

AMERICAN ACADEMY *of* ACTUARIES

March 1, 2010

Director Christina Urias
International Solvency (EX) Working Group
Via email: kdefrain@naic.org

Dear Director Urias,

The American Academy of Actuaries'¹ Regulatory Capital Requirements Task Force is pleased to provide its responses to questions posed in the *Consultation Paper on Regulatory Capital Requirements and Overarching Accounting and Valuation Issues for the Solvency Modernization Initiative*.

The replies were prepared with input provided by actuaries from four practice councils within the Academy: Life Practice Council, Casualty Practice Council, Health Practice Council, and Risk Management and Financial Reporting Council. Please note that a few questions have been omitted in the document below if no response is provided.

We welcome questions and comments from the NAIC as it moves forward in its Solvency Modernization Initiative. If you have any questions, please contact Tina Getachew, senior policy analyst, Risk Management and Financial Reporting Council, by phone at (202) 223-8196 or email getachew@actuary.org.

Sincerely,

Thomas Herget
Chair, Regulatory Capital Requirements Task Force
Risk Management and Financial Reporting Council
American Academy of Actuaries

¹ The American Academy of Actuaries (“Academy”) is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Responses to 60 Questions

<p>1) What is the purpose of regulatory capital requirements?</p>	<p>The purposes of the United States regulatory Risk-based Capital (RBC) system are to: 1) define a minimum capital level used as an early warning tool to identify weakly capitalized companies; and 2) establish solvency levels that trigger regulatory actions. In the years since RBC has been in place, other benefits have been observed, including motivating a company to avoid undesirable levels of risk (from a policyholder perspective), promoting a risk measurement and management culture within a company, and providing a tool for supervisors to assume control of a failing company.</p>
<p>2) What is the driver of capital levels held by companies? What determines how much capital a company actually holds (e.g., rating agencies, market, regulation, etc.)?</p>	<p>Most insurers look first to establish a level of capital to achieve or maintain their desired rating in addition to satisfying regulatory minimums and internal company standards. A company will use additional standards to establish a target for the level of capital held. Included in these additional standards are: 1) ease of access to external capital; 2) organic growth needs; 3) M&A plans; 4) parental guarantees; 5) support of affiliated insurers; 6) capital investment needs; 7) return on capital profit targets 8) availability of funds from parent or affiliates; 9) perceived volatility in reserves or operating results; and 10) economic capital models.</p>
<p>3) Do rating agencies' motivations and output differ from regulators'?</p>	<p>Yes. Regulators' primary concern rests with protecting the consumer and ensuring the company can meet its promises. Rating agencies are more focused on those aspects of an insurer's operations that affect its ability to satisfy its debt obligations. Both rating agencies (RAs) and regulators evaluate an insurers' solvency and ability to satisfy obligations to policyholders; however, RAs also place a value on the ongoing financial stability and future viability of an insurer to operate profitably in the future. Regulators have focused on weakly capitalized companies using uniformly calculated intervention thresholds. Such thresholds are quantitatively established. Regulators do utilize more qualitative considerations in risk-focused exams and have a confidential set of analytics used as early warning indicators. Rating agencies utilize proprietary formulas and qualitative considerations to grade individual companies on increasing levels of strength.</p>
<p>4) Should the US Regulatory Mission be modified to include evaluation of economic or target capital? ...to include financial stability?</p>	<p>If the NAIC is contemplating expansion of its regulatory mission to include a review of companies' ongoing financial condition (financial stability), then the regulatory mission will be more similar to a rating agency review. In conducting a more comprehensive review of an insurer's financial condition, regulators will need to examine qualitative studies, such as economic capital. The effective evaluation of economic capital would require an extensive commitment of industry and regulatory resources. Financial stability would also be evaluated by analyzing the quality of capital, strength of earnings, liquidity position, franchise value and many other elements. While economic capital models might be a useful tool in evaluating financial stability, they should not be required as a basis for</p>

	<p>regulatory capital. Nevertheless, many life insurers’ products have become so complex that a formulaic approach is becoming insufficient for assessing capital needs so a more complex approach is required.</p>
<p>5) What is a “total balance sheet” approach? How should that approach impact U.S. regulatory requirements?</p>	<p>A total balance sheet approach looks at the risks encompassed by the assets and liabilities, regardless of how they may be accounted for. Given the risks of the underlying assets and liabilities, the total level of assets necessary to support those risks is determined, with the required capital being the remainder after application of accounting rules for determining book assets and liabilities. Capital requirements are measured with direct recognition of the interaction of its assets and liabilities and how its risk profile changes as economic conditions change. Capital requirements are also based on the covariance of risks that affect asset and liability cash flows. An important characteristic of any accounting framework in this approach is that increasing or decreasing a liability measurement is generally offset by a change in the opposite direction of the required capital. In this way, the Total Balance Sheet approach recognizes the possible relative conservatism of reserves in an amortized cost framework. Frameworks based on market or fair values can also be considered for a Total Balance Sheet approach.</p>
<p>6) What is the capital level at which companies cannot operate in the market? At what level of capital should regulators become concerned (PCR)? At what level of capital should regulators take over (MCR)? Compared to these levels, at what level is the U.S. solvency system (which includes conservative accounting and RBC)?</p>	<p>We support a hierarchy of trigger points at which regulatory actions become progressively more intrusive. The current hierarchy of RBC trigger points, together with the proposed stress tests and analysis of RBC trends, constitute an ascending level of assertiveness in regulatory actions. It is difficult, however, to state a precise level at which to become concerned. Among the influences would be the cause of a decline, how quickly it can be reversed and whether it’s an industry-wide problem or a more limited one. The decision to take over a company should be based on the level of free capital, liquidity position, and its capacity to alter its risk profile. In addition, the decision to take over the company versus to supervise more closely will be influenced by an insurer’s business plans and anticipated profitability and ongoing viability.</p>
<p>7) What mechanism should be used to determine solvency action and control levels? Are the multipliers that are currently used to define the solvency control levels appropriate?</p>	<p>The solvency mechanism is dependent on the purpose of regulatory capital and the role of US regulators in evaluating financial stability. A factor-based approach may be acceptable for insurers with simpler products and straightforward assets. For insurers with more complex products and investments, scenario analysis will be needed to determine statutory solvency. In any case, the trigger points to determine action should have an underlying actuarial and statistical foundation.</p>
<p>8) How should the U.S. define its RBC levels using statistical safety level and time horizon definitions? What is the appropriate risk measure?</p>	<p>The choice of a risk measure and time horizon depends on the purpose of regulatory capital. The chosen time horizon should allow sufficient capital to accommodate new sales and risks. There should be enough cushion to absorb a shock and still pay promises. While the calculations are performed for the lifetime of contracts, the chosen time frame for analysis varies by company</p>

	and product. The US RBC formulae do not use a consistent measure (combination of statistical safety level and time horizon) for developing each RBC factor for liabilities between Life/Health and P&C while the same factors are generally used for assets.
9) Does economic (or target) capital evaluation have a role in the U.S. solvency framework? If so, what? Should a company's own economic evaluation relate to regulatory requirements? Should a company's own economic evaluation impact RBC or be considered outside of RBC?	If the US regulatory objective is expanded to include a financial stability focus, an economic capital model could be useful in establishing minimum solvency amounts. A company's goal for economic capital level will not be the same as the existing regulatory requirement since the company would not want to operate at the minimum requirement. Because economic capital measures desirable, not minimum capital, this internal model should be considered where areas of risk are not reflected in the formula. Any economic capital or other internal model application should be considered in addition to existing formula-based RBC requirements.
10) Are the factors included in the RBC still appropriate?	The factors, categories and methodologies in the RBC formulas need constant review for relevance and timeliness. The current RBC formula excludes many risks; the individual risk components (as well as the total components) are based on a specific risk tolerance based on historical experience. Many of the existing RBC factors, particularly related to the risk of default, have not been updated in some time. It would be especially valuable to examine those factors where results in the tail of the outcome distributions have changed.
11) Are there areas of the RBC formula that should be modified in the approach (example: more categories of assets, treating assets more granularly, more stochastic analysis)?	RBC should be modified if major risks are not being measured properly. Several Academy groups have provided input on this subject to the NAIC recently. The Academy's P&C RBC Committee's October 2009 report on P&C RBC and the recent financial crisis may be found at http://www.actuary.org/pdf/casualty/rbc_oct09.pdf . The Life Capital Adequacy Subcommittee and the Health Practice Council's Solvency Work Group have also provided input to the NAIC.
12) What is the appropriate methodology to consider interdependencies among risks (e.g., diversification)? Is the square-root covariance adjustment appropriate?	In the framework of a capital determination model, we expect that there will be differing sophistication in methods for determining interdependencies among risks, as is suitable for the insurer and the situation. The most sophisticated methods would implement correlation between risks by allowing all systemic forces, such as economic (e.g., inflation) or operational factors (e.g., changes in claims handling), to affect all sources of cash flow (loss, expense, etc) in realistic ways. A less complex alternative would be to use correlation matrices between risks to induce correlation between the results. The US RBC formulae give either 100% or 0% correlation credit; the formulae in other countries (e.g., EU) have adopted tables giving greater flexibility. It seems that the square root approach could be made "suitable in most instances" if it were not applied to 100% of the RBC for each risk. These methods are illustrative of what an insurer could do – we are not formally proposing these methods as candidates for adoption at this time as there may be other methods that could be used.
13) What risks should be	For formulaic RBC, the risks from natural catastrophe and

<p>added or excluded in the RBC calculation?</p>	<p>terrorism are not a current component of the P&C formula and might be needed there. Where internal models are employed, it is up to the actuary to ensure that all material risks have been reflected.</p>
<p>14) For each missing risk, should the risk be treated quantitatively or qualitatively? Should some risks be accounted for quantitatively but with a judgmental factor (e.g., 10% for unidentified operational risks)?</p>	<p>We realize it isn't possible to identify and include all possible risks. The risks addressed should be assessed both qualitatively and quantitatively. Those risks that are difficult to quantify, such as operational risk and systemic risk, will necessarily rely on more qualitative assessment than quantitative assessment. As future research into these risks evolves, we expect that their assessment will involve more quantitative elements. For now, and in certain situations, a purely judgmental application of a factor may be appropriate, but we should encourage best practices in this regard. Use of judgment should not result in overly optimistic or conservative results.</p>
<p>15) How should risk mitigation (e.g., reinsurance, hedging) be treated in the determination of capital requirements?</p>	<p>Risk mitigation practices whose effectiveness can be demonstrated should be directly reflected in the determination of required capital. However, accomplishing this introduces analytical challenges (such as collectability of reinsurance or efficacy of intended hedge strategies) into the evaluation process. The risk-focused financial examination process should recognize risks that the current RBC formulae may not adequately address.</p>
<p>16) Should there be off-balance-sheet items? If so, how should off-balance sheet items be considered in the solvency system?</p>	<p>Every material source of expense and revenue that a company might incur or realize needs to be considered in its solvency evaluation. Any item that could affect an insurer's solvency should be included in the capital adequacy framework.</p>
<p>17) Should internal models be allowed to determine capital requirements?</p>	<p>Yes, there is a role for internal models in the determination of capital requirements. Certain guaranteed benefits and investments can only be evaluated by using a model. Use of internal models for RBC in some areas has already been adopted by the NAIC. The use of internal models might slow down the process of taking over a failing company. Internal models need to be subject to actuarial standards of practice, controls and validation criteria.</p>
<p>18) Should partial modeling allowing company discretion be utilized in the RBC? If so, how?</p>	<p>Use of internal models for partial components of RBC has already been adopted by the NAIC such as for C-3 Phase 2 Market Risk. Certain guaranteed benefits and investments can only be evaluated by using an internal model. Internal models need to be subject to actuarial standards of practice, controls and validation criteria. Comprehensive instructions would help assure consistent application.</p>
<p>19) When modeling is used for capital requirement purposes, what safeguards should be considered to the modeling? What requirements should be established with modeling?</p>	<p>A set of principles and standards should be used to assess the overall correctness, extent, and level of controls for a company's use of an internal capital model. There have been several white papers published by the IAIS and CEIOPS for Solvency II, Lloyd's for their ICA and other regulators such as the Bermuda Monetary Authority on establishing standards and requirements, as well as an internal model practice note soon to be released by the IAA. Some categories for establishing standards would typically be: the company's own use of the model, the statistical techniques</p>

	<p>and mathematical theory, results calibration & validation, governance & controls and documentation. In addition, a requirement to audit the modeling that affects required capital would provide a much needed safeguard. Actuarial standards of practice must be established to ensure the integrity of a capital framework that includes internal models.</p>
<p>20) Which particular risks are more appropriately reflected by modeling? Which risks are effectively measured without extensive modeling, (e.g., risks where factor determination is credible and sufficient, non-material risks)?</p>	<p>Macro-type risks affecting the overall company and their interactions (correlations) are best reflected by modeling. Examples may include risks such as global economic scenarios, natural catastrophes, man-made catastrophes (e.g., terrorism), fluctuations in interest rates or the stock/bond market, policyholder behavior, management behavior, legal and/or social developments affecting entire industries or categories of business. Once the main risks for a company have been identified, relationships and dependencies can be established and the interactions can be represented and studied with modeling.</p> <p>Some examples of risks that could be handled without extensive modeling might be: reinsurance credit risk (assuming the reinsurers have been evaluated in the same manner as the cedants) where capital charges could be based on credit ratings; agents balances; non-admitted or off balance sheet risks (e.g., long-term leases); and operational risks (human resources, disaster recovery, litigation, etc.).</p>
<p>21) Should the MCR be influenced by an internal model?</p>	<p>For some insurers, a minimum capital requirement can be determined by formula and not influenced by internal models. For insurers with complex products, an internal model may need to be a component of MCR, as it currently is for life insurers. If a company is approaching MCR, regulators may require use of additional external tests and actuarial projections. An MCR test needs to be very objective since it leads to severe actions.</p>
<p>22) With implementation of internal models, does the use of a specified safety level and time horizon become imperative?</p>	<p>Yes. If internal models are used, specified safety levels should be set and be consistent across all states. A time horizon would be necessary as in reality companies have time to react to changes in capital requirements and manage their business. Differences by line of business should be considered (e.g., catastrophe exposed property vs. auto liability). Some commonly used metrics are a 1-year time horizon and 99.5% VAR or 99.0% TVAR and there are other possibilities.</p>
<p>23) Even with limited use of modeling in the current RBC, should that modeling be subject to prior approval by the regulators? What should be designated and/or approved (e.g., the approach — 1,000 scenarios — and key considerations or parameters)?</p>	<p>The models are available for review by state regulators. However, given the number and training of regulators, and the wide range of company relationships (groups of single-state companies to national companies), it is not practical today to prior-approve models. Further, the credibility of the model can best be demonstrated through the evaluation of specified stress testing. There are three ways to approach this approval process, each with their own pros and cons:</p> <ol style="list-style-type: none"> 1. Allow company discretion, but mandate assumptions and margins and standard scenarios as buffers or elements of conservatism to cover model risk;

	<p>2. Require prior approval of the process used to validate and maintain the model, along with continued reporting as it is used; or</p> <p>3. Allow regulators to mandate company specific assumptions. Another possibility is a requirement that a company's capital model get a formal actuarial opinion from an approved list of third-party actuarial firms or from a qualified actuary. These formal actuarial opinions could then be reviewed by the regulator for final approval. Once approved, there should be reciprocity among states. The approval should focus on assessing the modeling approach, key parameters and structure, and then determining if this is appropriate for the business.</p>
<p>24) What regulatory expertise is needed for model review? How should regulatory review of models be funded? For regulatory review of internal models, should there be a centralized review function?</p>	<p>Regulators would need to have actuarial or quantitative expertise in risk and capital modeling. A model review will require the expertise of actuaries trained in the design, maintenance, and analysis of company risk models. This expertise in risk models (including both specific and aggregate risks) is the needed foundation for a feedback loop-based oversight process that will allow speedier and more effective modifications or adjustments when the unexpected occurs. In addition, there could be a centralized review function to ensure consistency in approach and to help build a center of expertise in model assessment for the regulator. Reviews could be funded by the party seeking approval (i.e., a third party vendor or the individual company). Regulatory approval via centralization should follow the process of current statutory financial examination and not require each individual state to separately review and approve the model. We realize that states may wish to retain this actuarial and quantitative responsibility for themselves</p>
<p>25) What are the “level playing field” implications? What is the impact on small firms? How would a dual system of allowing internal model calculations by some firms impact the competitive marketplace?</p>	<p>RBC should be based on the risks created by the strategies being executed by a company, regardless of the company's size. The "level playing field" or market is usually more concerned with the actual level of capital being held which is typically much higher than regulatory capital. Certain benefits (for example, living benefits on a variable annuity) and certain investments can only be valued using a model, so if a company, regardless of size, offers the benefit or makes the investment, they must use a model to determine their value. If regulators do grant exemptions, those exemptions should be risk-based.</p>
<p>27) Should capital add-ons be considered in the RBC? Is this a concept that would apply at the MCR level as well as the PCR level?</p>	<p>Capital add-ons should result from application of internal models or from the result of a risk-based examination that demonstrates the need for additional capital.</p>

