NAIC National Association of Insurance Commissioners

Date: 10/7/19

Conference Call

GROUP CAPITAL CALCULATION (E) WORKING GROUP

Wednesday, October 30, 2019
11:00 a.m. ET / 10:00 a.m. CT / 9:00 a.m. MT / 8:00 a.m. PT

ROLL CALL

David Altmaier, Chair	Florida	Kathleen Orth	Minnesota
Kathryn Belfi, Vice Chair	Connecticut	Justin Schrader	Nebraska
Susan Bernard	California	David Wolf	New Jersey
Philip Barlow	District of Columbia	Edward Kiffel	New York
Roy Eft	Indiana	Jackie Obusek	North Carolina
Kevin Fry	Illinois	Dale Bruggeman	Ohio
Jim Armstrong	Iowa	Joseph DeMemmo	Pennsylvania
Rachel Davison/Christopher Joyce	Massachusetts	Mike Boerner/Doug Slape	Texas
Judy Weaver	Michigan	David Smith/Doug Stolte	Virginia
John Rehagen	Missouri	Amy Malm	Wisconsin

NAIC Support Staff: Dan Daveline/Lou Felice

AGENDA

1. Adopt Revised Debt Memorandum for Incorporation into GCC — Attachment A
   —*Commissioner David Altmaier (FL)*

2. Adopt Request for Model Law Development — Attachment B
   —Commissioner David Altmaier (FL)

3. Discuss Any Other Matters Brought Before the Working Group
   —*Commissioner David Altmaier (FL)*

4. Adjournment

W:\National Meetings\2019\Fall\Cmte\E\GCCWG\October Call\Agenda.docx

This page is intentionally left blank.

MEMORANDUM

TO: Group Capital Calculation(E) Working Group

FROM: David Altmaier, Chair, Group Capital Calculation (E) Working Group

DATE: ~~October 30, 2017 (revised April 19~~October 7, 2019~~, 2018~~)

RE: Treatment of Senior Debt and Surplus Notes in the Group Capital Calculation

As part of the discussions related to the determination of available capital under~~in~~ an RBC aggregation approach to a group capital calculation (GCC), the issue of how to treat senior debt and surplus notes needs to ~~will~~ be considered. As noted below, the treatment of Surplus Notes within the calculation is much more clearly guided by available accounting guidance. Less direction is found for the appropriate consideration of senior debt.

Background

Statement of Statutory Accounting Principles (SSAP) 41 establishes a strong State-based entity specific regulatory structure for surplus notes issued by insurers which is further supported by state receivership laws. SSAP 15 requires all types of debt, including senior debt to be recorded as a liability. However, SSAP 15 ~~both are~~ is based upon insurance legal entity principles that are not designed to consider the financial flexibility that senior debt issued by a non-insurer holding company can provide the insurance group. In addition, the current guidance does not consider any prohibitions / limitations on the investments of holding company debt instruments. Part of the reason for less regulatory guidance on holding company issuers of senior debt is related to the States' focus on insurance legal entities (a bottom up approach) vs. a GAAP consolidated approach to available capital that views the group as a single economic construct and eliminates any intra-group double-counting (a top down approach). ~~and even~~ ~~F~~further, current guidance does not apply ~~where~~ an economic valuation approach which ~~may~~ considers how such debt should be ~~is~~ characterized when the insurance holding company receives assets that can be allocated to provide capital to the legal entity insurer(s). Surplus notes are generally issued by insurers or mutual holding companies in a holding company structure. They may be issued to insurers within the group or to outside investors. Senior debt is generally issued by non-operating holding companies and is issued to investors that are outside the group (or outside the definition of control within the group). Other issues related to these instruments include the manner in which "subordination" of debt (other than surplus notes) is established, the quality of capital generated, and what becomes of the capital generated via issuance of such debt.

Entity vs. Consolidated view:

In a consolidated calculation the value of intra-group surplus notes or loans are offset and eliminated (i.e. the asset held by the purchaser and the debt reported by the issuer are offset). When surplus notes (or any type of debt) are issued to entities outside the group, consolidated GAAP will treat them as a liability along with any associated accrued interest on the issuer's balance sheet (***See APB 15*****).** Where the proceeds of other debt issued are held within the holding company structure, consolidated GAAP would offset that portion of debt issued against related capital that is held by affiliated entities or retained by the issuer. Any excess debt issues would be treated as a liability of the issuer.

