MEMORANDUM

TO: Group Capital Calculation(E) Working Group

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

DATE: October 7, 2019

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 an RBC aggregation approach to a group capital calculation (GCC), the issue of how to treat senior debt and surplus notes needs to 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 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). Further, current guidance does not apply an economic valuation approach which considers how such debt should be 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. 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, it may be appropriate to develop criteria within the GCC that permit some amount of subordinated senior debt to be added back to capital.

The Working Group will need to come to a consensus agreement on the most logical way to field test the impact of including 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?

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 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 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 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.