28) What should trigger capital add-ons?	A capital add-on should be considered where the current RBC methodology doesn't adequately assess the risk.
30) What changes should be made to RBC exclusions?	Any line of business appearing on an insurer's blank or any business under the jurisdiction of the states' insurance commissioner should be subject to an RBC approach.
31) If the U.S. solvency regime is expanded to explore economic capital, what exclusions should be made to those requirements, recognizing that those might be different from RBC exclusions?	There are no risk-based or actuarial justifications for exclusions. Exclusions are granted by regulators for various reasons.
32) What capital requirements should be employed for insurance entities currently excluded from RBC?	RBC requirements should be established uniformly by a single authority and reviewed periodically. This approach will ensure that capital standards are consistent across states.
33) What proportionality considerations should be given in the U.S.?	Capital standards should be established and monitored in proportion to the risk exposures of an individual company, regardless of size. The riskiness of the activity should drive capital requirements.
34) Is there a need to obtain uniformity in the minimum capital and surplus requirements by state? Should the NAIC recommend a best practice of minimum requirements?	All companies operating in the United States should follow a single set of standards for minimum capital determination. The NAIC RBC Model Law has been adopted by all states for Life and P&C (and by many for Health). Permitted practices by state to admit certain items into capital should not be allowed. Uniformity is essential for a level playing field. Further, to the extent that a total balance sheet approach is incorporated into future solvency standards in the US, the establishment of minimum reserves and capital is intertwined. Uniformity in reserve and capital standards across all states is essential. There is no risk-based justification to differentiate standards by state. The review of models is fundamentally a review of underlying risks. The regulator needs a comprehensive process to ensure that the company is measuring and validating its assessment of risks. A central review body can best coordinate and provide best practices for regulators to use. If internal models are used, we believe that full disclosure is a key feature.
35) What stress tests should be performed by the NAIC?	Companies themselves should perform all tests, including stress tests, since the NAIC will not typically have the information that would be needed to do them.
36) What stress tests and reverse stress tests should be performed by companies? What should be required to be reported to the regulator?	Time will be needed to study and describe the best approach to itemizing the breadth and depth of stress testing. We desire to work with the NAIC in this area. Currently, regulation does require some stress testing. In asset adequacy testing for reserves, many companies use a form of stress test known as the 'New York 7' scenarios. Additionally, one possibility is to stress test the key

	assumptions based on the company's own analysis of its risks.
37) Should the regulator specify stress test scenarios to run? If so, which ones? How often should they be done?	The regulator should specify a minimum set of stress tests only. Again, time will be needed to address this and the we wishe to work with the NAIC on this initiative.
38) Should the RBC calculation be publicly available?	Yes. Publicly available RBC results would provide needed transparency and enhance consistency, fairness, and acceptance.
39) If internal models are allowed for capital requirement purposes, should information be publicly available?	Yes, but only in a way that ensures that a company's proprietary methods, assumptions, systems, intellectual capital or competitive advantage are not compromised. Use of recognized capital models from third-party vendors would minimize many of these objections. Alternatively, perhaps a required disclosure of management's reasons for their internal model producing differing indications than RBC could be used in lieu of public disclosure of an internal capital model.
40) Should the valuation of all assets, liabilities, and capital resources for regulatory capital purposes be completed on a market-consistent or some other basis?	Any accounting basis selected for regulatory capital will have its weaknesses (as well as strengths). A concern about a market-consistent method is that it is not a codified accounting method. There is no authoritative source for its definition and maintenance, though it is being actively worked on and evaluated. While evolution of any accounting basis is desirable, there needs to be a mechanism to approve and circulate the establishment and review of methods and assumptions. While market-consistent liability valuations showed large volatility at year-end 2008 in the European MCEV work, the drivers of that volatility are being reviewed and analyzed.
41) Should the SMI wait for FASB and IASB to determine valuation requirements for public financial reporting prior to determining valuation for regulatory solvency purposes?	Yes. The IASB appears to be on track for a June 2011 standard. And, although it is not as easy to discern that the FASB is as well, they are running on the same track. While many issues remain to be resolved, several features of liability determination could be appealing for solvency analysis. These include: a) a best estimate liability based on many scenarios; b) a risk margin liability that would address variability in the best estimate; and c) a residual margin which would be an indicator of how much future profitability could exist within the current portfolio of business. The NAIC should assess how other countries adapt to the IASB's final standard as well as evaluating the facets of Solvency II. If feasible, it would be valuable if companies needed to produce a single, rather than two or three, sets of financial statements.
42) Should valuation differ between public financial reporting (GAAP) and supervisory financial reporting (SAP)?	Valuation does not have to differ between GAAP and SAP; Canada has had a single standard for many years. Even if a GAAP accounting system produces a more income statement - oriented approach, its resulting balance sheet could be modified for a sharper view of solvency. Any alternative accounting system used for solvency will

	<p>need to have adjustments made in order to be suitable for solvency purposes. A major argument for a single accounting system is that under a total balance sheet approach the reserves do not really matter since they are just subtracted from the total assets needed to produce the capital. Several desirable attributes of an accounting system most suitable for solvency measurement would include: a) liabilities determined on a single model; b) a uniform degree of conservatism (or even no conservatism) in all liabilities; c) a discount rate that reflects what assets are likely to earn; d) consistency between discount rates used for liabilities and assets; e) loss recognition / asset adequacy analysis; and f) a single view of amortized cost / current values for both assets and liabilities, as well as for all liability calculations. Insurer policy provisions, investment quality, and management practices will have far more impact on insurer solvency than the valuation basis selected to measure it. The amount of total assets needed to assure solvency is not dependent on the methods used to calculate liabilities. A total asset methodology should be independent of how much reserve is held, within some broad limit such that there isn't such a small capital requirement and high reserve requirement that companies routinely violate the equity requirement. This discussion is not, however, an endorsement of the use of GAAP for statutory accounting purposes; there are many considerations that need evaluation before such a step is taken.</p>
<p>43) How should procyclicality be addressed? What counter-cyclical adjustments should be made?</p>	<p>While procyclicality is a concern in difficult times, it's not clear to us that there is a complete solution. The reality is that even in bad times, things can get even worse. If the stock market has declined 20% for the past two years, it doesn't mean it can't decline 20% again. It is important that the solvency requirements be met in all times, good or bad. Requirements should not be relaxed when times are bad. The issue may be best addressed by an internal model based on the risks faced by a company, where those risks are dynamically reflected in the methodology.</p>
<p>45) For group capital assessment, what should the definition of a group be?</p>	<p>A group is the top level of the corporate structure, and all subsidiaries thereof, that the regulator has authority over.</p>
<p>46) What are the benefits of group capital assessment? Drawbacks?</p>	<p>The key benefit for group capital assessment is to provide a comprehensive view of all capital requirements under different jurisdictions and the overall capital resources available to meet the requirement. Benefits also include access to a larger pool of resources, access to corporate expertise in risk management and an understanding of how the total corporate risks interact with each other. The major drawback is that the promises to the insured are made by a specific legal entity in the group and survival of</p>

	that specific entity is necessary to assure fulfillment of that promise. It may be difficult if not impossible to impose a transfer of capital from one affiliate to another. Further, it may be problematic to measure it if it includes non-insurance and non-financial affiliates.
48) Should consolidated financial statements be required?	While this could be useful, if there is no access to an affiliate's capital, a consolidation for solvency management purposes might be misleading. Existing combined statements are valuable and should be retained. Consolidation with non-insurance entities that a regulator has no authority over may nevertheless produce indications of solvency issues.
49) What methodologies of calculation should be considered (e.g., consolidation vs. aggregation)?	Both consolidation and aggregation have merit; both provide information useful for the company. However, the aggregation approach normally yields a more conservative measure of a company's capital position.
50) How should unregulated entities and non-insurance entities be considered? Do insurance regulators have the expertise to determine the risks of non-insurance entities?	The parent organization should understand the risks associated with each of its entities. The parent organization should demonstrate controls for the risks taken in each entity. Insurance regulators typically don't have the expertise and resources to determine or evaluate the risk of non-insurance entities. Insurance regulators usually lack jurisdiction over non-insurance entities, except to the extent that state laws give them some jurisdiction over holding company activities.
51) Should diversification credits be applied at the group level?	It is good to review risks comprehensively at the group level; diversification credits could be considered. This needs to be tempered by the fact that there are walls preventing transfer of capital. If the regulator has no authority over the entire group, then capital needs for the entire group is an academic exercise with little relevance to the regulator. If calculated for the portion of the group that the regulator has authority over, then diversification credits within that portion of the group could make sense.
52) Should group support be implemented? If so, how would fungibility issues be addressed?	The benefit of a group viewpoint is that its report could outline support to the subsidiaries and the resulting impact to the group.
53) Should the NAIC consider an approach to group-wide capital requirements that span international jurisdictions?	It would be appropriate for the NAIC (states) to be a part of any Supervisory Colleges that address entire groups where significant parts are US insurance entities.
54) What considerations should be made regarding regulatory arbitrage?	Regulatory arbitrage should be avoided. To the extent possible, the NAIC should make it clear to all states that a common regulatory requirement is essential to customers having confidence in the system. So far, US regulators have been somewhat successful in achieving this; nevertheless, states with weaker regulation, weaker enforcement or deviating permitted practices should be identified and urged to bring their processes up to par.

	<p>Disclosure of differences permitted by a state is useful information and facilitates comparability.</p> <p>One area of regulatory arbitrage that needs to be avoided is the situation that would enable a company to hold insufficient assets in support of the risks that it is assuming. The NAIC has in the past adopted collateral requirements for reserve credits to insure that risks are properly reserved for, but has not extended these collateral requirements to ensuring that the capital backing the guarantees on products written to US consumers is adequate. The NAIC should seek to ensure that regulatory arbitrage does not allow a company to have inadequate resources to support its obligations where resources consist of both reserves and capital. It has been argued that regulatory arbitrage occasionally has served as a market mechanism for avoiding regulatory actions that are uneconomic or too conservative.</p>
55) Should the U.S. insurance solvency system be adjusted for systemic risk regulation? If so, how?	All significant risks need to be considered in capital adequacy determination. An internal model, as well as stress testing, should be reflective of those risks that are considered systemic.
56) Should wind-down plans be incorporated? If so, how?	A risk-based exam could review each company's plan to deal with shocks. One such shock could be the winding down of a part or the entire operation. For companies well above MCR, such an exercise may not be cost-justified.
57) What further studies regarding capital requirements should be performed and who should perform the studies?	The Academy, in working with the CAS and SOA where appropriate, will facilitate such studies and research. Several suggestions for such studies are mentioned in previous responses.
58) Should quantitative impact studies be performed in SMI?	Yes. Field testing is a good way to determine if an approach achieves its objective and identifies practical difficulties in implementation.
59) Should SMI revisions be phased in?	SMI revisions should be phased in. Companies, large and small, need time to implement and test their models. Companies, large and small, need time for an orderly transition of investments if needed. The accreditation approach supporting adoption of NAIC regulations should provide this needed time.
60) What additional capital requirement or overarching accounting/valuation issues should be considered in the SMI?	<p>While the NAIC's paper addresses a number of important foundational issues we recommend the Solvency Modernization Initiative Task Force undertake a broader consideration of the role of the regulator in a modernized solvency framework. Many of the concepts and solvency frameworks under discussion by the SMI Task Force may represent a paradigm shift in the role of some regulators in monitoring the financial condition of life insurers. A flexible regulatory process is needed that can respond quickly to emerging risks in order to maintain the integrity of the regulatory oversight process.</p> <p>The American Academy of Actuaries' Life Practice</p>

Council (LPC) has, as a foundation of its principle-based reserve and capital initiatives, supported an expansion of the US life regulatory mission to include a comprehensive understanding of the significant risk drivers of a life insurer's financial condition. This principle-based approach utilizes internal models and company experience and captures all material risks, as essential for calculating capital requirements for certain risks associated with life insurance. While RBC has been the basis for establishing regulatory intervention for taking over a single troubled life insurance company, understanding the significant long term risk drivers associated with life insurance and techniques for managing risks will be of significant value in assessing the health of individual companies and the industry itself as abnormal or uncommon risk events occur.

The LPC has supported a comprehensive review of the US Life RBC Framework as part of a principle-based approach to the determination of reserves and capital. As noted above, over time, several modifications have been made to the Life RBC formula, with the changes becoming increasingly complex and less effective. This evolutionary approach to modifying the Life RBC formula has still left a patchwork of methods for measuring risk, resulting in, sometimes, internally inconsistent methods and overlapping or missing risks. Life insurance products and investments have become too complex to have their risks captured by simple factors alone. Part of the SMI process, therefore, should include making use of the research that has taken place in the development of and continued work on a principle-based approach to Life RBC. As space is limited to present material in this document, we strongly urge that a separate presentation be arranged at the next meeting of the SMI Task Force at which the Academy's Life Practice Council may present the principles that have been involved in their recent work on modernizing RBC.

Additional issues the NAIC could consider as it modernizes its solvency framework include: a. Cost to industry to implement; b. Need for additional tools and regulators trained in risk management; c. Possible consistency with international solvency standards; d. Coordination of SMI project within the NAIC and with professional groups and industry stakeholders; and e. Timing of solvency modernization with IAIS efforts to coalesce into a single basis for a solvency and general purpose accounting framework.



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March 1, 2010

Christina Urias, Arizona Director of Insurance
Chair, International Solvency (EX) Working Group
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2662

Re: Comments on NAIC Consultation Paper on Regulatory Capital Requirements and Overarching
Accounting/Valuation Issues for the Solvency Modernization Initiative

Dear Director Urias:

The American Council of Life Insurers (ACLI) represents 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These 300 member companies represent over 90% of the assets and premiums of the U.S. life insurance and annuity industry. In addition to life insurance and annuities, ACLI member companies offer pensions, 401(k) and other retirement plans, long-term care and disability income insurance, and reinsurance. We appreciate the opportunity to offer these comments on behalf of our members.

We compliment the NAIC and its staff on the comprehensiveness of this Consultation Paper. Addressing the issues that it raises has been both challenging and useful. In several cases, the discussion about them has identified possible new projects that ACLI will have to discuss further.

We attach for your consideration our recently adopted Solvency Principles and Application Guidance. This is a living document, subject to future change. We recognize that many technical issues may arise as these high-level statements are considered in the U.S. regulatory framework and elsewhere. It is our intent and hope that these revised Principles and the associated Application Guidance will provide a strategic benchmark for discussions on solvency issues.

We appreciate the effort of the NAIC—its members, their staffs, and NAIC staff—to update and streamline U.S. supervision. As this project proceeds, we urge all to resist merely extracting discrete elements of other solvency regimes and overlaying them onto current NAIC and state practice. Further, it is imperative that the NAIC consider the integration of the current NAIC definition of life insurance reserves with the U.S. Federal Income Tax Code. The NAIC must take extreme care when considering changing the definition of either reserves (liabilities for policies and contracts) or policyholder cash/account values to avoid serious adverse consequences to both companies and policyholders. The ACLI will provide input on any specific changes to accounting that are proposed as part of solvency modernization in order to try to minimize these adverse consequences.

We hope that we have the opportunity to discuss with your Working Group and the Solvency Modernization Task Force these issues and others outside the scope of the Paper's direct questions and to continue to collaborate with you as this important project moves forward.

Very truly yours,

Marika F. Brady

Copy to Kris DeFrain

ACLI RESPONSE
To
NAIC Consultation Paper
On
**Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the
Solvency Modernization Initiative**

Q1- What is the purpose of regulatory capital requirements?

The current purpose of regulatory capital requirements is to secure an appropriate degree of protection for policyholders' interests and support of general confidence in the insurance industry.

Regulatory capital is meant to act as a floor to total financial resources to provide sufficient confidence that policyholder obligations can be reliably and fully discharged without strong regulatory intervention. It also provides a tool for supervisors to take appropriate regulatory action for weakly capitalized companies.

We note that regulatory capital is one component of a company's financial soundness.