By contrast, in the statutory entity-based calculation where surplus notes are issued intra-group to an affiliated insurer it creates capital value at the issuer level since such obligations are subordinated to policyholder claims, but is capital neutral to the purchaser at the entity level. In the group's capital structure SSAP 97 eliminates the value from the purchaser's surplus making the surplus note capital neutral at the group level. In addition, U.S. Risk-based Capital (RBC) assigns an asset risk charge (typically based on holding the note as a Schedule BA asset) to the purchaser. Therefore, the investment carried by the affiliate and any associated capital (e.g. RBC) charge to the affiliated purchaser(s) needs to be addressed in an aggregation approach. Under current SAP, senior or other debt instruments issued by a non-insurance holding company to the insurance company is generally considered an asset if the purchase of the debt is approved by the domestic regulator and to the extent criteria demonstrating the financial strength of non-insurance holding company is met. ~~, similar to GAAP, but it~~Its value would be eliminated under GAAP consolidated statement, however, since the non-insurance holding company would treat it as a liability.

Nature of subordination

For surplus notes, the State-based regulatory framework applies "contractual subordination" in that the subordination provisions to restrict movement of funds from the licensed insurer to repay the note are contained within the language of the note itself. For senior debt issued by a holding company, the State-based regulatory system relies on what is referred to as "structural subordination". In general, subordination ranks other creditors behind policyholders in priority of repayment. Structural subordination is achieved via regulation of movement of funds between insurers and other entities within the holding company structure. An example of how regulatory practices work under structural subordination is demonstrated in the regulatory review and oversight of stockholder dividends paid to the holding company. Dividends paid to the holding company are generally the primary source of income for holding companies which are then used to service their outside debt.

Treatment of Surplus Notes

Treatment of issuers of surplus notes and holders of surplus notes or capital notes is specified in SSAP #41 as follows:

3. Surplus notes ***issued*** *by a reporting entity that are subject to strict control by the commissioner of the reporting entity's state of domicile and have been approved as to form and content shall be reported as surplus and not as debt only if the surplus note contains the following provisions:*

> *a. Subordination to policyholders;*
> *b. Subordination to claimant and beneficiary claims;*
> *c. Subordination to all other classes of creditors other than surplus note holders; and*
> *d. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.*

9. ***Investments in*** *capital or surplus notes meet the definition of assets as defined in SSAP No. 4— Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement. Additionally, the amount admitted is specifically limited to the following two provisions:*

> *a. The admitted asset value of a capital or surplus note shall not exceed the amount that would be admitted if the instrument was considered an equity instrument and added to any other equity instruments in the issuer held directly or indirectly by the holder of the capital or surplus note.*
> *b. The surplus note shall be nonadmitted if issued by an entity that is subject to any order of liquidation, conservation, rehabilitation or any company action level event based on its risk-based capital. Subsequent to this nonadmittance, if any of the conditions described ceased to exist, the holder may admit the surplus note at the value determined under paragraph 11. If a surplus note was nonadmitted pursuant to this paragraph, and the surplus note was ultimately determined to be other-than-temporarily impaired, the reporting entity shall recognize a realized loss for the portion of the surplus note determined to be other-than-temporarily impaired, with elimination of a corresponding amount of the previously nonadmitted assets.*

In addition, SSAP 97 is referenced in SSAP#41 as follows:

Holders of Capital or Surplus Notes

13. For surplus notes issued and held (directly or indirectly), between insurance reporting entities and subsidiary, controlled and affiliated entities, the guidance in SSAP No. 97 requires adjustment to prevent double-counting of surplus notes. For example, an insurance reporting entity is not permitted to report the issuance of a surplus note as an increase in surplus and have an asset representing an investment in the SCA that includes the issued surplus note (held by an SCA). ***Pursuant to SSAP No. 97, the "investment in the SCA" shall be adjusted to eliminate the surplus note issued by the direct or indirect parent insurance reporting entity.*** *This treatment shall also apply for instances* *in which the SCA acquires any portion of outstanding surplus notes issued by the direct or indirect parent through any means (e.g., directly acquired from the parent, acquired through a third-party broker, or via the market.).*

