NAIC National Association of Insurance Commissioners
& The Center for Insurance Policy and Research

MEMORANDUM

TO: Group Capital Calculation (E) Working Group

FROM: NAIC Staff

DATE: Aug. 22, 2016 (Includes an Update on Page 3 from the Working Group's Aug. 26 Meeting)

RE: Questions on Various Aspects of the Inventory Method

Background Information

The Working Group has identified the inventory method as the most appropriate approach to the NAIC's group capital calculation, and there have been no objections to this approach. The benefits of the inventory approach include providing a roadmap of all entities within the defined group and providing valuable entity-level financial data to allow for additional analytical abilities. In regard to the inventory method, there are various topics that the Working Group has discussed during recent conference calls, although further consideration of these items is appropriate. The purpose of this memo is to identify those items and to pose questions that will hopefully provide feedback for the Working Group's consideration as part of its deliberations.

Factor to be Used for Non-Insurance Entities Not Subject to Other Capital Requirements

The Working Group has discussed the treatment of non-insurance entities that are not subject to capital requirements on several occasions and much of this discussion has focused on a flat charge that could be applied the entity's book/adjusted carrying value (BACV.) This approach is similar to what is currently utilized in the risk-based capital (RBC) formula. Utilization of a flat equity charge for non-insurance entities that are not subject to other capital requirements is a simple approach and would require a minimal amount of additional data. It also fits well with the position that all non-insurance entities should be treated the same no matter where they are owned in the holding company structure. However, it is understood that this approach is not necessarily risk-sensitive.

Question 1: Is applying a flat charge to an entity's BACV an appropriate approach for non-insurance entities that are not subject to other capital requirements? If the answer is no, please suggest an alternative approach, including why that approach is preferable to a flat charge.

If a flat-charge approach is utilized, the Working Group will need to determine what the charge should be. On an after-tax basis, the current RBC charge for most non-insurance affiliates is 22.5% of BACV. Using an RBC aggregation approach requires that RBC be used in the calculation for all RBC filers. The Capital Adequacy (E) Task Force and its working groups have spent a considerable amount of time developing the appropriate risk charge in the current RBC formula. Since the 22.5% factor was developed with the understanding that most of these affiliates utilize generally accepted accounting principles (GAAP), it has been discussed that the 22.5% charge may be appropriate for a group capital calculation when considering that GAAP is not as conservative as statutory accounting principles (SAP). This factor could be applied to calculate the minimum regulatory capital amount in the group capital calculation. The charge would have a minimum of zero to address cases in which there is negative equity in any entity in the group, including an intermediate or top holding company.

Question 2: If the Working Group decides that a flat charge should be applied to an entity's BACV, is the current RBC charge of 22.5% appropriate? If the answer is no, what should the charge be and why do you believe that charge is appropriate?

The Working Group has also discussed the possibility of a hybrid approach in which a flat charge is used initially and additional data is collected (i.e., industry code, total liabilities, net income, etc.) At some point, that data could be used to develop more risk-focused charges for certain types of non-insurers that are common to the industry (i.e., insurance agencies, investment management companies, etc.) Consideration should be given to how and from whom such data would be collected (e.g. via a broad-based data call, via data provided by volunteering groups or data collected by all groups over time.)

Question 3: Do you believe that use of a hybrid approach is appropriate? If the answer is yes, what data should be collected and how can that be used in determining a more risk-focused approach?

Treatment of Non-Insurance Entities that are Subject to Capital Requirements

During its Aug. 11 conference call, the Working Group discussed non-insurance entities that are subject to capital requirements, and this category primarily includes U.S. banks. When determining how the minimum regulatory capital amount should be calculated for purposes of the U.S. group capital calculation, two main options are apparent: 1) the entity's existing sectorial minimum capital requirement; or 2) a flat equity charge such as 22.5%. Using existing sectorial requirements is more risk-sensitive and is already calibrated to some sort of regulatory intervention level using an underlying GAAP accounting basis, while using a flat equity charge would be the simplest approach and is the most aligned with entity-level RBC charges.

Question 4: Which approach is more appropriate for non-insurance entities that are subject to capital requirements: the entity's existing sectorial capital requirement or a flat equity charge? Why do you feel that approach is more appropriate?

Question 5: If the Working Group decides that a flat charge should be used for these regulated entities, is the current RBC charge of 22.5% appropriate? If the answer is no, what should the charge be and why do you believe that charge is appropriate?

Use of Scalars for Non-U.S. Insurers

On the Aug. 11 conference call, the Working Group discussed the use of scalars by non-U.S. insurers. NAIC staff suggested that because of the lack of sufficient data currently available, the scalars initially be set at 1.0. Over time, the group capital calculation could obtain financial information for these non-U.S. insurers that could be analyzed to ascertain whether a different scalar for a particular jurisdiction is appropriate. Alternatively, a data call could be performed to collect several years of data right now. In their presentation to the Working Group at the Spring National Meeting, the American Council of Life Insurers (ACLI) and the American Insurance Association (AIA) suggested that metrics such as a country's qualified jurisdiction review or its Financial Sector Assessment Program (FSAP) results be used in determining the scalar. NAIC staff indicated that these reviews are more related to regulatory outcomes, as opposed to assessing the comparability of capital requirements across jurisdictions.

Question 6: Is analyzing financial information from non-U.S. insurers an appropriate approach to developing country-specific scalars? If the answer is yes, what specific financial information should be obtained and analyzed in developing the scalar? If the answer is no, what approach do you prefer and why is that approach more appropriate?

Question 7: If the Working Group elects to base development of country-specific scalars on financial information, should this information be collected over a number of years or should a data call be performed to collect this information now?

Question 8: If the data is collected over a number of years, what approach to these entities should be taken in the interim? Two possible options include the current RBC flat charge for the entity or the entity's non-scaled capital requirements.

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Update from the Working Group's Aug. 26 Meeting:
As a result of the discussion at the Working Group's Aug. 26 meeting, the following question has been added to this memo:

Question 9: Some of the above questions and related responses may be impacted by the chosen scope of the group for purposes of the group capital calculation. Please provide any comments, along with the related rationale, on the appropriate level for establishing the scope of the group for purposes of an analytical tool.

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