An ideal solvency assessment system should be focused upon the evaluation of the adequacy of an insurer's total financial resources to meet its insurance obligations at all times, with a reasonable and prescribed level of assurance (total financial resources requirement). Specifically:

- a. The total financial resources of the insurer should allow it to meet its future obligations arising from commitments already made, even under reasonably severe circumstances.
- b. The supervisory focus should be on the establishment of minimum solvency requirements and appropriate oversight of an insurer's condition relative to these requirements.
- c. The degree of assurance with which the adequacy of total financial resources is assessed should be defined and applied consistently.
- d. A properly defined total financial resources requirement should lead to the same degree of assurance whether held in reserves or required surplus.
- e. The solvency assessment system should treat domestic and foreign insurers equally without discrimination within a jurisdiction.
- f. While the focus of a solvency assessment system is on an insurer's ability to meet its insurance obligations, all of an insurer's obligations should be considered in this assessment.

Q2- What is the driver of capital levels held by companies? What determines how much capital a company actually holds (eg, rating agencies, market, regulation, etc)

Company capital levels are driven by several factors, including regulatory capital calculations, rating agency capital calculations, and internal funding capital calculations. Each of these should provide a view of the capital needs of the company relative to the risk of their business profile. Though one may be more conservative than another, each should be risk-based in their measurement. The key drivers are an insurer's business strategy and its management's assessments of its ability to meet its insurance obligations as they fall due.

Q3- Do rating agencies' motivations and output differ from regulators?

Yes. Rating agencies identify the risk of companies from an investor's perspective, *i.e.*, the likelihood the investor will be rewarded in the manner expected by the investor. Additionally, rating agencies intend to provide comparability among market participants. A regulator is concerned with having a strong level of assurance that a company can meet its obligations. While the regulator may desire some degree of comparability as a goal of their efforts, the degree is limited towards establishing the priority status for the allocation of regulatory resources rather than as a predictor of marketplace performance.

Q4: Should the US regulatory mission be modified to include evaluation of economic or target capital?...to include financial stability?

No. We believe that regulatory capital and target capital are different measures designed for different purposes. The primary tool of prudential regulation in the U.S. should be on the setting of the total financial resources requirement that is necessary to substantially ensure the solvency of the insurer so that it can continue to meet its insurance obligations at all times.

It would be useful for regulators in their overall risk assessment of insurers to understand and consider the capital management techniques and methodologies used by insurers. Defining target capital should not, however, be a regulatory responsibility.

Q 5: What is a “total balance sheet” approach? How should that approach impact U.S. regulatory requirements?

ACLI defines a total balance sheet approach as representing a solvency oversight structure that considers all of the balance sheet's content in the process of considering whether, and to what degree, a company has the ability to meet its obligations. This definition is similar to the concept we believe underlies the Canadian segregated fund requirements. The idea is that the only solvency provision that really matters is the "total balance sheet requirement," which is the sum of reserves and required capital. ACLI supports this concept but prefers the label "total financial resources requirement" in order to eliminate any possible confusion.

Standards should guard against double counting of risks and risk offsets.

As noted in the Consultation Paper, different definitions of "total balance sheet" appear to exist in different parts of the world. In many parts of the world, "total balance sheet" refers to a holistic system that includes a consistent measurement of assets and liabilities and consistently calibrated capital requirements. Often this is assumed to refer to a market-consistent approach, where the capital requirements are based on the impact of calibrated stresses to the balance sheet. In contrast, when many North American actuaries use the term "total balance sheet," they think of a concept derived from Canadian segregated fund requirements.

Q6: What is the capital level at which companies cannot operate in the market? At what level of capital should regulators become concerned (PCR)? At what level of capital should regulators take over (MCR)? Compared to these levels, at what level is the U.S. solvency system (which includes conservative accounting and RBC)?

Regulators should become concerned when the probability that an insurer will not have sufficient financial resources to meet its insurance obligations as they fall due increases to a level above that predetermined by regulators to be representative of their risk tolerance. The level at which the regulator should consider taking over the company is when it is probable that the insurer will not have sufficient financial resources. See our response to Q8.

In addition, if the purpose of RBC is not only as a takeover trigger for regulators but as an early warning signal for troubled companies, then this does indicate that regulators need to know and understand if the RBC measures and signals actually reflect the underlying economic realities of the companies. Often these measures may well be broadly accurate in normal times, but in times of crisis or significant economic or political changes they may lose some (or much) of their precision.

Q7: What mechanism should be used to determine solvency action and control levels? Are the multipliers that are currently used to define the solvency control levels appropriate?

Experience with RBC over the last 15 years should provide evidence about how well the current control levels have worked. For any new framework, an attempt should be made to calibrate it to past experience.

Q8: How should the U.S. define its RBC levels using statistical safety level and time horizon definitions? What is the appropriate risk measure?

ACLI supports a consistently defined level of security and a time horizon for solvency purposes. Although we lack a consensus view on the specifics of a Prescribed Capital Requirement (PCR), some examples might be:

- A PCR of 99% CTE (conditional tail expectation, *i.e.* the average of the worst 1% of outcomes) over one year. The solvency provisions would also include a terminal provision to provide for the runoff of the business. (Canada, under development)
- A PCR of 99.5% percentile stress over one year, which would also include a terminal provision to provide for the runoff of the business. (Europe, under development)
- A “total financial resources requirement” of CTE 90 based on a stochastic lifetime runoff approach, less reserves. (This is the concept embedded in the C-3 Phase II methodology).

Though ACLI has not developed a consensus position on the specifics, we note that the statistical safety level and time horizon dimensions are inextricably linked and should be evaluated together.

Q9: Does economic (or target) capital evaluation have a role in the U.S. solvency framework? If so, what? Should a company’s own economic evaluation relate to regulatory requirements? Should a company’s own economic evaluation impact RBC or be considered outside of RBC?

See response to Q4.

Q10: Are the factors in the RBC still appropriate?

We note that there are several current and recent projects to modify RBC, including C3P3, commercial mortgages/MEAF, derivatives/risk mitigation, RMBS, CMBS, and C3P2 review. We support these efforts.

Q11: Are there areas of the RBC formula that should be modified in the approach (example: more categories of assets, treating assets more granularly, more stochastic analysis?)

See response to Q10.

Q12: What is the appropriate methodology to consider interdependencies among risks (E.G. diversification)? Is the square-root covariance adjustment appropriate?

In the context of the recent crisis, our members urge that recent experience presents a unique opportunity to study interdependencies among risks and advance the science of risk management in this important area, as part of the Solvency Modernization Initiative.

Q13: What risks should be added or excluded in the RBC calculation?

See response to Q10.

Q14: For each missing risk, should the risk be treated quantitatively or qualitatively? Should some risks be accounted for quantitatively but with judgmental factor (e.g. 10% for unidentified operational risk)?

See response to Q10.

Q15: How should risk mitigation (e.g. reinsurance, hedging) be treated in the determination of capital requirements?

A solvency assessment system should account for the interaction and correlation between risks, and the use of reinsurance, diversification, hedging and other risk mitigation programs of an insurer.

Q16: Should there be off-balance-sheet items? If so, how should off-balance sheet items be considered in the solvency system?

A solvency assessment system should reflect an insurer's liabilities and off-balance sheet items, and consider all material risks and risk mitigation having a potential impact on its ability to meet its insurance obligations. Cash flows are the basic building blocks of any methodology.

Q17: Should internal models be allowed to determine capital requirements?

A solvency assessment system should allow for the integration of an insurer's internal models into the process of calculating required supervisory levels if such internal models are subject to a rigorous and verifiable process, are supported by sound risk management practices, and are subject to supervisory review. A standardized approach may have limitations in capturing the risk profile of the business with sufficient clarity and detail. That is why a solvency assessment system should include and encourage an appropriate combination of standardized methods, stress testing, and internal models to evaluate an insurer's capacity to meet its insurance obligations with a high level of confidence. All such methods should be appropriate to the nature, scale, and complexity of an insurer's risk profile. We address the standards that should be applicable in our response to Q19.

Q18: Should partial modeling allowing company discretion be utilized in the RBC? If so, how?

We note that partial modeling is allowed under C3 Phases 1 and 2.

Q19: When modeling is used for capital purposes, what safeguards should be considered to the modeling? What requirements should be established with modeling?

On the first question, see our response to Q17. On the second, our members believe that standards should be sensitive to the risk profile specific to each insurer. Those standards, by necessity, will establish norms applicable to all insurers. It is important that these standards are established with a reasonable level of granularity so that significant differences in risk profiles among insurers are captured. Recognizing its limitations, a properly designed and validated internal model can enhance the effectiveness of solvency and risk assessments. Supervisors should establish appropriate standards regarding the integration of internal models into the solvency framework.

Q20: Which particular risks are more appropriately reflected by modeling? Which risks are effectively measured without extensive modeling (e.g. risks where factor determination is credible and sufficient, non-material risks)?

See our responses to Q17 and Q19. ACLI will be considering developing policy on these issues.

Q21: Should the MCR be influenced by an internal model?

ACLI will be considering developing policy on these issues.

Q22: With implementation of internal models, does the use of a specified safety level and time horizon become imperative?

Yes, ACLI believes that the level of assurance should be prescribed. The level of assurance may be defined as a specific probability that total financial resources will be adequate to satisfy insurance obligations with a specified level of certainty. That probability and level of certainty should be consistently applied. Here consistency means across insurers, among the different risks within an insurer, and for an insurer over time. Note that consistency between risks is a pre-condition to ensuring consistency between insurers since different insurers will have different risks in different proportion.

Q23: Even with limited use of modeling in the current RBC, should that modeling be subject to prior approval by the regulators? What should be designated and/or approved (e.g. the approach- 1,000 scenarios- and key considerations or parameters)?

ACLI will be considering developing policy on these issues.

Q24: What regulatory expertise is needed for model review? How should regulatory review of models be funded? For regulatory review of internal models, should there be a centralized review function?

We urge that a general policy and overarching framework on using internal models in a risk-based capital framework should be established first. A clear understanding of the level of reliance regulators should place upon internal models is an important concept that needs to be discussed.

Further, ACLI could not support any new services by the NAIC until there is an established external review process.

Q25: What are the “level playing field” implications? What is the impact on small firms? How would a dual system of allowing internal model calculations by some firms impact the competitive marketplace?

A solvency assessment system should be appropriate to the nature, scale, and complexity of an insurer’s risk profile and should allow for the integration of an insurer’s internal models into the process of calculating required supervisory levels if such internal models are subject to a rigorous and verifiable process, are supported by sound risk management practices, and are subject to supervisory review.

Q26: Are the powers in the Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in Hazardous Financial Condition, effectively, capital add-ons?

No. Many of the itemized deficiencies cannot be remedied effectively with additional capital, as recognized by the broad powers granted to the commissioner under Model Section 4.B. Further, any insurer subject to an order under the Model may request an administrative hearing.

Q27: Should capital add-ons be considered in the RBC? Is this a concept that would apply at the MCR as well as the PCR level?

ACLI cannot endorse capital add-ons within the state regulatory environment as our members believe that large disparities would emerge among states.

Q28: What would trigger capital add-ons?

See response to Q27.

Q29: Does the leverage ratio in banking have a place in insurance regulation? If so, where?

ACLI will be considering developing policy on these issues.

Q30: What changes should be made to RBC exclusions?

ACLI will be considering developing policy on these issues.

Q31: If the U.S. solvency regime is expanded to explore economic capital, what exclusions should be made to those requirements, recognizing that those might be different from RBC exclusions?

ACLI will be considering developing policy on these issues

Q32: What capital requirements should be employed for insurance entities currently excluded from RBC?

ACLI will be considering developing policy on these issues

Q33: What proportionality considerations should be given in the U.S.?

See our response to Q25.

Q34: Is there a need to obtain uniformity in the minimum capital and surplus requirements by state? Should the NAIC recommend a best practice of minimum requirements?

In general, ACLI supports improvements in state regulation through the establishment of uniform standards and administration of regulation.

Q35: What stress tests should be performed by the NAIC?

ACLI will be considering developing policy on these issues.

Q36: What stress tests and reserve tests should be performed by companies? What should be required to be reported to the regulator?

ACLI will be considering developing policy on these issues.

Q37: Should the regulator specify stress scenarios to run? If so, which ones? How often should they be done?

ACLI will be considering developing policy on these issues.

Q38: Should the RBC calculation be publicly available?

An insurer should be allowed to publish any appropriate information about itself that it wishes to publish and should also assure that such information is accurate and not misleading. This would encourage the market to increase disclosure.

Q39: If internal models are allowed for capital requirement purposes, should information be publicly available?

ACLI believes that a solvency assessment system should encourage insurers to disclose to the public relevant and reasonable information on their risk and solvency management practices. In doing so, it should take into account the need to protect proprietary or confidential information. Further, an insurer should be allowed to publish any appropriate information about itself that it wishes to publish and should also assure that such information is accurate and not misleading.

Q40: Should the valuation of all assets, liabilities, and capital resources for regulatory capital purposes be completed on a market-consistent or some other basis?

ACLI will be considering developing policy on these issues.

Q41: Should the SMI wait for FASB and IASB to determine valuation requirements for public financial reporting prior to determining valuation for regulatory solvency purposes?

ACLI will be considering developing policy on these issues.

Q42: Should valuation differ between public financial reporting (GAAP) and supervisory financial reporting (SAP)?

ACLI is developing policy on this and related issues.

Q43: How should procyclicality be addressed? What counter-cyclical adjustments should be made?

ACLI is developing policy on this and related issues.

Q44: Should capital resource requirements utilize a tiering structure of capital? Should there be tied assets? If so, how?

ACLI will be considering developing policy on these issues.

Q45: For group capital assessment, what should the definition of a group be?

ACLI will be considering developing policy on these issues.

Q46: What are the benefits of group capital assessment? Drawbacks?

According to the International Association of Insurance Supervisors, the term “insurance group” means a group corporate structure which contains two or more insurers. The structure of international insurance groups may derive from an ultimate holding company which is not an insurer. Such a holding company can be an industrial or commercial company, another financial institution (such as a bank), or a company

the majority of whose assets consist of shares in insurance companies (and/or other regulated financial institutions).

Insurance groups operate in a variety of ways. Some operate as separate legal entities, while others are run on a fully integrated or consolidated basis. The assessment approach taken should be based upon how an insurer chooses to operate, i.e., on a legal entity or on consolidated group basis. Key features of the latter type of group include the parent's full faith and guarantee of insurance obligations issued in different jurisdictions; risks and capital are managed on a group-wide basis; and that there are no restrictions prohibiting the mobility of capital within the group. Still other groups are managed with some characteristics of each approach.

For insurance groups operated on more of a legal entity basis, the purpose of group-wide solvency assessment is to assess risks that may affect an insurer as a consequence of being part of a group, such as systemic risk, reputational contagion, or leveraging. For such groups that choose to operate as a collection of legal entities, it also follows that—

- *Group-wide capital adequacy assessment is a critical component of solvency assessment.* The balance sheet of the individual group entities should be considered simultaneously rather than consolidating them into a single balance sheet for the group. The regulatory capital requirement and resources of group members form a set of connected results but no overall regulatory group capital requirement is used for regulatory purposes. The group capital adequacy assessment is necessary in order to better assess the risks and benefits which may affect an insurer as a consequence of being part of a group. From a regulatory point of view, the purpose is to consider group risks (*i.e.*, the risk that the financial resources of a group may be adversely affected by an event in a solo entity, a group-wide occurrence, or an event external to the group).

As noted above, insurance groups may operate on a fully integrated or consolidated basis and thereby be eligible for the benefits of group supervision. This means that—

- *All of an insurance group's assets are dedicated to its insurance obligations, and the interests of any other stakeholders (e.g., shareholders) are secondary.* The implication of this proposition is that all capital should be available to pay all insurance contracts and no guaranteed obligations will be reduced in order to satisfy any non-guaranteed insurance payments. To achieve this, there must be no barriers prohibiting mobility of capital within the group.

- *Group-wide capital adequacy assessment is a critical component of solvency assessment.* Evaluation of the adequacy of an insurer's total financial resources to meet its insurance obligations should occur at the group (or total-company) level. Solvency assessment standards that are consistent across jurisdictions would reduce regulatory arbitrage.

- *The group manages its risks and its solvency on a holistic basis.*

Under any approach (*i.e.*, legal entity, consolidated or hybrid), group-wide solvency assessment should be applied in a way that properly aligns with the risk and operational characteristics of the group and its members. Diversification benefits should be recognized to the full extent they can be demonstrated to the group supervisor.

Q47: What are the benefits of group capital quantification of regulatory requirements? Drawbacks?

See response to Q46.

Q48: Should consolidated financial statements be required?

See response to Q46.

Q49: What methodologies of calculation should be considered (e.g. consolidation vs. aggregation)?

All calculation methodologies should be considered as long as they meet the principles and guidance outlined in the ACLI's *Solvency Principles and Application Guidance* document.

Q50: How should unregulated entities and non-insurance entities be considered? Do insurance regulators have the expertise to determine the risks of non-insurance entities?

Insurance groups differ in structure, and they are managed or operate in a variety of ways. No one approach to supervision will fit all insurers. U.S. insurance regulators may not have the resources, background, or expertise to regulate all non-regulated entities.