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities
Investment in Preferred Stock or Surplus Notes of a Subsidiary, Controlled and Affiliated Entity
20. Any parent reporting entity that has issued a surplus note, which has been acquired by an SCA (held directly or indirectly), ***shall adjust the investment in the SCA to eliminate the issued surplus note to prevent double counting of the surplus note at the parent reporting entity.*** *Without adjustment, the issued surplus note would be reported both as an increase in surplus by the parent reporting entity, as well as an admitted asset of the parent through the "investment in an SCA." The surplus note shall also be eliminated for instances in which the SCA acquires any portion of outstanding surplus notes issued by the parent through any means (e.g., directly acquired from the parent, acquired through a third-party broker, or via the market.).*

By operation of SSAP97 the value of the surplus note in an affiliate purchaser is eliminated in the RBC roll-up of that entity. However, in the GCC aggregation approach, the group is de-stacked and stand-alone entities are established at their specified accounting values. These stand-alone values will include an asset for the investment in surplus note(s). So in such cases that investment must be eliminated along with any regulatory capital charge where applicable. Thus, surplus notes issued to non-affiliated entities outside of the group create new capital for the group while those issued within the group do not create new capital at the group level.

Treatment of Senior Debt

While there is no specific SAP regulatory treatment (independent of GAAP treatment as a liability) for debt issued by a non-operating holding company, it is recognized that in an insurance-led holding company structure that funds needed to repay the holders of the debt may be generated and provided by the insurers in the group in the form of stockholder dividends. Therefore, it is reasonable to recognize the structural subordination described above in considering how to treat the debt for purposes of available capital. However, because the issuance of debt within a holding company structure makes assets available within the holding company system that could be used to help absorb losses originating from the insurer or another entity within the holding company structure for which the group capital calculation attempts to require capital ~~for~~, it may be appropriate to develop criteria within the GCC that ~~places limits on the~~ permit some amount of subordinated senior debt to be added back to capital~~that is included~~.

~~To inform the Working Group thinking on the appropriate treatment, NAIC staff has looked to the approaches taken by credit rating in considering the inclusion of senior debt. The result is a less than conclusive view from the agencies.~~

~~It is important to note that the rating agency view of senior debt is based on a different perspective and purpose than is the regulatory view. The rating agency view focuses on assigning financial strength ratings to groups and individual entities for use by a wide variety of market stakeholders. In contrast, the regulatory view is focused on safeguards in the regulatory framework over the flow of capital out of the insurers so as to protect policyholders, at specific points in time. These two views, while similar, do allow for divergence in the consideration of how senior debt is included in the calculation and consideration of the "safety" of an insurance entity or group. It is not the intent of this memo to suggest mimicking the analysis process of a given rating agency.~~

The Working Group will need to come to a consensus agreement on the most logical way to field test the impact of including ~~double leverage for~~ structurally subordinated senior debt as additional group capital within the GCC. If this capital resource is to be included, why? If it is to be is to be constrained or capped, to what level and why? ~~In considering this issue, while the Working Group can be usefully informed by the approaches taken by the credit rating agencies if and where such approaches align with the principle of structural subordination.~~

If it can be demonstrated that higher amounts of the debt can be tied to the principle of structural subordination (e.g. a higher percentage of the proceeds were down-streamed to the insurers or entities under similar regulatory supervision as U.S. insurers), then a higher allowance could be considered consistent with the amount of proceeds that are down-streamed to insurers in the group.

It is also important to consider that the base for total available capital under the U.S. insurance regulatory structure is generally lower than what is recognized under consolidated GAAP rules. Therefore, if ~~a cap~~the addition of subordinated debt to be included as capital is deemed appropriate, a case for a slightly higher allowance, based on regulatory accounting rules combined with the strength of structural subordination may be considered.

Quality of Capital
Under SAP (or GAAP) there is no distinction in quality of capital (i.e. tiering) for assets that meet the definition of admitted assets such as surplus notes. Based on this, it seems logical that any other asset values allowed in an aggregation approach should be treated similarly. However, there is such a distinction under U.S. banking rules and there may be under other sectoral rules. So it seems logical to respect the available calculations of the regulators in those sectors.

