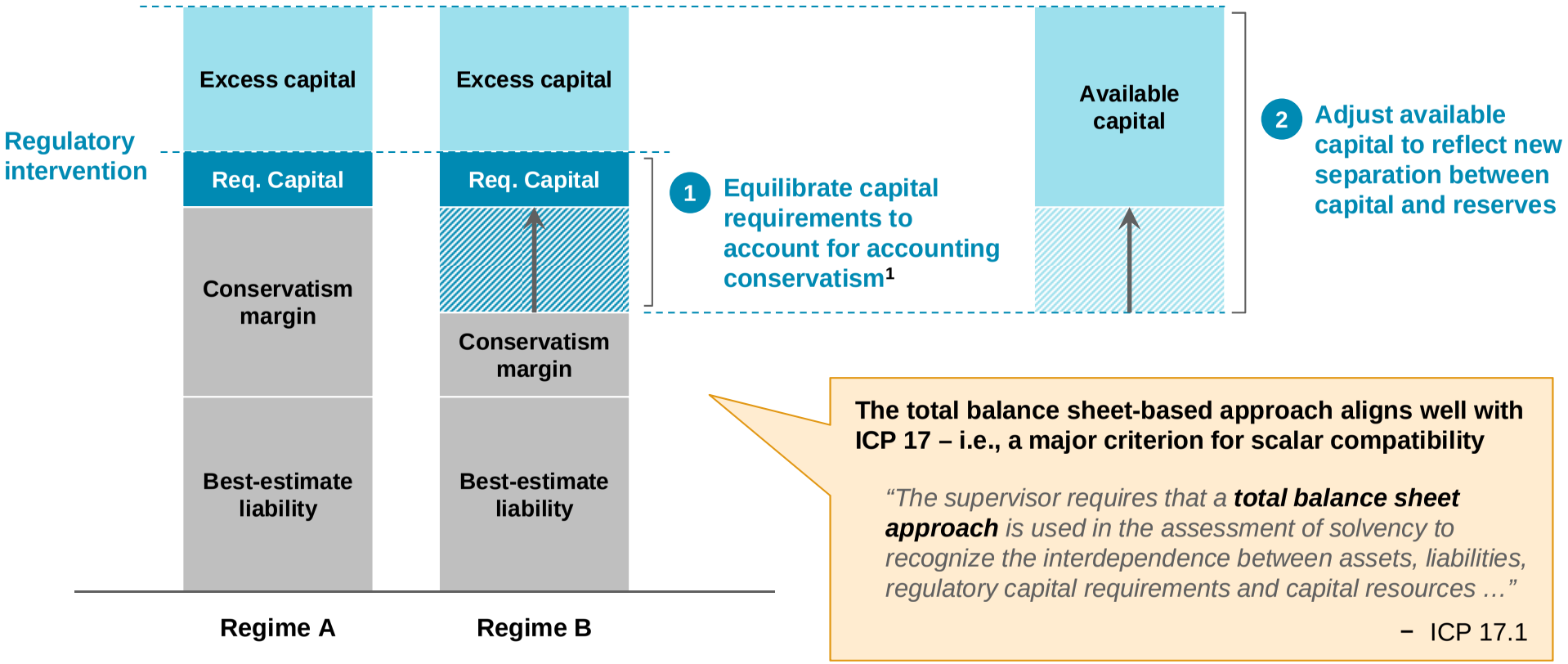
As a result, scalars calibrated under the two approaches can produce inappropriate outcomes

Proposal recognizes different accounting conservatism levels to equilibrate capital requirements

Principle 1: Reflects appropriate regime
Principle 4: Comparable across regimes
Principle 5: Transparent

Total balance sheet requirement of an illustrative insurer in two regimes

Illustrative



The total balance sheet-based approach aligns well with ICP 17 – i.e., a major criterion for scalar compatibility

*"The supervisor requires that a **total balance sheet approach** is used in the assessment of solvency to recognize the interdependence between assets, liabilities, regulatory capital requirements and capital resources …"*

– ICP 17.1

1. Also accounts for differences in asset valuation and admissibility rules (e.g., for intangible assets). For instance, assets admitted under Regime B but not Regime A may be considered a "contra-liability" in Regime B that is subsequently removed when raising Regime B's conservatism margin to equilibrate Regime B and Regime A.