Q51: Should diversification credits be applied at the group level?

Diversification benefits should be recognized in the group-wide capital assessment only when and to the extent they can be demonstrated to the group supervisor. Groups or subgroups operated on a fully integrated or consolidated basis should be able to share the benefits of diversification effects among individual members. As noted above, such groups must be able to show that there are no barriers prohibiting the mobility of capital. (Note that a simple informational requirement would not be considered a barrier as long as the regulator has no opportunity to block the transfer.) In practice, this means that mobility of capital will need to be assessed on a case-by-case basis, taking into account the different circumstances of such groups, and the existence and properties of capital and risk transfer instruments that exist between any individual members of the group, such as financial guarantees and reinsurance agreements.

Q52: Should group support be implemented? If so, how would fungibility issues be addressed?

See response to Q51.

Q53: Should the NAIC consider an approach to group-wide capital requirements that span international jurisdictions?

See responses to Q46 through Q51.

Q54: What considerations should be made regarding regulatory arbitrage?

The cause of 'regulatory arbitrage' is widely divergent regulatory regimes across jurisdictions and sectors. Harmonizing solvency regimes among countries will reduce opportunities to arbitrage the differences among them.

Q55: Should the U.S. insurance solvency system be adjusted for systemic risk regulation? If so, how?

ACLI believes that the U.S. life insurance industry does not present a systemic risk to the U.S. economy. Further, systemic risk regulation is currently being discussed by our Congress, at the national level. We do not support systemic risk regulation at a sub-national level.

Q56: Should wind-down plans be incorporated? If so, how?

See response to Q55.

Q57: What further studies regarding capital requirements should be performed and who should perform the studies?

We believe that a study of proposed counter-cyclical measures is of primary importance and immediacy. How risk mitigation is recognized in regulatory capital should also be reviewed.

Q58: Should quantitative impact studies be performed in SMI?

Yes, such studies should precede any material changes to the current framework as the impact of potential change must be understood.

Q59: Should SMI revisions be phased in?

Yes, in principle. How they should be phased in will depend on the scope and nature of the proposed revisions.

Q60: What additional capital requirement or overarching accounting/valuation issues should be considered in the SMI?

We appreciate the opportunity to emphasize two points that we believe are critical:

- a. A solvency assessment system is more than just the calculation of a numerical value determining how much capital an insurer requires. The perspective gained from a comprehensive evaluation of an appropriately selected set of quantitative and qualitative considerations can be significantly greater than the sum of the individual parts.
- b. An insurer that manages its risks and capital well should be recognized and the level of supervision adapted to be commensurate with a risk-based supervisory approach. This does not necessarily mean a low level of supervision, but rather a level of supervision appropriate to the level of risk to which the insurer is exposed and to its ability to manage the risks.

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NOTE for READERS

- The term “insurance obligations” includes a life reinsurer’s obligations under its treaties with ceding insurers.
- All Application Guidance is new language.
- Some terms, listed on the last page, require additional work to clarify them.

Introduction

This document sets forth principles of the American Council of Life Insurers for solvency supervision taking into account global initiatives on international solvency. We believe the principles should serve as the underpinnings of a solvency framework applicable to life insurance and life reinsurance companies globally that treats domestic and foreign insurers equally without discrimination in U.S. and international jurisdictions.

The objectives of the solvency framework should be to:

- a) Implement a system based on consistent principles where supervisors can utilize company risk management practices, subject to appropriate levels of oversight, to define capital adequacy requirements;
- b) Provide a reasonable and identified level of policyholder protection, without regard to size, geographic location, and legal form of the insurer;
- c) Encourage insurers to use best practice risk management techniques;
- d) Foster the transparency of solvency requirements to insurers;
- e) Foster the transparency of insurers' capital adequacy to consumers;
- f) Encourage harmonization of global supervisory solvency requirements and cooperation among supervisors; and
- g) Promote a sound and competitive insurance market through an efficient and effective supervisory environment.

The American Council of Life Insurers (ACLI) is a U.S. based trade association backed by an industry with more than 200 years of experience protecting American families, workers, and businesses. ACLI represents 340 life insurance companies operating in the United States before federal and state legislators, regulators, and courts.

ACLI member companies are the leading providers of financial and retirement security products covering individual and group markets. They provide life insurance, long-term care insurance, disability income insurance, annuities, pensions such as 401(k), 403(b), and 457 plans, Individual Retirement Accounts, and reinsurance.

Approach

Principle 1: A solvency assessment system should be focused upon the evaluation of the adequacy of an insurer's total financial resources to meet its insurance obligations at all times, with a reasonable and prescribed level of assurance (total financial resources requirement).

- a) The total financial resources of the insurer should allow it to meet its future obligations arising from commitments already made, even under reasonably severe circumstances.
- b) The supervisory focus should be on the establishment of minimum solvency requirements and appropriate oversight of an insurer's condition relative to these requirements.
- c) The degree of assurance with which the adequacy of total financial resources is assessed should be defined and applied consistently.
- d) A properly defined total financial resources requirement should lead to the same degree of assurance whether held in reserves or required surplus.
- e) The solvency assessment system should treat domestic and foreign insurers equally without discrimination within a jurisdiction.
- f) While the focus of a solvency assessment system is on an insurer's ability to meet its insurance obligations, all of an insurer's obligations should be considered in this assessment.

Application Guidance for Principle 1—Approach

An effective solvency assessment system benefits both supervisors and insurers by evaluating the level of assurance provided by an insurer's total financial resources in support of its insurance obligations. This evaluation allows a supervisor to establish minimum requirements. It allows an insurer to measure its risks in a consistent manner among its different risks and over time. It also allows the insurer to operate its business so that it exposes itself to risks mindful of its financial capacity to undertake them. A solvency assessment system that supports these outcomes can be expected to have a number of dimensions. Among these are internal models and standardized methods, as well as different approaches to assessing risk and articulating the financial implications of potential future events. *Principle 1* defines some key elements of an effective approach applicable to all dimensions of an effective solvency assessment system.

First among these key elements is the recognition that the total financial resources requirement of an insurer is critical to insurer solvency assessment. It is not enough to consider just the resources in excess of liabilities since liability valuation systems in different jurisdictions may reflect different levels of conservatism and serve other purposes such as determination of the deductibility of reserves for tax purposes. From a solvency perspective, the required capital should be expressed as the total financial resources requirement less the reserves or balance sheet provisions. In some jurisdictions the total financial resources requirement is called the total assets requirement.

A second key element is time. The adequacy of the insurer's resources to pay obligations over time should be considered, not just the adequacy over a specified short time horizon. It should be noted that the phrase "meeting obligations at all times" implies an evaluation of the ability to meet accelerated obligations in a stressed environment, (*i.e.*, the system should consider the solvency implications of liquidity stress events). Lastly, *Principle 1* recognizes that, since "full assurance" is not possible theoretically or practically, a reasonable level of assurance should be established and clearly specified.

Sub-principle a) makes reference to future obligations arising from commitments already made. Clearly the intention is to reflect that insurance obligations will unfold over time. As to the level of assurance that a solvency system should attain, this *sub-principle* specifies that it should provide for reasonably severe circumstances, not just something worse than average.

Sub-principle b) identifies the supervisor as the party responsible for establishing the minimum solvency requirement. This responsibility encompasses establishing the level of severity that should be covered. It should be noted that more than one minimum supervisory level is not precluded. For example, one minimum might function as the point below which the supervisor is authorized to seize the company; another, higher, minimum might lead to different, less severe intervention, *etc.*

Sub-principle c) points out the need for the level of assurance to be defined. The level of assurance may be defined as a specific probability that total financial resources will be adequate to satisfy insurance obligations with a specified level of certainty. That probability and level of certainty should be consistently applied. Here consistency means across insurers, among the different risks within an insurer, and for an insurer over time. Note that consistency between risks is a pre-condition to ensuring consistency between insurers since different insurers will have different risks in different proportion.

Sub-principle d) clarifies a fundamental element of the approach. The assessment of resources available to meet insurance obligations should consider total financial resources, and the measure of the level of certainty needs to apply to the total financial resources requirement. In particular, it points out that since different accounting bases exist for determining reserves, required surplus will result so that overall the same level of defined assurance is maintained. This means that balance sheet reserves or provisions plus required capital are assessed in total so any variances in balance sheet reserves due to differences in accounting basis will be compensated by adjustments to the level of required surplus.

Sub-principle e) reiterates the need for equal treatment regardless of the form, *e.g.*, stock or mutual, and principal domicile of the insurer. In order to achieve this, the methodology will need to treat all risks consistently.

Sub-principle f) notes that the *raison d'être* of special solvency regulations for insurance companies is their relationship to their policyholders. This relationship is based on the issuance of a long-term contract to an entity that does not have perfect knowledge at the time of sale that the issuing entity will exist when a claim is needed to be paid. Therefore, solvency regulation should be focused on ensuring that policyholders' claims will be paid with a reasonable level of assurance.

However, insurer insolvencies have occurred due to business obligations other than policyholder obligations. In addition, hedging programs, without proper controls, could potentially strain an insurer's solvency. Therefore, all business obligations should be reflected in the assessment of an insurer's solvency.

DRAFT

Methodology

Principle 2: A solvency assessment system should reflect an insurer's, liabilities and off-balance sheet items, and consider all material risks having a potential impact on its ability to meet its insurance obligations.

- a) A solvency assessment system should reflect all material factors that could influence the possible cash flows of the insurer during the lifetime of the contracts.
- b) A solvency assessment system should require that the valuation of all future cash flows and associated risks should be based on a methodology that provides consistent results.
- c) A solvency assessment system should account for the interaction and correlation between risks, and the use of reinsurance, diversification, hedging and other risk mitigation programs of an insurer.
- d) A solvency assessment system should reflect an insurer's ability to manage its response to events, as they occur, that could impact the insurer's capital position.
- e) A solvency assessment system should be appropriate to the nature, scale, and complexity of an insurer's risk profile and should allow for the integration of an insurer's internal models into the process of calculating required supervisory levels if such internal models are subject to a rigorous and verifiable process, are supported by sound risk management practices, and are subject to supervisory review.

Application Guidance for *Principle 2—Methodology*

Effective risk management should not be constrained to the use of one single method to assess and measure risk. Early analysis of the 2008-09 financial crisis shows that banks that utilized a number of measures appear to have fared better than those that relied on one methodology only. Future post-mortems will likely confirm this early indication and show its applicability to insurers as well. These *Principles* recognize this by referring to a “system” of solvency assessment, rather than referring to a single approach.

In order to evaluate the adequacy of an insurer's total financial resources to meet its insurance obligations, however, it is necessary to allow for the inclusion of all assets, liabilities, off-balance sheet items, and all quantifiable risks in as consistent and comparable a manner as possible. Also, external benchmarks based on a consistently applied methodology can provide an insurer important input to its own risk analysis and management.

Sub-principle a) sets the stage for a more detailed articulation of the *Principle* by confirming that cash flows are the basic building blocks of any methodology. It recognizes that risk measurement is an assessment of variability, rather than expectation.

Sub-principle b) recognizes that the measurement of all future cash flows and associated risks/uncertainties on a methodology that provides consistent results. The requirement for consistency is meaningful because consistency permits the calibration of measures to a common level of confidence. It also highlights the need for consistency in the methodologies used to develop the outcomes used in a standardized method. In particular, a solvency assessment system should encourage consistency among insurers with comparable risk profiles and for insurers across time.

Sub-principle c) raises the matters of correlation, diversification, and risk mitigation. The current crisis points out that dramatic differences in correlations are possible in a stressed situation (*i.e.*, far in the tail) compared to a more typical environment (*i.e.*, closer to the mean). Post-crisis examinations will present a unique opportunity to study this and advance the science of risk management in this important area. This *sub-principle c)* also introduces the need to incorporate an insurer's risk mitigation, where demonstrated to be effective, into the analysis. This is explored more fully in *Principle 4*.

Sub-principle d) extends the solvency assessment system to a dynamic assessment of the adequacy of an insurer's capital resources on a continuing basis in both expected and unexpected future conditions. In this assessment, an insurer should take into account those actions that it is prepared and can expect to take in the normal course of business to respond to potential adverse events, thereby mitigating their potential impact on the insurer. Examples of such actions include changes to dividends or other non-guaranteed elements and changes indicated by established hedging programs.

Sub-principle e) recognizes that supervisors are likely to make use of standardized methods of computing capital charges for small insurers, for insurers without a robust, supervisor-approved internal model, and for certain risk types, such as operational risk. It should be recognized that a standardized approach may have limitations in capturing the risk profile of the business with sufficient clarity and detail. A solvency assessment system should include and encourage an appropriate combination of standardized methods, stress testing, and internal models to evaluate an insurer's capacity to meet its insurance obligations with a high level of confidence. All such methods should be appropriate to the nature, scale, and complexity of an insurer's risk profile.

Standards

Principle 3: A solvency assessment system should define clear, objective and enduring standards on the implementation of supervisory capital requirements by insurers.

- a) Standards should be set by the supervisors in an open and transparent way with appropriate consultation with the industry. An insurance supervisory authority should apply the similar administrative procedures as prescribed for all financial services supervisory authorities in that jurisdiction.
- b) Standards should be sensitive to the risk profile specific to each insurer.
- c) Standards should be harmonized as closely as possible across jurisdictions.
- d) Standards should guard against double counting of risks and risk offsets.

Application Guidance for *Principle 3—Standards*

Principles 1 and 2 establish core guidelines for the approach and methodology underlying a good solvency assessment system. Implicit in those *Principles* is the expectation that both supervisors and insurers will use this system, although in different ways. Establishing and maintaining the system is best served by effective consultation between supervisors and the industry.

In the context of an effective solvency assessment system, some supervisory standards will need to be established (*e.g.*, as referred to *sub-principle 1 b*). The *Principle* starts with a clear statement of what the consultation should strive to achieve, namely, clarity, objectivity and endurance.

As relates to endurance, note that the objective is not “a once and final” outcome. Future economic events may lead to changes in the solvency assessment system. For example, there is much current discussion of the merits of a counter-cyclical approach whereby capital would be built-up in good times and released in bad times. Changes will be necessary, and so a principle on the process of creating standards for a solvency assessment system is important.

Sub-principle a) points out the need for openness and for consistency with other sectors in the financial services industry to avoid regulatory arbitrage for similar activities between regulatory entities. Although most of the dialogue can be expected to occur between the supervisor and the insurance industry, other parties, including the public at large, should be able to participate too. Transparency and openness should extend as broadly as feasible.

Sub-principle b) calls attention to the fact that standards, by necessity, will establish norms applicable to all insurers. It is important that these standards are established with a reasonable level of granularity so that significant differences in risk profiles among insurers are captured. Recognizing its limitations, a properly designed and validated internal model can enhance the effectiveness of solvency and risk assessments. Supervisors should establish appropriate standards regarding the integration of internal models into the solvency framework.

Sub-principle c) calls for harmonization of solvency regulation across different insurance supervisory jurisdictions. The openness and transparency called for by *sub-principle a)* make it possible for this to occur; added effort is encouraged so that consistency is achieved. Clearly the trend post-crisis is in this direction for supervision throughout the financial sector.

Sub-principle d) reiterates the need to avoid double counting risks. As stated in *Principle 1*, establishing a solvency standard specifying a “reasonable and identified” level of assurance for the level of total financial resources required to satisfy insurance obligations is key.

Enterprise Risk Management

Principle 4: Consideration of the scope and effectiveness of an insurer's risk management framework should be an integral part of the supervisor's assessment of an insurer's solvency.

- a) A solvency assessment system should require an insurer to have a sound process for assessing its capital adequacy in relation to its risk profile. Such insurer assessment should include policies and procedures to identify and assess all material sources of risk and ensure that they are incorporated into its capital requirements.
- b) The internal risk and capital assessment should be integrated into the management process and decision-making culture of the business.
- c) An insurer's risk management framework should consider the interaction between solvency and liquidity.

Application Guidance for *Principle 4—Enterprise Risk Management*

A solvency assessment system is more than just the calculation of a numerical value determining how much capital an insurer requires. Other factors, such as the quality of corporate governance and risk management, should also be taken into account alongside capital adequacy assessment. *Principle 4* addresses the importance of a sound risk management process to assure the effectiveness of the quantitative assessment of insurer capital adequacy.

The purpose of insurance is the assumption, pooling, and spreading of risk so as to mitigate the risk of adverse financial consequences to individuals and businesses that are policyholders. For this reason, a thorough understanding of risk types, their characteristics and interdependencies, the sources of the risks, and their potential impact on the business is essential for insurers. To do this well, an insurer needs to have a competent understanding of risk and to implement sound risk management practices. A purpose of both risk and capital management is to protect policyholders and capital providers from adverse events. Therefore insurers combine the management of risk and capital.