Recommendations for an aggregation approach to a GCC:

1. Surplus Notes –In all cases, treat the assets transferred to the issuer of the surplus note as available capital. If the purchaser is an affiliate, eliminate the investment value from the affiliated purchaser of the surplus note. If the purchaser is an insurer or other regulated entity, eliminate the purchaser's capital charge (e.g. RBC charge) on the Surplus note investment.

2. Subordinated Senior Debt issued –Recognize ~~double leverage for~~ structurally subordinated debt as available capital to some degree and only to the extent funded (i.e. any receivables for non-paid-in amounts would not be included for purposes of calculating the allowance). For purposes of recognition both of the following criteria are required to be met:

a. The instrument must have ~~has~~ a fixed term (a minimum of five years at the date of issue or refinance, including any call options).
   b. Supervisory approval is required for any extraordinary dividend or distribution from any insurance subsidiary to fund the repurchase or redemption of the instrument. There shall be no expectation, either implied or through the terms of the instrument, that such approval will be granted without supervisory review.

3. For initial field testing:
   a) Construct the initial field testing template so as to collect data on senior debt issued to be included as capital such that a range of caps relative to total available capital can be evaluated to assess the level. For purposes of testing a range of caps as a percentage of total available capital, the total available capital base should be defined as aggregated entity based capital (e.g. SAP available capital for U.S insurers) plus the outstanding value of the senior debt.
   b) In addition to 3a, construct the initial field testing template so as to collect data on debt that includes equity like features (so-called hybrids) and other subordinated debt issued, including the extent that the proceeds are down-streamed to the regulated entities or otherwise used for the benefit of those entities at the time of issuance of the debt instruments, such that an additional cap for these instruments can be evaluated. For purposes of testing an allowance as a percentage of total available capital, the total available capital base should be defined as aggregated entity based capital (e.g. SAP available capital for U.S insurers) plus the outstanding value of the senior debt and hybrids or other subordinated debt.
   c) As one option for field testing, a cap should be tested based on the amount of proceeds of the debt that is down-streamed to the regulated entities or otherwise used for the benefit of those entities at the time of issuance of the debt instruments.
   d) Recognize the proceeds of surplus notes and structurally subordinated senior debt as capital in line with the criteria described above, but respect quality of capital classifications defined by other U.S. sectoral regulators on their regulated entities' available capital.

4. Other recommendations:
   a) Review and establish appropriate allowance criteria for hybrid debt that recognizes the instruments' required equity features.
   b) Continue discussion, in consultation with NAIC international team, to maintain consistency on the boundaries of what constitutes structural subordination and how it should be measured.

REQUEST FOR NAIC MODEL LAW DEVELOPMENT

This form is intended to gather information to support the development of a new model law or amendment to an existing model law. Prior to development of a new or amended model law, approval of the respective Parent Committee and the NAIC's Executive Committee is required. The NAIC's Executive Committee will consider whether the request fits the criteria for model law development. Please complete all questions and provide as much detail as necessary to help in this determination.

Please check whether this is: ☐ **New Model Law** **or** ☒ **Amendment to Existing Model**

1. **Name of group to be responsible for drafting the model:**

   Group Capital Calculation (E) Working Group

2. **NAIC staff support contact information:**

   Dan Daveline
   ddaveline@naic.org
   (816) 783-8134

3. **Please provide a brief description of the proposed new model or the amendment(s) to the existing model. If you are proposing a new model, please also provide a proposed title. If an existing model law, please provide the title, attach a current version to this form and reference the section(s) proposed to be amended.**

   - ***Insurance Holding Company System Regulatory Act (#440)***
   - ***Insurance Holding Company System Regulation with Reporting Forms and Instructions (#450)***

   In 2015, the NAIC adopted the following charge to the Financial Condition (E) Committee who subsequently formed the Group Capital Calculation (E) Working Group to carry out such a change.

   "Construct a U.S. group capital calculation using an RBC aggregation methodology; liaise as necessary with the Comframe Development and Analysis (G) Working Group on international capital developments and consider group capital developments by the Federal Reserve Board, both of which may help inform the construction of a U.S. group capital calculation."

