NAIC

Proposed

Group Capital Calculation (GCC)

12/7/2019

Introduction

The National Association of Insurance Commissioners (NAIC) began development of the Group Capital Calculation (GCC) in late 2015 following extensive deliberation on potential valuation models and methodologies. The GCC is a natural extension of work state insurance regulators had begun, in part driven by lessons learned from the most recent Financial Crisis, to better understand an insurance group's financial risk profile for the purpose of enhancing the protection of policyholders. While state insurance regulators already have the legal powers to obtain any information regarding the capital positions of affiliated business entities, and they do, there has not been a consistent or coherent analytical framework for evaluating such information and monitoring trends. As such, the GCC is designed to meet this need, delivering financial solvency regulators a panoramic, transparent view of the interconnectedness, business activities, and underlying capital support for an insurance group.

The GCC uses a bottom-up aggregation approach, accounting for all available capital/financial resources, and the required regulatory capital based on the valuation of assets and liabilities of the various corporate entities, including insurers, financial and non-financial businesses. The GCC, and related financial reporting, will provide comprehensive accounting and transparency to state insurance regulators, making risks more easily identifiable and quantifiable. 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]. Altogether, the GCC will deliver an important set of information and capital ratio to facilitate earlier engagement with company management regarding potential business operations of concern and communication with other insurance regulators.

The current proposal entered the field-testing phase on May 10, 2019 with over 30 U.S. based firms, including property & casualty, life, and health insurers. Field testing has now been concluded and a revised template and instructions is expected to be exposed in the Spring of 2020 after which final decisions are expected to be made on various outstanding issues. It is anticipated that final adoption of the GCC will occur in 2020.

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[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

The GCC Aggregation Methodology

As described above, the proposed GCC is an aggregation or grouping of the available financial resources and calculated required capital of all material legal entities in an insurance group. The proposal currently being field tested includes the following types of entities and general requirements of the GCC calculation (See *GCC Testing Instructions* for more specific requirements[4]):

1) **U.S. Insurers** – The available capital/financial resources of U.S. domiciled insurers is determined by statutory accounting principles (SAP) as defined by state law and the NAIC *Accounting Practices and Procedures Manual*, which defines assets, liabilities, and in-turn net available capital/financial resources, or sometimes referred to as policyholder surplus. The calculated capital for these insurers is subject to state law that requires these insurers to maintain minimum capital based on the applicable NAIC *Risk-Based Capital formula*.

2) **Non-U.S. insurers** – Similar to the available capital/financial resources and calculated required capital of U.S. insurers, the available and calculated capital of non-U.S. insurers is determined by reference to the home jurisdiction's capital requirements. While most non-U.S. jurisdictions do not possess the same level of industry specific technical guidance, as included in the NAIC *Accounting Practices and Procedures Manual*, all jurisdictions have established accounting standards that insurers are required to follow to determine available capital/financial resources. In some cases, this represents local Generally Accepted Accounting Principles (GAAP), which may or may not be consistent with International Financial Reporting Standards (IFRS). While the GCC utilizes the available capital/financial resources and home jurisdictions' capital requirement, it does so after considering appropriate scalars to produce comparable measures for risk which can be aggregated into the group-wide measure.

3) **U.S. Captive Insurers**[5] -- While the valuation of assets of captives can vary from state to state (e.g. often using U.S. GAAP or modified U.S. GAAP), the proposed GCC estimates the available capital/financial resources using a simplified form of Statutory Accounting Principles (SAP) by non-admitting (i.e. not counting) certain types of assets as capital typically allowed by GAAP but not allowed under SAP. With respect to liabilities, the GCC specifically attempts to quantify the estimated overstatement of specific types of liabilities[6] to measure net available

[4] https://naic.org/documents/cmte_e_grp_capital_wg_field_test_instructions.pdf?13

[5] US Captive Insurers that are used to self- insure the group are not treated as insurers but rather as non-regulated business entities.