The supervisory process should incorporate a suitably holistic approach in the evaluation of an insurer's overall solvency position. This implies that considerations beyond the quantitative assessment of total financial resource requirements (whether determined on standardized *or* advanced methods) need to be factored into the solvency assessment process and, ultimately, into any requisite supervisory actions. These considerations could include the results of supplementary quantitative analysis as well as more qualitative assessments of the quality and effectiveness of the insurer's risk management processes and capabilities. The perspective gained from a comprehensive evaluation of an appropriately selected set of quantitative and qualitative considerations can be significantly greater than the sum of the individual parts. That perspective is expected to result in a much more robust and effective solvency assessment regime.

An insurer that manages its risks and capital well should be recognized and the level of supervision adapted to be commensurate with a risk-based supervisory approach. This does not necessarily mean a

low level of supervision, but rather a level of supervision appropriate to the level of risk to which the insurer is exposed and to its ability to manage the risks. It also implies a degree of internal risk management appropriate to the nature, scale and complexity of the insurer. Importantly, risk sensitive regulatory financial requirements should provide the incentive for optimal alignment of risk and capital management by the insurer and by the regulator.

Where a risk is not readily quantifiable, an insurer should make a qualitative assessment appropriate to that risk and sufficiently detailed to be useful for risk management. An insurer should analyze the controls needed to manage such risks to ensure that its risk assessments are reliable, especially for events that may result in high operational costs or operational failure. Such analysis is expected to inform an insurer's judgments in assessing the size of the risks as well as to enhance its overall risk management.

Sub-principle a) makes explicit the need for an insurer to undertake a sound process of full identification and assessment of risk types, their characteristics and dependencies, the sources of the risks, and their potential impact on the business. This assessment should also consider the impact of the insurer's risk mitigation programs, including the additional costs and any potential operational or other risks that these programs may themselves introduce. Armed with this information, an insurer should assess its capital adequacy in relation to its own particular risk profile.

Sub-principle b) acknowledges the need for an insurer to apply the insight gained from its internal risk management process to its ongoing and long-term management and decision making. It makes clear that the solvency assessment system should not be designed solely to enable the insurer to complete as-requested information for the supervisor. The culture of the business should embrace an active internal risk assessment and risk management process.

Sub-principle c) calls out the importance of liquidity and its interaction with solvency. This includes liquidity risks due to systemic issues that tighten the credit market or otherwise make raising additional capital difficult.

Supervision of Insurance Groups

Principle 5: Solvency assessment standards should efficiently address supervision and capital adequacy of insurance groups.

- a) Solvency assessment standards should be established for an insurance group on a group-wide basis.
- b) Solvency assessment standards for insurance groups should recognize the interaction and correlation of all risks across an insurance group and the degree of capital mobility-within an insurance group.
- c) Supervision of insurance groups should be designed and implemented to maximize the efficiency of the supervisory process.

Application Guidance for Principle 5—Supervision of Insurance Groups

According to the International Association of Insurance Supervisors, the term “insurance group” means a group corporate structure which contains two or more insurers. The structure of international insurance groups may derive from an ultimate holding company which is not an insurer. Such a holding company can be an industrial or commercial company, another financial institution (such as a bank), or a company the majority of whose assets consist of shares in insurance companies (and/or other regulated financial institutions).

Insurance groups operate in a variety of ways. Some operate as separate legal entities, while others are run on a fully integrated or consolidated basis. The assessment approach taken should be based upon how an insurer chooses to operate, *i.e.*, on a legal entity or on consolidated group basis. Key features of the latter type of group include the parent’s full faith and guarantee of insurance obligations issued in different jurisdictions; risks and capital are managed on a group-wide basis; and that there are no restrictions prohibiting the mobility of capital within the group. Still other groups are managed with some characteristics of each approach.

For insurance groups operated on more of a legal entity basis, the purpose of group-wide solvency assessment is to assess risks that may affect an insurer as a consequence of being part of a group, such as systemic risk, reputational contagion, or leveraging. For such groups that choose to operate as a collection of legal entities, it also follows that—

- *Group-wide capital adequacy assessment is a critical component of solvency assessment.* The balance sheet of the individual group entities should be considered simultaneously rather than consolidating them into a single balance sheet for the group. The regulatory capital requirement and resources of group members form a set of connected results but no overall regulatory group capital requirement is used for regulatory purposes. The group capital adequacy assessment is necessary in order to better assess the risks and benefits which may affect an insurer as a consequence of being part of a group. From a regulatory point of view, the purpose is to consider

group risks (*i.e.*, the risk that the financial resources of a group may be adversely affected by an event in a solo entity, a group-wide occurrence, or an event external to the group).

As noted above, insurance groups may operate on a fully integrated or consolidated basis and thereby be eligible for the benefits of group supervision. This means that—

- All of an insurance group's assets are dedicated to its insurance obligations, and the interests of any other stakeholders (e.g., shareholders) are secondary. The implication of this proposition is that all capital should be available to pay all insurance contracts and no guaranteed obligations will be reduced in order to satisfy any non-guaranteed insurance payments. To achieve this, there must be no barriers prohibiting mobility of capital within the group.
- Group-wide capital adequacy assessment is a critical component of solvency assessment. “Evaluation of the adequacy of an insurer’s total financial resources to meet its insurance obligations,” as stated in *Principle 1*, should occur at the group (or total-company) level. Solvency assessment standards that are consistent across jurisdictions would reduce regulatory arbitrage.
- The group manages its risks and its solvency on a holistic basis.

Under any approach (*i.e.*, legal entity, consolidated or hybrid), group-wide solvency assessment should be applied in a way that properly aligns with the risk and operational characteristics of the group and its members. Diversification benefits should be recognized to the full extent they can be demonstrated to the group supervisor.

Sub-principle a) affirms the importance of supervisors of insurers within a group forming a comprehensive view of the business strategy, financial position, legal and regulatory position, risk exposure, risk management and governance processes of the insurance group as a whole. This allows supervisors to assess (and react to, as necessary) the financial condition and solvency of the respective insurers within the group. Where the insurance business of the group is carried out in a number of jurisdictions and a number of different supervisors are involved, this makes supervising on a group-wide basis more challenging and the coordination of supervisory activities more important.

Sub-principle b) highlights the correlation and interaction of risks within groups, which will depend on the scale, nature, and complexity of the group’s risks. The fungibility and mobility of capital must be clearly defined and appropriate parameters established, which is a complex challenge. Diversification benefits should be recognized in the group-wide capital assessment only when and to the extent they can be demonstrated to the group supervisor.

Groups or subgroups operated on a fully integrated or consolidated basis should be able to share the benefits of diversification effects among individual members. As noted above, such groups must be able to show that there are no barriers prohibiting the mobility of capital. (Note that a simple informational requirement would not be considered a barrier as long as the regulator has no opportunity to block the transfer.) In practice, this means that mobility of capital will need to be assessed on a case-by-case basis, taking into account the different circumstances of such groups, and the existence and properties of

capital and risk transfer instruments that exist between any individual members of the group, such as financial guarantees and reinsurance agreements.

For all groups, incorporating the effects of risk management into solvency assessment is critical, as it promotes and rewards strong risk management and discourages excessive risk concentration. A key component for effecting solvency standards in all insurance groups is ensuring that each individual insurer within an insurance group is able to maintain or acquire sufficient liquidity to meet its insurance obligations.

Sub-principle c) notes that there must be a functional structure for group supervision that is effective from the insurance supervisors' perspective and efficient from the insurers' perspective. This can be achieved by designating a group supervisor, establishing a college of supervisors, or using a combination of both approaches. The means used will depend on the characteristics of the group itself, as well as the nature of the legal and supervisory regime relevant to the group's insurance members. Harmonized standards strengthened by mutual recognition agreements and a closer cooperation between supervisors would likely contribute to an effective global solvency system.

Disclosure

Principle 6: A solvency assessment system should encourage insurers to disclose to the public relevant and reasonable information on their risk and solvency management practices.

- a) Any requirements for public disclosure on the way insurers manage risk should take into account the need to protect proprietary or confidential information.
- b) An insurer should be allowed to publish any information about itself should it wish to do so.

Application Guidance for *Principle 6--Disclosure*

The first 5 *Principles* address how insurers and their supervisors should approach the assessment of solvency, the methodology that should be used, standards, risk management, and supervision of groups. They do not specifically mention the public at large or the subset of the public that constitute an insurer's policyholders. This *Principle* makes clear that communication with the public also warrants consideration.

Continuing in the vein of open and transparent communication between insurers and supervisors, this *Principle* extends that openness to sharing information with the public. It implicitly recognizes that some parts of the public have sufficient insight into the financial workings of an insurer to benefit from the information provided. Conversely, although perhaps to a lesser extent than with supervisors, it also acknowledges that armed with timely, relevant, and reasonable information, the public (or a knowledgeable subset) will utilize this to make decisions with respect to commencing or maintaining a financial relationship with an insurer or to suggest changes at an insurer's position or strategy in order to agree to commencement or maintenance of a relationship.

It can be said that this *Principle* extends the duality of usage referenced in the *Principle 3* Application Guidance—that both supervisors and insurers will use this system—to include the public. This extends the objective of making the solvency assessment system useable.

The *Principle* calls for insurers to be encouraged to disclose information. Once commenced, encouragement will come from public expectations. That is, if some insurers disclose relevant and useful information, the public will demand similar information from the others or reduce the amount of business they do with those that do not disclose. But to get the process started, it is assumed supervisors will provide incentive and encouragement. Supervisors should provide standards for disclosure regarding accuracy and fairness.

Both prescribed and voluntary disclosures should include qualitative discussion. A supervisory regime should acknowledge that purely quantitative core disclosures are inadequate without context, *i.e.*, a qualitative discussion of the risk profile of an insurer. Both quantitative and qualitative disclosures are essential to enhancing the robustness of the market discipline fundamental to a sound supervisory regime.

Sub-principle a) acknowledges that supervisors will prescribe some manner of public disclosure, and it points out the need to protect proprietary and confidential information. In the dialogue between supervisors and insurers to define “proprietary and confidential,” it is important that an insurer be open to sharing new information (*i.e.*, information that has not up to now been shared) and consider the fact that, once required, all insurer-competitors will be disclosing similar information. It is important to recognize that the “public” is a very diverse group, including equity and debt stakeholders, current and prospective policyholders, counterparties and other financial intermediaries, and rating agencies and equity analysts. Prescribed disclosures should not inappropriately disadvantage an insurer in dealings with any subset of the public.

Sub-principle b) speaks to the publication of information not required. In many respects, it represents “encouragement by the market” to increase disclosure. Insurers should be allowed to respond as doing so presumably will be to their competitive advantage. Insurers will assure that any published information is accurate and not misleading.

All material risks

Insurance obligations

Full faith and guarantee

Integrated group

Liquidity

Mobility of capital, capital mobility

Operational risk

Reasonably severe circumstances



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Re: *Comments of the American Insurance Association regarding:*

- *Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative*
- *Consultation Paper on Corporate Governance and Risk Management*

The American Insurance Association (“AIA”) appreciates the opportunity to provide comments on the above referenced consultation papers. AIA is a national trade association representing insurance companies writing all lines of property and casualty insurance. AIA plans to participate in the interim meeting of the Solvency Modernization Initiatives Task Force (“SMITF”), at which the issues raised in these papers are expected to be discussed. The brief comments we provide today represent our initial reactions to the consultation papers. We expect to provide more detailed comments during our testimony at the interim meeting as our member companies, who have been consumed over the past two months with year-end reporting obligations, continue to provide us with their reactions to these papers.

Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative

Concerns

Periodic review of the regulatory capital requirements in the United States is a worthwhile endeavor. As the Task Force proceeds with its review, it should be mindful of a number of concerns.

- *The purpose(s) behind the U.S. regulatory capital requirements regime.* We encourage the members of the Solvency Modernization Initiatives Task Force to review capital requirements within the U.S. regulatory system and to candidly evaluate the objectives of these capital requirements. In fact, the goals and objectives of a capital requirements

regime are fundamental threshold issues. No other question can be properly addressed if the Task Force does not first identify the purpose of a capital requirements regime.

- *The tools available for reviewing the effectiveness of the U.S. regulatory capital requirements system.* The most prominent tool for evaluating capital requirements is, of course, the risk-based capital system (“RBC”). The RBC system was developed in response to a number of insurer failures in the ‘80s and early ‘90s. It is our understanding that regulators at that time believed they needed a tool that would allow for timely intervention before an insurer failed. The Task Force should review whether the RBC system has served and continues to serve that purpose. In addition, the Task Force should consider the effectiveness of all other regulatory tools, such as the risk-focused surveillance framework, which may provide useful information for identifying conditions that may impact insurer capital levels.
- *The role of statutory minimum capital requirements.* In addition to the RBC system, states generally impose a minimum level of capital that an insurer must hold in order to qualify for a license with respect to a particular line of business. At a minimum, the Task Force should evaluate the relationship, if any, between these statutory minimum capital requirements and the RBC system. To the extent states continue to impose statutory minimum capital requirements, the Task Force ought to consider whether such requirements should be coordinated and consistent with the risk-based capital system.
- *Borrowing concepts from foreign regulatory regimes.* It is fair to acknowledge that Europe’s Solvency II directive has generated considerable discussion and introspection inside and outside of Europe. The concepts and ideas discussed in the NAIC’s consultation paper on capital requirements appear to come from documents of the International Association of Insurance Supervisors (“IAIS”), which in turn borrowed most of those concepts from Solvency II. We caution the Task Force against benign acceptance of these concepts – many of which arise from a regulatory system that does not share the U.S. perspective on contract and tort liability. The reliance on internal models for regulatory purposes may be inconsistent with regulatory objectives, since insurers use their models for internal management purposes, such as evaluating and allocating capital among its business lines and among companies within the enterprise. Also, there may be no business need for developing an internal capital model on a legal entity basis, even though the U.S. regulatory approach has been, to date, focused on the legal entity. The Task Force should refrain from adopting requirements that would lead to developing models for the legal entity model when such a model would provide no utility to the insurer.

The Task Force should also note that the history of business practices in the U.S. may be drastically different from foreign jurisdictions. Plus, many jurisdictions outside the U.S. do not incorporate the concept of guaranty funds into their regulatory structure. These examples are just a few of the key differences between the U.S. insurance regulatory system and that of the European Union, which generated the Solvency II directive. If nothing else, these differences call for caution when comparing elements of the U.S. regulatory system and those of foreign jurisdictions.

- *Jumping the gun on accounting and valuation issues.* The Financial Accounting Standards Board (“FASB”) is the U.S. accounting standard-setter. In the international arena, the International Accounting Standards Board (“IASB”) acts as the global

accounting standard-setter. The FASB and the IASB have been working in tandem on developing a global insurance contracts standard. The joint effort has not been easy and often there are divergent views on significant technical issues. Because U.S. insurance regulators historically have developed statutory accounting by modifying “generally accepted accounting principles”, as promulgated by the FASB, it may be premature for the NAIC to incorporate the accounting and valuation guidance that the IAIS has incorporated into its core principles. Instead, the Task Force should consider what U.S. regulators need in terms of accounting and valuation guidance, in order to fulfill the regulatory obligations. AIA has consistently stated that an effective insurance contracts accounting standard for U.S. insurers must:

- Reflect the legal and business environment of the insurance model, as well as the law of large numbers, the effects of diversification, and the management of claims on a portfolio basis;
- Provide a clear definition of insurance contracts and the scope of the guidance;
- Apply a measurement objective that reflects how property & casualty insurance contracts are actually settled;
- Measure pre-claim liabilities using the unearned premium reserve;
- Use entity specific cash flows to value post-claim liabilities when relevant industry data is unavailable;
- Recognize revenue as earned; and
- Allow for the preparation of understandable, comparable and consistent financial statements that provide decision useful information to users in a cost-effective manner.

If suitable for regulatory purposes, we encourage the Task Force and regulators to utilize these principles as you move forward with your evaluation of the U.S. solvency system.

Conclusion

Finally, we wish to emphasize to the Task Force that capital requirements are not – and should not be considered – a tool for preventing insurer failures. All business endeavors involve a certain amount of risk. In fact, the insurance industry developed out of the need for commercial enterprises to spread their risk, in order to mitigate the risk of failure. And that is a fundamental concept that the Task Force must always remember: insurers help to mitigate risk, but can never eliminate it; thus, taking on the risks of others creates risk of failure to the insurance enterprise. Setting capital requirements in a manner that avoids all risk to the insurer would make insurance unobtainable, and thus vitiate the important value that insurers provide to society. Instead, capital requirements should be a tool that helps management better understand the risks they take on and to encourage best management practices that will help reduce overall risk to the enterprise.