   The Group Capital Calculation (E) Working Group has been developing the group capital calculation (GCC) since receiving its charge and in May, with the assistance of 33 insurance groups and 15 lead states, began testing the current construction. The lead states are currently reviewing the completed templates and take aways from the testing are expected to be summarized and discussed at the Fall National Meeting in Austin. Upon completion of the field-testing, state regulators will use the results to further improve the construction of the calculation and at this junction, the Working Group is striving to adopt the calculation sometime in 2020. In order to allow states to be able to adopt the GCC, the Working Group is seeking approval to modify the Insurance Holding Company System Regulatory Act (#440) and the Insurance Holding Company System Regulation with Reporting Forms and Instructions (#450). While the Working Group has not concluded the exact construct of such changes, the Working Group expects Section 4 of #440 will need to be revised to require a new filing and #450 will need to be revised to add the new filing and a related new section (Form G).

4. **Does the model law meet the Model Law Criteria?** ☒ **Yes** **or** ☐ **No** **(Check one)**

   (If answering no to any of these questions, please reevaluate charge and proceed accordingly to address issues).

   a. **Does the subject of the model law necessitate a national standard and require uniformity amongst all states?** ☒ **Yes** **or** ☐ **No** **(Check one)**

If yes, please explain why:

State insurance regulators currently perform group analysis on all U.S. insurance groups, including assessing the risks and financial position of the insurance holding company system based on currently available information. However, state regulators currently do not have the benefit of a consolidated statutory accounting system and financial statements to assist them in these efforts. The GCC is expected to fill this void since it requires an aggregation and display of the individual company's available capital and operating figures. More specifically, the GCC and related reporting will provide more transparency to insurance regulators regarding the insurance group and make risks more identifiable and more easily quantified. In this regard, the tool will assist regulators in holistically understanding the financial condition of non-insurance entities, how capital is distributed across an entire group, and whether and to what degree insurance companies may be subsidizing the operations of non-insurance entities, potentially undermining the insurance company's financial condition and/or placing upward pressure on premiums to the detriment of insurance policyholders. It is envisioned that this calculation will provide an additional early warning signal to regulators so they can begin working with a company to resolve any concerns in a manner that will ensure that policyholders will be protected. Importantly, the GCC will complement existing group supervisory tools already available to state insurance regulators, such as the *Form F Enterprise Risk Report*[1], the *Own Risk and Solvency Assessment Summary Report*[2] and the *Form B Holding Company Filings*[3].As such, we would expect it to be a national standard

b. **Does Committee believe NAIC members should devote significant regulator and Association resources to educate, communicate and support this model law?**

☒ **Yes** **or** ☐ **No** **(Check one)**

5. **What is the likelihood that your Committee will be able to draft and adopt the model law within one year from the date of Executive Committee approval?**

☒ **1** ☐ **2** ☐ **3** ☐ **4** ☐ **5** **(Check one)**

High Likelihood **Low Likelihood**

Explanation, if necessary:

As previously noted, the Working Group is striving to adopt the calculation sometime in 2020 and it is expected that revisions to the model be adopted by the NAIC within that same time period so that states can begin to implement through changes to state law.

6. **What is the likelihood that a minimum two-thirds majority of NAIC members would ultimately vote to adopt the proposed model law?**

☒ **1** ☐ **2** ☐ **3** ☐ **4** ☐ **5** **(Check one)**

High Likelihood **Low Likelihood**

Explanation, if necessary: See previous discussion.

---

[1] *Insurance Holding Company System Model Act* (#440) and supporting *Insurance Holding Company System Model Regulation* (#450) require the annual filing of an Enterprise Risk Report (Form F) which requires the disclosure on material risks within the insurance holding company system that could pose enterprise risk to the insurer

[2] Risk Management and Own Risk and Solvency Assessment (ORSA) Model Act (#505) require the annual filing of an ORSA Summary report that includes 1) Description of the Insurer's Risk Management Framework; 2) Insurer's Assessment of Risk Exposure; and 3) Group Assessment of Risk Capital and Prospective Solvency Assessment

[3] *Insurance Holding Company System Model Act* (#440) and supporting *Insurance Holding Company System Model Regulation* (#450) require the annual filing of an Registration Statement (Form B) which includes, among other items, the annual financial statements of the ultimate controlling person in the insurance holding company system and all of its affiliates and subsidiaries

7. What is the likelihood that state legislatures will adopt the model law in a uniform manner within three years of adoption by the NAIC?