Total balance sheet calibration approach draws upon regulatory triggers and average operating ratios to determine the scalar values

Principle 1: Reflects appropriate regime
Principle 4: Comparable across regimes
Principle 5: Transparent

- Measuring capital requirements for common risks in each regime would provide the "purest" way to calibrate scalars[1]
  - -Define stylized insurers with representative portfolios at a targeted high level of capitalization
  - -Calculate available & required capital in regimes of interest
- While regulators may decide to undertake such an exercise in the future, an "excess capital ratio" approach can serve as a reasonable proxy in the interim

1 **Across regimes, identify the capital trigger at which regulators mandate similar actions**

- Assumes that regulators have similar total balance sheet requirements at the regulatory trigger

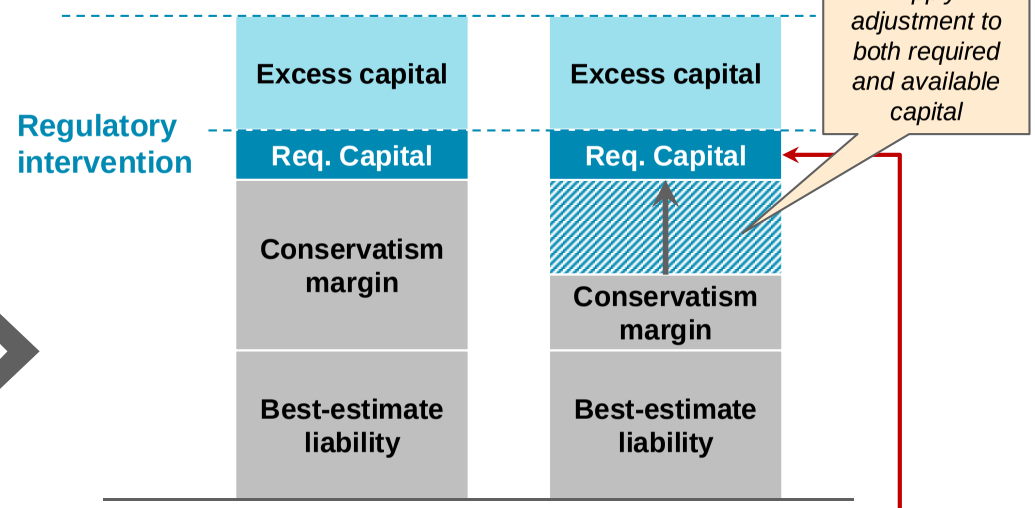
2 **Measure average capital ratios for similar companies[2] under each regime**

- Assumes that similar companies hold similar levels of assets relative to their liabilities and risks

3 **Calculate the ratio of excess capital to required**

$$\text{Excess Ratio} = \frac{\text{Avg. capital ratio - Regulatory trigger}}{\text{Regulatory trigger}}$$

"Excess capital ratio" calibration Illustrative



	Regime A	Regime B
Average ratio	500%	180%
Excess ratio	400% of Required Capital A	80% of Required Capital B

$$\text{Scalar} = \frac{\text{Req. Capital A}}{\text{Req. Capital B}} = \frac{\text{Excess Ratio B}}{\text{Excess Ratio A}} = \frac{80\%}{400\%} = \boxed{0.20}$$

1. Captures the full range of balance sheet differences across regimes, including asset admissibility, reserving standards, capital requirements, and tax treatment of reserves vs. capital
2. These companies can be identified either through credit/financial strength ratings or via other metrics – e.g., total assets, total revenue – in combination with lines of business.

Attachment Two

Variable annuity required capital – for both captives and non-captives
Proposed approach stabilizes the division between reserves and capital

Principle 1: Reflects appropriate regime
Principle 2: Minimal adjustments to existing regimes
Principle 3: Indifferent to corporate structure
Principle 4: Comparable across regimes
Principle 5: Transparent

Total Asset Requirement

Calculation is unchanged from the current statutory framework

- Maintains the spirit of the current statutory framework – i.e., minimum total funding requirement
- Includes cash surrender value and reserves/capital for guarantees

Required capital

[X]% of TAR

Reserves

(100% – [X]%) of TAR

- The approach would apply to both captives and non-captives to ensure consistency
- **[X]%** would be a pre-calibrated percentage that stays fixed over time
- We expect that **[X]%** should be in the range of 1-1.5%; further work is needed to define the calibration

Recognizing the NAIC's work on VA reserving and capital requirements, we intend this approach to be an interim solution pending any NAIC revisions to the statutory framework

Attachment Two