As we stated earlier, the above comments represent our initial reactions to this consultation paper. We look forward to discussing this paper more fully at the upcoming interim meeting of the SMITF.

Respectfully Submitted,

Phillip L. Carson
Assistant General Counsel

Consultation Paper on Corporate Governance and Risk Management

The American Insurance Association represents insurers that provide virtually every kind of property and casualty coverage in the U.S. and internationally. Accordingly, we have been deeply involved in U.S. and international discussions on appropriate regulatory responses to the financial crisis. We appreciate the opportunity to file these preliminary comments and to actively participate in the NAIC's future deliberations on these topics.

At the outset, it is important to take significant account of recent work on the subject of insurers and the financial crisis. Just last week, two reports were issued, one by the Geneva Association and one by Professor Weiss of the NAIC's Center for Insurance Policy Research. In general, both reports concluded that insurers, especially property and casualty insurers, had weathered the financial crisis well, are financially sound, and do not generally pose a "systemic risk". Obviously, insurers already take corporate governance and risk management seriously.

Particularly in the context of this very good performance by insurers, it is important to review any new regulatory requirements, including all of those under the Solvency Modernization Initiative (SMI), for compliance with the Organization for Economic Cooperation and Development's (OECD's) Policy Framework for Effective and Efficient Financial Regulation, including the related guidance and checklist, issued on December 3, 2009, to which the U.S. is a party. The OECD policy framework provides, *inter alia*, that new regulation should be based on a clear statement of objectives and analysis of alternatives and that the least costly, but still effective, policy option should be selected.

In light of the positive performance of insurers during the financial crisis and the OECD framework, any additional regulation, as proposed in this paper, should be justified by a clear demonstration that a serious problem exists and the selected approach is shown to be the most cost/effective remedy for the problem.

In addition, the SMI Task Force should be wary about new forays into the field of corporate governance. In addition to the usual caution that the NAIC should avoid creating possible conflicts with existing state corporate governance provisions, we encourage the Task Force to take a comprehensive look at tools and processes – such as the Model Audit Rule and the Risk-focused Surveillance Framework – that the NAIC and the states have already put in place to address corporate governance concerns.

Below are some specific comments by paragraph.

Section 1.1

The section refers to a move to principle-based regulation, yet the paper strongly suggests the possibility of extensive, specific and new regulatory mandates, that could amount to new "rules", including a "risk management policy", a "risk tolerance statement" and the "Own Risk and Solvency Assessment (ORSA)", along with potential mandates on their contents, timing, use and approval.

More importantly, the section contains no evidence that in the context of existing US corporate governance law, more regulation of insurers' governance is justified. And if some additional regulation is justified, are the specific proposals the most cost/effective alternatives? Without such showings, we are concerned that the new corporate governance mandates may not be warranted or effective.

Section 1.2

Subsections (a) and (c) seem to allow regulators to impose on Directors a “fit and proper” standard. We agree that “proper” is a legitimate concern for regulators. But allowing regulators to determine whether a Director is “fit”, especially in the highly politicized circumstances of some US insurance regulation, could be a serious mistake that could even undermine good management and effective corporate governance.

Section 1.3

This section contains a long list of proposed new specific mandates. Again, each one should be based on reliable proof that there is a problem and that the mandate will effectively and efficiently address it.

Subsection (e) suggests going beyond the current mandates, to provide new “specific oversight requirements”. Again, without a clear demonstration of need, such new requirements should not be imposed.

Experience has shown that any corporate governance structure should be supported by on-going training to assure that as personnel change, the objectives will be continuously achieved.

Section 1.4

Subsection a) again suggests a “fit and proper” standard for Senior Management. While we agree with a “proper” test, for prior compliance with law, a “fitness” test might be extremely dangerous in the politicized circumstances of some U.S. insurance regulation.

Section 1.5

Clear immunity and confidentiality protection will be needed for any new information that results from this work.

Section 2.2

This section seems quite proscriptive. Not only does it propose mandating the “framework/function” but it proposes that: “The SMI should consider what should be included within a risk management framework/function, how such a function may be independently maintained...” And in subsection a), it states that: “The SMI should consider how and when oversight should be provided by the Board of Directors in the risk management function.” Again this language suggests a detailed rules-based approach, without sufficient justification of need.

Section 2.3

This section mandates a “risk management policy” and then lays out detailed requirements, including its contents, how often it is updated, and who should approve it. Without a showing of failure under current requirements, can these new rules be proven that they are needed and that they will be cost/effective?

Section 2.4

This section would mandate still another document and related work, entitled a “formal risk tolerance statement”. Then the section goes on to suggest the adoption of highly proscriptive requirements, including “tolerances” and “how the statement should be incorporated into the

insurer's risk management practices." Again, there needs to be proof of wide-spread failure in this area and that this is the most cost effective way to address it.

Section 2.5

This would call for yet more specific mandates, including "categories of risks" and "what level of detail should be included within the documentation."

We are concerned about the provision for "reputational risk" because of its vague and subjective nature and the capability of using it as a self-fulfilling prophecy, whereby a regulator could engage in damaging publicity, however unwarranted, and then use the fallout from that publicity as a justification to carry out an adverse solvency related action.

Section 2.6

This is a highly specific, detailed new set of mandates. Not only is the ORSA required, but the section goes on to provide: a) "The SMI should consider how often an ORSA should be performed, updated and the results reported to the Board of Directors"; b) "The SMI should consider which risks should be addressed within the ORSA and at what level of detail"; and c) "The SMI should determine what the time horizon may be and what specifically should be included within such a continuity analysis." If an ORSA is to be mandated, it may be that some specificity will be helpful for compliance. But before mandating an ORSA, regulators should demonstrate that there are real problems that would be cost effectively remedied by the ORSA as proposed.

Section 2.8

This section creates the possibility for yet more specific mandates: "The SMI should consider what information should be shared with the regulator and how often, and standards should be developed for the regulatory review of risk management and ORSA information. In addition, the SMI should determine how risk management and ORSA information should be used within the solvency monitoring framework."

Conclusion

As the overall good performance of insurers demonstrates, insurers take corporate governance and risk management quite seriously and are already subject to extensive regulation. Before new regulatory mandates are created, we respectfully request the SMI to engage in a careful review of what is broken and what is the most cost effective way to fix it.

Respectfully submitted,

David F. Snyder,
Vice President and Associate General Counsel



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February 23, 2010

Christina Urias
Chair, International Solvency (EX) Working Group
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108

RE: Consultation Paper on Regulatory Capital Requirements

Dear Ms. Urias:

Aviva USA strongly supports the goals and objectives of the Solvency Modernization Initiative (SMI) and appreciates the opportunity to comment on the NAIC Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues. Our response will not address each individual question raised in the Consultation Paper, but instead, will focus on providing summary comments regarding several key themes raised by the paper. These themes include:

1. Purpose of regulatory solvency standards
2. Principle-based versus factor-based solvency standards
3. Use of internal models
4. Importance of total balance sheet and recognizing conservatism in statutory reserves
5. Choice of risk measure used in US solvency standard
6. Market consistent approaches versus real world run-off approaches
7. Role of economic capital evaluation in US regulatory solvency framework
8. Consistency with international solvency standards.
9. Achieving equivalency status under SII.

Following the comments on each of the above topics is an appendix that maps these nine themes to the specific questions in the Consultation Paper.

Please contact me if you have any questions or comments on our response.

Sincerely,

A handwritten signature in black ink that reads "David E. Neve".

David E. Neve, FSA, CERA, MAAA
Vice President, Capital Management

Aviva USA Response

Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues NAIC Solvency Modernization Initiative Task Force

Our response will focus on several key themes raised by the paper. Following the comments on each of these themes is an appendix that maps the themes to the specific questions in the Consultation Paper.

1. Purpose of US regulatory solvency standards

The current purpose of the US regulatory Risk Based Capital (RBC) system is to define a minimum capital level that is used as an early warning tool to identify weakly capitalized companies, and provide a process to appropriately trigger regulatory action. Its purpose is not to serve as a precise capital adequacy model that defines a required level of capital to cover company obligations at a certain confidence level (i.e. 95th percentile). However, it is common practice for non-regulators (such as rating agencies and investors) to use a multiple of the RBC standard as a measure of capital adequacy, despite its stated purpose to only be a minimum standard to identify weakly capitalized companies. Aviva USA generally agrees with the current purpose, but supports a change in the basic framework that goes beyond a simple “pass/fail” test, to a standard that is based on a theoretical level of capital that will be sufficient to cover company obligations at a targeted confidence level, such as 90 CTE. It may make sense to define multiple confidence targets (i.e. 87 CTE, 85 CTE) to trigger varying degrees of regulatory intervention, rather than the current approach of applying a series of fixed percentages to the RBC amount calculated under the formula. Consistent with this view, we support the 6 purposes of an effective capital requirement standard from the IAA listed in item 15 of the NAIC Consultation paper.

In contrast, the purpose of capital models used by rating agencies is to define a level of required capital that is commensurate with a particular financial strength rating, rather than as a minimum capital standard to determine when regulatory intervention is necessary. Most rating agencies have their own proprietary capital adequacy model and determine the level of required capital commensurate with a desired financial strength rating. Rating agencies also include qualitative factors when assessing the overall credit rating, such as quality of management, diversity of distribution systems and product offerings, and quality of enterprise risk managements processes. The level of capital held by most companies (including Aviva USA) is driven by rating agency considerations. This capital level is typically 3-4 times the regulatory RBC amount (i.e., 3-4 times the company action level).

2. Principle-based versus factor-based solvency standards

Aviva USA strongly supports the movement to a principle-based approach to solvency standards, as opposed to the current factor-based prescribed approach. While the current RBC system is a risk – based system, the use of static risk factors that are the same for all companies cannot adequately capture all of the underlying risks of the company. And some risk factors require the use of stochastic modeling to properly quantify the financial impact to the company. Aviva USA believes that a principle-based system (one that uses assumptions based on company experience along with internal cash flow models) is superior to a factor-based system, particularly if the level of complexity of products and assets continues to increase. Further, the movement to a principle-based system in the US is consistent with the direction the European Union and other parts of the globe are moving in regard to solvency standards, helping support the objective of the US regulatory system achieving third party equivalence (see section 9 below).

3. Use of internal models

Aviva USA supports the use of internal models to replace the current “one size fits all” risk factors, if appropriate controls, consistency, fairness and transparency can be effectively implemented and enforced. A company’s internal modeling represents their own, more customized view and provides better information to the regulator about the company’s ability to meet their financial obligations. However, adequate controls and enforcement will need to be implemented to minimize the improper use of internal models. Such controls include documentation and disclosure of assumptions and the justification for them, prescribed assumptions and/or methodologies for risk factors that the company has limited ability to control, and robust stress testing of key assumptions. While we support a limited number of prescribed stress testing scenarios, we believe it is important for the company to determine the stress tests that best reflect the risks of the company.

4. Importance of total balance sheet approach and recognizing conservatism in statutory reserves

Under the Total Balance Sheet approach, total admitted assets of the company are compared to the sum of liabilities and required capital. In this way, it can be demonstrated whether the company has sufficient assets to cover their obligations taking into account both the level of reserves held by the company and the minimal capital requirement. An important characteristic of this approach is that increasing or decreasing the level of margin included in required reserves is generally offset by a change in the opposite direction of the required capital.

It is also very important to emphasize that under the Total Balance Sheet approach, the relative conservatism built into statutory reserves is recognized as a form of “hidden capital”. US regulators have established statutory reserve requirements that include margins for conservatism that reflect the solvency objectives of statutory reporting. A rigorous asset adequacy analysis is required to test whether the assets backing reserves are adequate to fulfill the obligations of the company. To perform this test, most companies utilize a cash flow testing approach based on multiple deterministic and stochastic economic scenarios, along with stress testing of policyholder behavior, mortality, expenses and other key risk factors. The favorable outcome of this analysis for most companies demonstrates that assets backing reserves are more than adequate and that reserves include a prudent level of conservatism.

Aviva USA encourages the NAIC to move to a total balance sheet approach for solvency purposes. We believe this is a superior solvency approach compared to focusing only on the RBC capital requirement and ignoring the “hidden capital” built into statutory reserves.

5. Choice of risk measure used in US solvency standard

We support the use of the CTE metric (also called Tail VaR) since the VaR metric only captures one point in the distribution, and ignores the impact of “tail risk”, that is the degree of “fatness” in the tail beyond the VaR point. From the American Academy of Actuaries C3 Phase 3 guidance:

“CTE is a statistical risk measure that provides enhanced information about the tail of a distribution above that provided by the traditional use of percentiles. Instead of only identifying a value at the 95th percentile (for example) and ignoring possibly exponentially increasing values in the tail, CTE provides the average over all remaining values in the tail. Thus for many “traditional” loss distributions that are near normal CTE(90) will approximate the 95th percentile, but for distributions with “fat tails” from low probability, high impact events, the use of CTE will provide a higher, more revealing (and conservative) measure than the traditional percentile counterpart.”

We believe an appropriate first “trigger point” (i.e. the Prescribed Capital Requirement, or PCR level) should be set around the 90 CTE (tail VAR level), or the 95% VAR level, using a long term horizon consistent with the product lifetime. The CTE measure is more appropriate since it captures the degree of “tail risk” in the distribution of results, producing a more conservative (i.e. higher) level of required capital.

6. Market consistent approaches versus real world run-off approaches

For life and annuity products, Aviva USA prefers the use of a real world, run-off approach over a long time horizon, consistent with the life-cycle of the products. We believe this run-off approach is a more appropriate framework than using a risk neutral, market consistent one-year shock approach due to the long term nature of most life insurance and annuity products, and the common practice of holding assets to maturity. A real world run-off approach is less sensitive to temporary market swings than market consistent approaches, which we believe is appropriate for annuity and life insurance obligations that are often long term nature and therefore, should be less subject to short term market swings.

The use of a real world, run-off approach is also more consistent with the amortized cost (i.e. book value) approach of current statutory reporting. Another benefit of the real world run-off approach is that it is less procyclical in nature than market consistent approaches.

7. Role of economic capital evaluation in US regulatory solvency framework

Aviva USA supports modifying the mission of US regulatory solvency standards to include an evaluation of economic or target capital, but only to the extent that the economic capital is viewed in combination with economic reserves as part of a total asset requirement under an economic framework. We believe adding an economic capital requirement to the current statutory reserve requirement would be inappropriate. Further, as long as US regulators continue to utilize the current statutory reporting framework, we support the inclusion of an economic framework as a supplement to, not a replacement of, the current regulatory RBC standard. However, if the US regulators eventually replace the current statutory reporting framework with an economic reporting framework of some kind, then consideration should be given to adopting an economic capital requirement in conjunction with an economic reserve requirement.

8. Consistency with international solvency standards

Aviva USA encourages the SMI Task Force to establish a clear SMI objective of consistency with international solvency standards currently under development. In our view, consistency does not imply being strictly identical in terms of detailed calculations and/or methodologies, but rather consistency of principles and outcomes. There may be situations where differences in calculations and/or methodologies exist (given the characteristics of certain products, risks, etc) yet the over-riding principles and outcomes are still consistent.

A related issue that would help create consistency with international solvency standards is for the NAIC to continue to maintain consistency between US solvency standards and US statutory accounting standards. We believe it is critical that both continue to be aligned while seeking to achieve consistency with international solvency standards.

9. Achieving equivalency status under SII

US based insurers owned by a European parent will be at a competitive disadvantage if the US solvency system does not achieve equivalence under Solvency II. Therefore, we encourage the SMI Task Force to include an SMI objective that the US solvency system achieves third country equivalency status under Solvency II. To this end, we encourage the NAIC to adopt and communicate the following principles:

- Assessment of third country equivalency should be based on a principle-based assessment rather than a rule-based assessment. Compliance with stated principles rather than strict compliance with the “indicators” is sufficient to support an equivalency finding.
- Indicators do not provide conclusive proof that the objectives and principles have been met. No single indicator should be viewed as being vital to an equivalence finding.
- The overriding test for assessing equivalency is whether the regulatory system ensures the protection of policyholders and beneficiaries.
- Recognition should be given to the evolving nature of both Solvency II and the regulatory regimes in third countries when assessing equivalency, so as to permit a period of transition and/or grandfathering. Recognition should be given to current and proposed developments in third country regulatory regimes.
- Recognition should be given to the different risk appetites between Europe and the US, which can manifest itself in different measures of capital adequacy.
- Assessment of equivalency should take into consideration the potential for putting some companies at a competitive disadvantage simply due to the geographical location of the head office of the parent company or the third country company.

In addition to the principles listed above, we believe it is essential that the NAIC agree to designate the domiciliary state of European owned entity to interact on behalf of all states.