[6] These liabilities are referred to as XXX Term Life Insurance (Term) and AXXX Universal Life Insurance (UL) with secondary guarantees where XXX denotes the reserves prescribed by Section 6 of the NAIC *Valuation of Life Insurance Policies Model Regulation* (Model 830) while AXXX denotes the reserves prescribed by Section 7 of the NAIC *Valuation of Life Insurance Policies Model Regulation* (Model 830) and by Actuarial Guideline XXXVIII, *The Application of the Valuation of Life Insurance Policies Model Regulation* (AG 38)

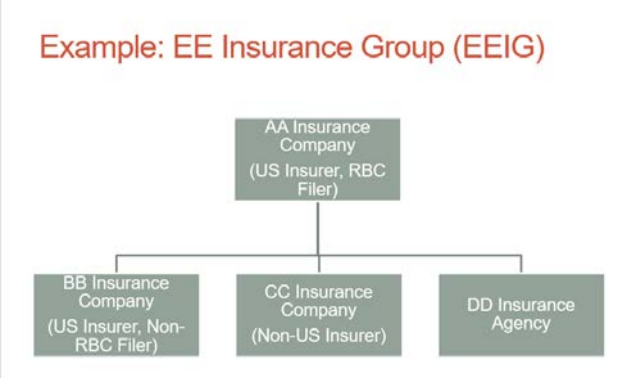
capital/financial resources.[7] With respect to calculated capital, the GCC utilizes the applicable Risk Based Capital (RBC) formula for captives.

4) **U.S. Insurers Not Subject to RBC**-Some types of U.S. insurers are not subject to an RBC formula (e.g. Financial Guaranty Insurers, Title Insurers). For these entities, the available capital/financial resources is determined by reference to state law and the NAIC *Accounting Practices and Procedures Manual*. However, since an RBC formula does not exist, calculated capital is determined by reference to the state minimum capital requirements set out in state law.

5) **Non-Insurers Subject to Regulatory Capital Requirements**-Non-insurers such as banks are subject to their own valuation methods (typically GAAP) and their own regulatory capital requirements (e.g. OCC, Federal Reserve, FDIC or other requirements for banks).

6) **Non-Regulated Business Entities**-The GCC also requires available capital/financial resources and calculated capital to be gathered for all non-regulated business entities that could pose a material risk to insurers. This specifically includes financial entities which tend to carry more risk and non-financial entities such as asset managers or investment advisors. In both cases the GCC will utilize the valuation used by such legal entities (typically U.S. GAAP) and a calculated capital based upon a risk factor. Because financial entities tend to carry more risk, the GCC utilizes a higher factor for determining this calculated capital than for the other non-regulated business entities.

The proposed GCC uses an aggregation and elimination approach, where each of the above legal entities' available capital/financial resources and calculated capital are combined, then eliminations are utilized to prevent any double counting of available capital/financial resources or calculated capital. The following example illustrates the use of eliminations for both available capital/financial resources and calculated capital.



EEIG Financial Information

Entity	Total Available Capital	Minimum Regulatory Capital
AA Insurance Company	$50.0M	$10.5M[2]
BB Insurance Company	$3.0M	$0.6M[2]
CC Insurance Company	$6.0M[1]	$0.8M[2]
DD Insurance Agency	$2.0M[1]	$0.6M[3]

[1] For non-RBC filers, this is available regulatory capital or stockholder's equity
[2] Pre-trend test level RBC (or equivalent amount in foreign jurisdiction)
[3] Calculated using 30% charge (similar to current charge for other affiliates)

(Calculations herein have been simplified for demonstration purposes.)

[7] Since XXX Term and AXXX UL with secondary guarantees are also written by U.S. domiciled insurers, this estimate of overstated liabilities is also calculated for such U.S. domiciled insurers under the formula.

Calculation of ARC

Entity	TAC	Less Subs' TAC	Adjusted TAC
AA Insurance Company	$50.0M	($11.0M)[1]	$39.0M
BB Insurance Company	$3.0M	0	$3.0M
CC Insurance Company	$6.0M	0	$6.0M
DD Insurance Agency	$2.0M	0	$2.0M
ARC (EEIG Group Total)			**$50.0M**

[1] Amount is TAC for subs noted above as follows: $3.0M+6.0M+2.0M = $11.0M

Note: All entities are owned at 100%, so there is no deduction for minority interests.