☒ **1** ☐ **2** ☐ **3** ☐ **4** ☐ **5** **(Check one)**

High Likelihood **Low Likelihood**

Explanation, if necessary:

At this juncture, the changes to the NAIC models are expected to 1) require the filing of the GCC with the state; 2) provide important confidentiality protections; 3) provide exemptions for who is not expected to file the GCC. As such, variations by states related to these elements are not expected.

8. Is this model law referenced in the NAIC Accreditation Standards? If so, does the standard require the model law to be adopted in a substantially similar manner?

The Group Capital Calculation (E) Working Group has not discussed whether the GCC should be an accreditation standard. However, because the GCC is expected to be required of the largest and most complex U.S. insurance group who operate in all states, a national standard is appropriate.

9. Is this model law in response to or impacted by federal laws or regulations? If yes, please explain.

Yes. Under Title V of the Dodd-Frank Act, the U.S. Department of the Treasury and the Office of the U.S. Trade Representative are authorized to jointly negotiate covered agreements, defined under the Dodd-Frank Act as written bilateral or multilateral agreements between the United States and one or more foreign governments, authorities or regulators regarding prudential measures with respect to insurance or reinsurance, on the condition that the prudential measures subject to a covered agreement achieve a level of protection for insurance or reinsurance consumers that is "substantially equivalent" to the level of protection achieved under U.S. state insurance laws. On Sept. 22, 2017, the U.S. Department of the Treasury and the Office of the U.S. Trade Representative signed the "Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance" (Covered Agreement). On December 18, 2018, a separate Covered Agreement was signed between the U.S. and the United Kingdom, which is mirrors the language from the agreement with the EU, and has the same timing requirements for implementation.

The Covered Agreement includes requirements on reinsurance collateral, group supervision and group capital. Specifically, Article 4(h) provides that the host supervisor (i.e., a supervisory authority from the territory in which an insurance group has operations but which is not the territory where the worldwide parent is domiciled or headquartered) may not impose a group capital assessment or requirement at the level of the worldwide parent, but only if the insurance group is subject to a group capital assessment imposed by the home supervisor. The group capital assessment of the home supervisor must include a worldwide group capital calculation capturing risk at the level of the entire group, and the home supervisor must have the authority to impose preventive, corrective or otherwise responsive measures on the basis of the assessment, including the authority to impose capital measures where appropriate.

Under Article 10(e) of the Covered Agreement, supervisory authorities in the European Union shall not impose a group capital requirement at the level of the worldwide parent undertaking of the insurance or reinsurance group, with regard to a U.S. insurance or reinsurance group with operations in the European Union, for 60 months after the date of provisional application of the Covered Agreement; i.e., Nov. 7, 2022. The NAIC is developing a group capital calculation intended to serve as an analytical tool for evaluating an insurer's capital position at the group level, but which is not intended to be applied as a group-level capital requirement or standard. The *Statement of the United States on the Covered Agreement with the European Union* provides further clarification with respect to this group capital assessment:

> The Agreement limits the worldwide application of EU prudential group insurance measures on U.S. insurers operating in the EU. The Agreement provides that U.S. insurers and reinsurers can operate in the EU without the U.S. parent being subject to the group level governance, solvency and capital, and reporting requirements of Solvency II, and reinforces that the EU system of prudential insurance supervision is not the system in the United States. The Agreement does not require development of a group capital standard or group capital requirement in the United States. Article 4(h) contemplates that the states will develop a group-wide capital assessment. Through the National Association of Insurance Commissioners (NAIC), the states are in the process of developing a group capital calculation which is intended to serve as an analytical tool for evaluating a firm's capital position at the group level. **The United**

> **States expects that the NAIC's group capital calculation will satisfy the "group capital assessment" condition of Article 4(h)**, provided that the work is completed and implemented within five years of the date on which the Agreement is signed. [Emphasis added].

Any state with U.S. groups operating in either the European Union or the United Kingdome will need to adopt these legislative changes by Nov. 7, 2022 in order to effectuate compliance with the Covered Agreement.