Appendix

Mapping the nine major themes to the specific questions in the Consultation Paper

Theme	Consultation Paper Question Number
1. Purpose of regulatory solvency standards	1, 2, 3
2. Principle-based versus factor-based solvency standards	10, 11
3. Use of internal models	17, 18, 19, 35, 36, 37
4. Importance of total balance sheet and recognizing conservatism in statutory reserves	5
5. Choice of risk measure used in US solvency standard	6, 7, 8
6. Market consistent approaches versus real world run-off approaches	8, 40, 43
7. Role of economic capital evaluation in US regulatory solvency framework	4, 9
8. Consistency with international solvency standards	34, 41
9. Achieving equivalency status under SII	49
Questions not addressed directly	12-16, 20-33, 38, 39, 42, 44-48, 50-60

MEMORANDUM

TO: Director Christina Urias
Chair, International Solvency (EX) Working Group

FROM: Alan Seeley
Chair, Solvency Modernization Initiative Subgroup of the Capital Adequacy Task Force

DATE: March 1, 2010

RE: Comments on Regulatory Capital Requirements Consultation Paper

The Capital Adequacy Task Force recently formed a subgroup to address referrals from the Solvency Modernization Task Force regarding evaluation of alternative approaches to regulatory capital measurement, and to review the U.S. RBC system specifically. Attached are some initial comments on the Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative that was released for comment by the International Solvency (EX) Working Group until March 1, 2010.

Please note that these are initial comments to encourage further discussion and should not be taken as a final view for any issue of either the Capital Adequacy Task Force or the Task Force's Solvency Modernization Subgroup.

We feel that the current risk-based capital formula provides a strong, albeit mostly standardized regulatory capital calculation for the U.S. insurance industry, and serves its purpose within the overall solvency monitoring structure as identified in the U.S. Solvency Framework Paper recently adopted by the Financial Condition (E) Committee. But it is a good time to identify strengths and weaknesses of the current methodology for establishing regulatory capital across the industry, and to consider enhancements for the future, in addition to looking in more depth at how Companies set their own internal capital needs beyond regulatory capital requirements

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**Solvency Modernization Initiative Subgroup
of the Capital Adequacy (E) Task Force**

Comments on “Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative”

Q1: What is the purpose of regulatory capital requirements?

A1: The purpose of regulatory capital requirements is to set a level of capital below which regulators possess the legal authority to intervene in the insurer’s operations. It should be noted that regulatory capital requirements are just one part of the set of regulatory tools within the U.S. solvency framework.

Q2: What is the driver of capital levels held by companies? What determines how much capital a company actually holds (e.g., rating agencies, market, regulation, etc.)?

A2: In most situations, rating agencies are a primary driver of the levels of capital held by insurers since investors and large commercial policyholders are generally more concerned with insurers’ rating agency ratings than RBC ratios. The capital levels required to maintain good rating agency ratings are usually substantially above regulatory capital levels.

Q3: Do rating agencies’ motivations and output differ from regulators’?

A3: Rating agencies are motivated to provide information useful to investors in insurance companies. To do so they provide letter grades rather than pass/fail benchmarks.

Q4: Should the US Regulatory Mission be modified to include evaluation of economic or target capital? ...to include financial stability?

A4: We do not perceive a need to modify the primary focus of the current U.S. Insurance Regulatory Mission, which is the protection of policyholders. This inherently includes an evaluation of insurers’ financial stability and ability, in the long as well as short terms, to honor their commitments to policyholders. Economic capital may have a place in financial analysis and can be used during risk-focused examinations to evaluate an insurer’s ability to assess its own overall solvency risk.

Q5: What is a “total balance sheet” approach? How should that approach impact U.S. regulatory requirements?

A5: The term “total balance sheet approach” has not yet been defined with adequate functional clarity. Its impact on U.S. regulatory requirements will be better understood once FASB and IASB determine their valuation requirements for financial reporting.

- Q6: What is the capital level at which companies cannot operate in the market? At what level of capital should regulators become concerned (PCR)? At what level of capital should regulators take over (MCR)? Compared to these levels, at what level is the U.S. solvency system (which includes conservative accounting and RBC)?
- A6: In order to continue to operate effectively in the market, most insurers need to satisfy the capital levels and other conditions necessary to maintain specific rating agency ratings. Regulators should become concerned when an insurer fails to meet a rating agency rating that is critical to its market operations or when the insurer's financial strength begins to deteriorate. Regulators should take over an insurer when the insurer's continued operation poses a threat to its policyholders. A hindsight study of the effectiveness of the U.S. regulatory system in reducing insolvencies during the period of time that RBC has been in effect should be undertaken in order to intelligently answer the last part of this question.
- Q7: What mechanism should be used to determine solvency action and control levels? Are the multipliers that are currently used to define the solvency control levels appropriate?
- A7: It is not certain that applying multipliers to "authorized control level risk-based capital" is the best way, since the purposes of various interventions differ. For example, it may be true that PCR levels should be based on longer, going-concern time horizons while MCR levels should be based on shorter, wind-up time horizons. If time horizons differ, then the application of different multipliers to the same RBC dollar amount may be the wrong approach.
- Q8: How should the U.S. define its RBC levels using statistical safety level and time horizon definitions? What is the appropriate risk measure?
- A8: If statistical safety levels (i.e. "confidence levels") are to be used, efforts should be undertaken to make them as robust as possible, including incorporating types of events that haven't yet occurred. While a one-year time horizon seems to have gained international popularity, time horizons should be tailored to the potential volatility in a given line of business, the type of regulatory intervention, and the adequacy of other regulatory tools available (see the U.S. Solvency Framework Paper). Regarding risk measures, TVaR should be used instead of VaR in recognition of the skewed nature of most types of insurance risks.
- Q9: Does economic (or target) capital evaluation have a role in the U.S. solvency framework? If so, what? Should a company's own economic evaluation relate to regulatory requirements? Should a company's own economic evaluation impact RBC or be considered outside of RBC?
- A9: Economic capital should have a limited role in the U.S. solvency framework, namely to provide regulators with insight into an insurer's current and prospective operations and long-term financial strength as well as the insurer's ability to understand and assess its own solvency risks and capital needs. An insurer's own economic evaluation should not have a direct relationship to, or impact on, regulatory capital calculations.

Q10: Are the factors included in the RBC still appropriate?

A10: There may need to be some disaggregation of risk factors for investment risk in order to recognize evolving investment vehicles (the Invested Asset WG is working in this area). Also, the impact of taxes on the factors should be reviewed across the three RBC formulas. While most RBC factors may still be appropriate, a more expansive study needs to be done.

Q11: Are there areas of the RBC formula that should be modified in the approach (example: more categories of assets, treating assets more granularly, more stochastic analysis)?

A11: See A-10.

Q12: What is the appropriate methodology to consider interdependencies among risks (e.g., diversification)? Is the square-root covariance adjustment appropriate?

A12: For regulatory capital it may be preferable to assume minimal interdependencies since the current co-variance calculation can drive unwarranted reduction in risk capital and differences between the industry segments. There also does not appear to be consensus on the appropriate methodology for quantifying diversification credit. We would benefit greatly from advice on this matter from the American Academy of Actuaries and/or the International Actuarial Association.

Q13: What risks should be added or excluded in the RBC calculation?

A13: It may be that systemic risks that can cripple entire portions of the U.S. insurance industry are not yet sufficiently factored into RBC. Operational risks and intra-group contagion risks are examples of other areas worthy of examination.

Q14: For each missing risk, should the risk be treated quantitatively or qualitatively? Should some risks be accounted for quantitatively but with a judgmental factor (e.g., 10% for unidentified operational risks)?

A14: Consideration could be given as to whether qualitative considerations can be used as risk modifiers in the RBC calculation or as mitigating factors in the review of RBC reports or RBC plans. Also, since one of the core purposes of RBC is to provide a transparent methodology for determining when a regulator can legally intervene in the operations of an insurer, introducing judgmental factors into RBC could weaken those legal underpinnings. It might be better to leave qualitative or judgmental considerations outside of RBC and let them come into play when determining Hazardous Financial Condition.

Q15: How should risk mitigation (e.g., reinsurance, hedging) be treated in the determination of capital requirements?

A15: The treatment should meet the following two objectives: to provide an incentive to mitigate risk; and to ensure that the supposed capital relief from the mitigation will be real and not overstated or too costly in tough markets. For reinsurance, additional or reduced capital could be required based on the financial strength, the nature, or the affiliations of the reinsurer.

Q16: Should there be off-balance-sheet items? If so, how should off-balance sheet items be considered in the solvency system?

A16: No comment at this time.

Q17: Should internal models be allowed to determine capital requirements?

A17: While internal models can have a prominent role in determining economic or target capital, they should probably be used on only a limited and controlled basis in determining regulatory capital, such as for C3 interest rate risks in Life RBC and for catastrophe risks in P&C RBC. Allowing the general use of internal models for determining U.S. regulatory capital may not be a good idea at this time for several reasons. First, the legal transparency of RBC calculations may be undermined. Second, insurance regulators in many or most states lack the expertise to intelligently evaluate internal models. Third, smaller insurers that cannot afford internal modeling would be at a disadvantage. Fourth, if we try to sidestep some of these concerns by allowing or encouraging vendors to produce “generic” internal models for widespread use, how would this be much different from a standardized methodology such as RBC?

Q18: Should partial modeling allowing company discretion be utilized in the RBC? If so, how?

A18: Partial modeling should only be allowed for specific risks, and the parameters for such partial models should be established by the NAIC.

Q19: When modeling is used for capital requirement purposes, what safeguards should be considered to the modeling? What requirements should be established with modeling?

A19: If modeling is allowed to be used, then it should be subject to prior regulatory approval. The NAIC should establish an office, similar in concept to the NAIC’s Securities Valuation Office, to evaluate internal models. All models should be subject to the statistical quality, calibration and use tests recommended by the IAIS.

Q20: Which particular risks are more appropriately reflected by modeling? Which risks are effectively measured without extensive modeling, (e.g., risks where factor determination is credible and sufficient, non-material risks)?

A20: Modeling is clearly helpful for risks associated with catastrophes and with complex, long-term life products or investment-linked products.

Q21: Should the MCR be influenced by an internal model?

A21: Probably not, since the MCR triggers the strongest type of regulatory intervention and therefore requires the greatest level of legal transparency.

Q22: With implementation of internal models, does the use of a specified safety level and time horizon become imperative?

A22: The specification of safety levels and time horizons is a worthy discipline in its own right, regardless of whether it’s applied to internal models or to a standardized RBC methodology. If internal models are to be used, it becomes even more important to

establish safety level, time horizon and risk measure specifications in order to calibrate internal models to RBC.

Q23: Even with limited use of modeling in the current RBC, should that modeling be subject to prior approval by the regulators? What should be designated and/or approved (e.g., the approach — 1,000 scenarios — and key considerations or parameters)?

A23: There should be some measure of regulatory oversight or approval and possibly a floor scenario for regulatory capital purposes.

Q24: What regulatory expertise is needed for model review? How should regulatory review of models be funded? For regulatory review of internal models, should there be a centralized review function?

A24: Model review requires expertise in insurance products, accounting, investments, risk assessment and actuarial projections. Cat modeling also requires expertise in meteorological, geological and terrorism risk assessment. Much of this expertise is beyond the in-house capabilities of most state insurance departments. For that reason it's imperative that the NAIC develop a centralized model review function analogous to SVO for the analysis of investments. Insurers that submit internal models should be assessed for the cost of their review.

Q25: What are the “level playing field” implications? What is the impact on small firms? How would a dual system of allowing internal model calculations by some firms impact the competitive marketplace?

A25: An expectation appears to exist that insurers that choose to use internal models would, in many or most cases, calculate regulatory capital requirements below those produced by the standardized RBC. If that is correct, then the standardized RBC calculations may need to be recalibrated to produce higher results in order to maintain industry-wide regulatory capital requirements. Larger insurers, which can better afford the cost of producing internal models, would then be at an advantage in supporting lower cost of capital requirements. If vendors of internal models emerge, which is likely, then the cost of internal modeling would likely drop, benefiting smaller insurers. A more limited set of models may be more appropriate for small insurers that choose to go the modeling route. Regarding “unleveling” the competitive marketplace, we should keep in mind that the amount of capital that an insurer maintains is determined primarily by rating agencies, by business plans and by the insurer's access to capital markets, and not by regulatory capital requirements.

Q26: Are the powers in the *Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition*, effectively, capital add-ons?

A26: Yes.

Q27: Should capital add-ons be considered in the RBC? Is this a concept that would apply at the MCR level as well as the PCR level?

A27: If capital add-ons are, by their nature, intended to cover types of risk that are hard to quantify, then it may be inappropriate to attempt to include them in RBC. Maintenance of some level of conservatism in Statutory Accounting can serve as a capital add-on by reducing the “total capital available” part of the calculation (i.e. the numerator in the RBC ratio).

Q28: What should trigger capital add-ons?

A28: Regulators’ awareness of operational risks, off balance sheets risks and other types of risks that fall outside of RBC and that may place the insurer in a hazardous financial condition. Some of these can come to light via financial analysis or the risk-focused exam process.

Q29: Does the leverage ratio in banking have a place in insurance regulation? If so, where?

A29: No comment at this time.

Q30: What changes should be made to RBC exclusions?

A30: The current RBC exclusions for title insurers and for financial and mortgage guaranty insurers may have resulted from an expectation that their markets already required them to be well-capitalized and perhaps also from a desire to avoid undertaking the work of designing RBC models tailored to relatively small lines of business. Nonetheless these exclusions should, in theory, be eliminated. A practical question is whether the P&C RBC model can appropriately incorporate these lines of business or whether these lines do indeed need their own RBC models.

Q31: If the U.S. solvency regime is expanded to explore economic capital, what exclusions should be made to those requirements, recognizing that those might be different from RBC exclusions?

A31: We assume that each insurer determines its own economic capital needs regardless of its size or the lines of business it writes. If the U.S. solvency regime is expanded to explore economic capital, there would therefore probably be no need to exclude any lines from economic capital analysis. However, there is some expectation that the level of sophistication and scope of the economic capital model will be proportional to the nature and size of the entity.

Q32: What capital requirements should be employed for insurance entities currently excluded from RBC?

A32: The current rule-based capital requirements for these entities should be targeted for review and potential replacement with risk-based measures. The solvency experiences and systemic risk exposures of each of the several types of excluded entities (e.g. title insurers, mortgage guarantee insurers) need to be studied as part of this review.

Q33: What proportionality considerations should be given in the U.S.?

A33: Small insurers may not be able to afford internal models and regulators may not want to expend the resources needed to review regulatory capital models for numerous small insurers.

Q34: Is there a need to obtain uniformity in the minimum capital and surplus requirements by state? Should the NAIC recommend a best practice of minimum requirements?

A34: Minimum capital and surplus requirements come into play when an insurer initially obtains a license in a particular state. Those requirements are then supplanted by ongoing RBC requirements, which are usually higher than minimum capital and surplus requirements, thereafter making those minimum capital and surplus requirements irrelevant for most insurers. Nonetheless, there is probably no valid rationale for minimum capital and surplus requirements to differ among states.

Q35: What stress tests should be performed by the NAIC?

A35: Stress tests that evaluate the effect of various systemic risks upon the insurance industry.

Q36: What stress tests and reverse stress tests should be performed by companies? What should be required to be reported to the regulator?

A36: No comment at this time.

Q37: Should the regulator specify stress test scenarios to run? If so, which ones? How often should they be done?

A37: Yes, the NAIC should determine and develop specific stress test scenarios for insurers to run. Some of these tests would likely differ for life insurers vs. P&C insurers vs. health insurers vs. mortgage guarantee insurers. Since most of an insurer's cost in running a particular stress test is likely incurred in designing the first run, these tests should probably be performed annually.

Q38: Should the RBC calculation be publicly available?

A38: We recommend that the details of insurers' RBC filings remain confidential, but recognize that the results can be disclosed with enforcement of improper ranking or other marketing uses of RBC results.

Q39: If internal models are allowed for capital requirement purposes, should information be publicly available?

A39: Internal models should probably remain confidential since these models are customized to the insurer and contain business projections and other information that is not contained in the insurer's Annual Statement or other public sources. However, some level of disclosure of the underlying assumptions in the model, or at least a disclosure that a modeling was utilized to determine regulatory capital, may be warranted.

Q40: Should the valuation of all assets, liabilities, and capital resources for regulatory capital purposes be completed on a market-consistent or some other basis?

A40: No comment at this time.

Q41: Should the SMI wait for FASB and IASB to determine valuation requirements for public financial reporting prior to determining valuation for regulatory solvency purposes?

A41: Yes, particular since FASB and IASB expect to finalize their determinations next year.

Q42: Should valuation differ between public financial reporting (GAAP) and supervisory financial reporting (SAP)?