Calculation of MRC

Entity	ACL per RBC Filing[1]	Less: Subs' ACL	Adjusted ACL	Multiply by 3.0[2]	MRC[3]
AA Ins. Co.	$10.5M	($2.0M)[4]	$8.5M	* 3.0	$25.5M
BB Ins. Co.	$0.6M	0	$0.6M	* 3.0	$1.8M
CC Ins. Co.	$0.8M	0	$0.8M	NA	$2.2M
DD Ins. Agency	$0.6M	NA	NA	NA	$0.6M
MRC Total					**$30.1M**

[1] For non-RBC filers/insurers, use estimated pre-trend test level. Non-regulated entities, use 30% charge.
[2] US insurers only
[3] Or estimated post-trend test level. Non-regulated entities, use 30% charge.
[4] Amount is ACL for subs noted above as follows: $0.6M+0.8M+0.6M = $2.0M

In the above example, available capital/financial resources are referred to as available regulatory capital (ARC) and total authorized capital (TAC[8]) and minimum calculated capital is referred to as minimal regulatory capital (MRC) and authorized control level (ACL[9]). As shown, since AA Insurance Company owns each of the other business entities in the organizational chart, $11 million (which is the amount of available capital/financial resources in the subsidiaries of AA) is eliminated from the TAC column since accounting methods include those as an asset on AA Insurance Company's balance sheet. Also, because RBC requires a parent insurer to hold regulatory capital for its subsidiaries, it's necessary to eliminate that amount from the parent's (AA Insurance Company) calculated capital. Therefore, in this example $2 million of calculated capital is eliminated from the ACL.

Deriving the Group Capital Ratio & Related Field-Testing Items

The methodology also includes the potential for certain limited adjustments after the aggregation and eliminations have been performed. Conceptually these adjustments are performed "on-top", or after the aggregation of the legal entity figures, because they are generally not applied to the individual legal entity available capital/financial resources and calculated capital since those are existing legal requirements. More specifically, such adjustments may either be applied to the Group Capital Ratio directly or displayed as supplemental calculations along with the Group Capital Ratio (e.g. with and without such adjustments). The **following** adjustments were evaluated during the field testing process:

1) **Prescribed & Permitted Practices**-These represent differences between the company's required available capital/financial resources due to valuation differences between state law/state practices and the NAIC *Accounting Practices and Procedures Manual.*

2) **XXX Term/AXXX UL with Secondary Guarantees**-These represent differences between the company's required available capital/financial resources and an estimated available

[8] Terminology used in RBC for available capital/financial resources
[9] Terminology used in RBC for calculated regulatory capital

capital/financial resources using the estimated adjustments described in the U.S. Captive Insurers methodology on the previous page.

3) **Senior Debt**-This represents debt that is not already recognized as available capital/financial resources under all known accounting principles (SAP, U.S. GAAP or IFRS) but may have some value to the group under the U.S. insurance regulatory requirements where extraordinary dividends must be approved by the state. The proposed GCC gives some credit (addition to reported available capital/financial resources) to this debt. The field-testing process will be used to evaluate the extent of the credit to be applied.

While not on-top adjustments, certain other elements were also evaluated during the field-testing process. The testing considered other mechanical issues that arise in an aggregation relate to non-admitted entities (either for SAP or RBC). The GCC also tested several capital calculations for other types of financial business entities which are generally perceived to carry more risk than non-financial business entities; the testing also considered various alternative calculations depending upon the type of financial entity. Finally, non-insurers who are determined by the lead state to pose a material risk to the insurers will also be included in the calculation utilizing their applicable valuation and a calculated capital based upon one of three methods that were tested. The testing also gathered information from the lead state and the participants to help define with greater precision methods that can be used in defining material risk for determining when non-regulated business entities can be excluded from the calculation.

Use of the Group Capital Ratio

The resulting group capital ratio will be utilized by regulators to evaluate the capital position of the group. However, the benefits of the GCC far exceed the single figure that the ratio represents. The GCC (and other aggregation approaches) provide relevant information on available and calculated capital of the material entities in the group, which will assist in understanding how capital is distributed across an entire group. More importantly, the GCC includes a full inventory of companies and selected financial information (net income, premiums, liabilities, debt, etc.) that can be analyzed by state regulators. This will assist with identifying trends as they occur over time and which suggest risk is increasing, thereby providing an early warning signal to regulators. By comparison, consolidated reporting utilizes a top-down approach that typically does not provide the same level of detail as to the location of capital within. Also, it can rely on valuation approaches that differ from those utilized by regulators to evaluate the solvency of their regulated institutions, thereby making it less aligned with the objective of policyholder protection.

Anticipated Timeline

The adoption of the final GCC and instructions will occur in 2020 after appropriate adjustments are made to address any issues that arose during the field-testing process as well as based on further feedback from

stakeholders. In addition, it is contemplated that the GCC will be a confidential regulatory filing and, as part of the process, regulators will consider the implementation of the appropriate confidentiality protections.