A42: A single valuation method for public financial reporting and supervisory financial reporting would facilitate comparisons of the valuation of insurance companies with the valuation of other financial services industries, both domestically and globally. Also, the conservatism produced by SAP can probably be achieved by appropriately modifying risk factors in the RBC models. Nonetheless, the abolition of SAP would have an income tax impact on insurers that needs to be addressed.

Q43: How should procyclicality be addressed? What counter-cyclical adjustments should be made?

A43: The concept of retaining additional regulatory capital during strong economic priors or hard insurance cycles to be released in difficult times has some merit and should be explored.

Q44: Should capital resource requirements utilize a tiering structure of capital? Should there be tied assets? If so, how?

A44: Categorizing (i.e. “tiering”) types of capital instruments according to their availability for paying claims and other obligations to policyholders, and then setting parameters around the types of capital in an insurer’s portfolio, makes inherent sense. The current U.S. regulatory system already addresses some of these issues (e.g. limitations on the portion of assets that can be in real estate or in affiliate investments). Further enhancements in this area, including the potential adoption of a capital tiering structure, should be investigated.

Q45: For group capital assessment, what should the definition of a group be?

A45: We defer this question to the Group Solvency Issues (EX) Working Group.

Q46: What are the benefits of group capital assessment? Drawbacks?

A46: We defer this question to the Group Solvency Issues (EX) Working Group.

Q47: What are the benefits of group capital quantification of regulatory requirements? Drawbacks?

A47: We defer this question to the Group Solvency Issues (EX) Working Group.

Q48: Should consolidated financial statements be required?

A48: We defer this question to the Group Solvency Issues (EX) Working Group.

Q49: What methodologies of calculation should be considered (e.g., consolidation vs. aggregation)?

A49: We defer this question to the Group Solvency Issues (EX) Working Group.

Q50: How should unregulated entities and non-insurance entities be considered? Do insurance regulators have the expertise to determine the risks of non-insurance entities?

A50: We defer this question to the Group Solvency Issues (EX) Working Group.

Q51: Should diversification credits be applied at the group level?

A51: We defer this question to the Group Solvency Issues (EX) Working Group.

Q52: Should group support be implemented? If so, how would fungibility issues be addressed?

A52: We defer this question to the Group Solvency Issues (EX) Working Group.

Q53: Should the NAIC consider an approach to group-wide capital requirements that span international jurisdictions?

A53: We defer this question to the Group Solvency Issues (EX) Working Group.

Q54: What considerations should be made regarding regulatory arbitrage?

A54: If we allow the use of internal models, we will need to ensure that companies don't game the system by utilizing their internal models for regulatory capital only when those models produce regulatory capital lower than RBC.

Q55: Should the U.S. insurance solvency system be adjusted for systemic risk regulation? If so, how?

A55: The US insurance solvency system should address systemic risks. Inclusion of systemic risk factors in the various RBC models may be an appropriate way to accomplish this.

Q56: Should wind-down plans be incorporated? If so, how?

A56: No comment at this time.

Q57: What further studies regarding capital requirements should be performed and who should perform the studies?

A57: The appropriateness of the current square root method for determining diversification credits should be examined. The American Academy of Actuaries, should they be willing, would likely be the party best skilled and positioned to undertake this. See A-12.

Q58: Should quantitative impact studies be performed in SMI?

A58: Yes. To the extent possible, the likely impact of any material changes to RBC or other components of the U.S. insurance solvency regime should be measured prior to making those changes.

Q59: Should SMI revisions be phased in?

A59: Yes. All parties – insurers, regulators, investors and policyholders – need time to understand, implement and adjust to revisions of the current regulatory system.

Q60: What additional capital requirement or overarching accounting/valuation issues should be considered in the SMI?

A60: The impact of SMI on insurers' income tax liabilities.

March 1, 2010

**To: Director Christina Urias,
Chair of the International Solvency (EX) Working Group**

From: Capital Initiatives Working Group

**Re: Comments on Consultation Paper on Regulatory Capital Requirements
and Overarching Accounting / Valuation Issues for the Solvency
Modernization Initiative**

The Capital Initiatives Working Group (CIWG) is comprised of seven well known and respected U.S. Life Insurance and Multi-line insurance groups (MassMutual, MetLife, New York Life, Northwestern Mutual, Prudential, Reinsurance Group of America and State Farm) that are working together to monitor developments and make recommendations concerning the future modernization of minimum regulatory capital standards in the U.S.

The CIWG believes it is critical to the long-term health of our industry to have minimum capital standards in place that will appropriately safeguard the promises made to our policyholders at an appropriate level of assurance, while at the same time avoiding unnecessary redundancy in capital. Without these safeguards, the value proposition we bring to the marketplace is weakened significantly (i.e., our contracts have no value if consumers are not confident in our ability to pay). At the same time, we believe it is equally important that insurance companies are able to offer their products at competitive prices while providing a fair return on the capital deployed. To foster fair competition in the U.S. marketplace, capital standards should be consistent for all companies, regardless of the domicile of a parent company.

The goal of the working group is to participate in the development of capital standards to achieve these goals, using as much of the existing research as possible. To this end, the CIWG will develop a framework for an appropriate minimum capital standard that adequately protects the safety and soundness of the U.S. life insurance industry, while at the same time providing the opportunity to achieve a fair return on the capital deployed.

It is our view that the factor-based RBC system has served regulators, the industry and customers well, succeeding over its 15+ year existence in the role for which it was initially designed. However, the fact that the basic RBC framework is nearly 20 years old, and the economic environment, financial analysis thinking and technology, and the industry's products have all evolved significantly over that time leads us to believe that the framework is in need of a comprehensive review. We believe that regulators and the industry have done a reasonable job of updating RBC when necessary, but these fixes are generally piece-meal improvements, focused on only the most glaring current weaknesses and do not result in a comprehensive standard that will effectively serve the industry in the future as product innovation continues.

The CIWG has agreed on a set of principles that need to be inherent in any minimum capital standard. Among these principles are the following:

- Minimum regulatory capital requirements must ensure the safety and soundness of our industry, while avoiding unnecessary redundancy in capital.
- Each legal entity should be required to meet the minimum regulatory capital standards on its own.
- The minimum required capital standard should be based on an objective test in order to enable a quick judgment about a company's capital position.
- Required minimum capital levels should appropriately capture all meaningful risks and their interrelationships and reflect substantiated risk mitigation practices within a company.
- The system should not create inappropriate and unnecessary volatility in a company's minimum capital standards, especially during periods of financial stress.
- When used, modeling approaches should be "standardized" and methodologies should be consistently applied across all companies. Where models are used, all companies should be required to evaluate the same scenarios. The evolution of actuarial and financial analysis is such that a disciplined/focused element of professional actuarial and financial judgment will likely be part of the solution when modeling approaches are used.
- The system should balance the competing needs of effectively measuring all risks versus practicality and simplicity.
- The system should address the concerns of all insurance companies, large or small companies, life, health, property and liability, public or mutual, etc., and recognize the importance of maintaining a level playing field.

The CIWG is very pleased to attach for your consideration our answers to the questions laid out in the Consultation Paper. Many of these questions refer to areas concerning the setting of regulatory capital on which the CIWG has previously had very detailed discussions. The responses reflect the consolidated thinking of the CIWG. While we all agree on general principles, it is important to be clear that for some of the issues raised by the Consultation Paper, there is not complete consensus among the CIWG members. As a result, not every company agrees with every answer in the attached.

Going forward, the CIWG intends to provide a document fleshing out our conceptual framework. In addition to incorporating our principles in our framework, we will focus on the following:

- A new/modernized approach to RBC
 - Focus on identifying weakly capitalized companies.
 - Leave in place a framework for regulatory action triggers that is comparable to what we have today.
 - Be auditable by the regulator.
- Issues concerning and contrasting the total balance sheet approach and the required surplus approach (Question 5 of the Consultation Paper). In addition, we will include thoughts about how capital should relate to reserve redundancies under the statutory accounting system.
- The implications of a system that, where appropriate, will likely involve an evolution from where US regulation is today by using current modeling techniques and capturing correlations amongst products and risks. Any such system must balance the competing needs of effectively measuring all risks versus practicality and simplicity.
- The issues related to the introduction of modeling approaches to be used. In particular, these approaches may necessitate some elements of professional actuarial/other financial judgment as part of the process. We will address issues related to the introduction of these elements on a controlled, well-defined and disciplined basis.
- The issues around scenario generation, the use of stress scenarios and the possibility of using scenario reduction techniques.

The U.S. insurance industry and the NAIC are watching the Solvency II initiative unfold in Europe. Solvency II is an important step for Europe in the modernization of its solvency standards and incorporates several principles that are attractive, including recognition of the importance of the alignment between risk assessment and capital requirements. However, Solvency II may ultimately be inconsistent with the principles discussed above.

One concern is the prospect of group-level solvency, which could remove the requirement that legal entities are required to stand on their own. If U.S. requirements are stronger than those under Solvency II, group-level solvency could allow foreign regulators to apply amounts they deem excessive in U.S. legal entities as credits against reserves and surplus in foreign legal entities.

A second concern is that Solvency II may allow for a proliferation of non-standard company-specific internal models of risk. Under Solvency II, companies may use internal models to lower their minimum capital. While these models would be subject to approval by the regulators, in practice they would still be hard to compare and it would be very difficult for anyone except the model builder to understand and critique them. In addition, we are concerned that companies may not be required to use consistent future assumptions in stochastic scenario generation. We believe that, recognizing the point above concerning the possibility of some element of professional judgment being part of the process, more defined standard approaches and consistent methodologies are necessary for regulatory reserve and capital requirements.

A third concern is that Solvency II may require valuation methods linked to current market consistent approaches that would create inappropriate and unnecessary volatility in a company's minimum capital standards. This may be a particular problem during periods of financial stress, where, as we have seen, due to short-term liquidity issues and fear, asset values may fall much more rapidly than liability values. Our view is that, even before the 2008-2009 economic crisis, the use of current market consistent approaches should have given all pause as to their applicability to the U.S. Life Insurance Industry. The use of current market consistent approaches could needlessly put some companies under supervision based on current spot interest rates when their obligations are longer term.

The CIWG desires to have a close working relationship with the NAIC on developing a regulatory capital standard. We anticipate providing our discussion document fleshing out our conceptual framework prior to the Summer NAIC meeting. In the interim we welcome the opportunity to meet with you to periodically update you on our progress and to discuss issues of concern to you.

Members of the Capital Initiatives Working Group

Company	Primary Representative	Title
MassMutual	Dave Carlson	Corporate Vice President and Actuary
MetLife	Dave Parsons	Vice President and Senior Actuary
New York Life	Joel Steinberg	Senior Vice President and Chief Actuary
Northwestern Mutual	Robert Meilander	Vice President – Corporate Actuary
Prudential	Ajay Sawhney	Senior Managing Director-Treasurer's
Reinsurance Group of America	Scott Cochran	Senior Vice President, Corporate Actuary and Chief Risk Officer
State Farm	Bill Sergeant	Director – Office of Accounting Policy

Capital Initiatives Working Group

Comments on Consultation Paper on Regulatory Capital Requirements and Overarching Accounting / Valuation Issues for the Solvency Modernization Initiative

The responses reflect the consolidated thinking of the CIWG. While we all agree on general principles, it is important to be clear that for some of the issues raised by the Consultation Paper, there is not complete consensus among the CIWG members. As a result, not every company agrees with every answer.

Q1- What is the purpose of regulatory capital requirements?

The purposes are to:

- (1) Make certain that all insurance entities have sufficient financial resources to provide comfort that policyholder obligations can be reliably and fully discharged in all but the most remote situations of financial distress.
- (2) Provide signals to the regulators that a company is at or trending toward a weakly capitalized status so that regulators can address issues before they become major problems.

Q2- What is the driver of capital levels held by companies? What determines how much capital a company actually holds (eg, rating agencies, market, regulation, etc)

Drivers and determinants of the level of capital held by companies include:

- (1) Rating Agencies – where companies factor in the level of capital required by rating agencies to meet certain rating criteria
- (2) The perspective of regulators
- (3) Shareholders – who prefer not to see a company have excess capital producing low returns
- (4) Future plans – including expected strong new business growth and potential mergers and acquisition activity that may require temporarily boosting capital
- (5) A company's own internal modeling of capital needs, reflecting the risk inherent in its mix of assets and liabilities

Q3- Do rating agencies' motivations and output differ from regulators?

Rating agencies motivations differ from those of the regulators:

- (1) Regulators are dominantly concerned with the portion of companies that are at or trending towards becoming weakly capitalized and being able to step in and address issues before they become major problems.
- (2) Rating agencies also share concern over weakly capitalized companies, but spend much more time and energy in making gradations among adequately capitalized companies.
- (3) Regulators tend to be very objective in applying capital rules, while rating agencies will typically apply more judgmental factors into their final ratings.
- (4) Rating agencies are often viewing things from a "bondholder" orientation, with concern not only on capitalization, but also on profits and growth.

Q4: Should the US regulatory mission be modified to include evaluation of economic or target capital?..to include financial stability?

The mission presented is appropriate as is.

Financial stability and systemic risks presented by the industry should be considered in order to improve confidence in the industry and the regulatory system.

Q5: What is a "total balance sheet" approach? How should that approach impact U.S. regulatory requirements?

A total balance sheet approach to solvency assessment involves the aggregation and consolidation of all of a legal entity's assets, liabilities, capital and risks.

A total balance sheet approach to solvency would determine the total assets necessary to meet all obligations at a high level of confidence. An increase in the level of reserves would result in lower additional capital to achieve the necessary total assets and likewise, a decrease in the level of reserves would result in higher additional capital.

The approach currently used in the US is a required surplus approach, which adds a layer of capital on top of current statutory liabilities, regardless of the level of conservatism in those liabilities. This is intended to ensure statutory solvency in a high percentage of scenarios. To the extent reserves are overly conservative, the regulatory mission of providing an effective and efficient marketplace for insurance products can become compromised using a required surplus approach.

In practice, if reserves are set at an appropriately conservative level, a total balance sheet approach and a required surplus approach should produce comparable levels of required capital.

Q6: What is the capital level at which companies cannot operate in the market? At what level of capital should regulators become concerned (PCR)? At what level of capital should regulators take over (MCR)? Compared to these levels, at what level is the U.S. solvency system (which includes conservative accounting and RBC)?

Clearly defined levels of required capital should be established as dividing lines between no regulatory concern (above PCR), the area of regulatory concern (between MCR and PCR) and where regulatory controls become necessary (below MCR).

Confidence levels need to be established for both MCR and PCR. The confidence levels to be established should be based on the probability of failure that is acceptable to the regulators in order to meet their mission. A study of past company failures and how predictive RBC was in those cases may be instructive.

The level of failure should be established at a very high confidence level for PCR (X% confidence of no failure over a P year period) and a somewhat lower level of confidence for MCR (Y% confidence of no failure over a Q year period). The levels of X and Y and the P and Q time periods need to be determined.

Companies below MCR must result in a takeover by the regulator. After that, the regulator will determine whether the company should continue to operate in the market under its supervision and what restrictions would be placed on the company going forward.

Depending on the underlying liabilities within an insurance company, current RBC requirements, when factoring in current reserving requirements, may be above or below the target confidence levels for MCR and PCR.

Q7: What mechanism should be used to determine solvency action and control levels? Are the multipliers that are currently used to define the solvency control levels appropriate?

In general, approaches that capture confidence levels may be superior to approaches that rely on a multiple of a formulaic required capital level. In order to determine confidence levels, simulations of asset and liability performance in response to the uncertainty of economic and policyholder behavior variables are necessary.

To establish whether current RBC multipliers are appropriate, a past study of failures and whether or not the regulatory ratios were triggered would be instructive.

Q8: How should the U.S. define its RBC levels using statistical safety level and time horizon definitions? What is the appropriate risk measure?

Ideally, the time horizon should be comparable to the time horizon contemplated in the current RBC regulations, which is a long-term horizon, intended to be for the lifetime of the inforce liabilities.

For calculation ease, higher solvency thresholds over shorter time horizons may be preferable to lower solvency thresholds covering longer durations.

Where short time horizons are used, a critical issue is the valuation of the remaining liabilities at the end of the time horizon. Shorter time horizons have the disadvantage of being heavily dependent on the valuation.

Q9: Does economic (or target) capital evaluation have a role in the U.S. solvency framework? If so, what? Should a company's own economic evaluation relate to regulatory requirements? Should a company's own economic evaluation impact RBC or be considered outside of RBC?

Models that evaluate prescribed stochastic scenarios may portray more accurate risk quantification of solvency capital than formulaic approaches. Therefore, it may be useful for regulators to utilize the results from company models that evaluate prescribed scenarios.

A company's own economic capital or target capital level should not be used in setting that company's regulatory capital requirements. Internal capital assessments may be useful to the regulator in the evaluation of companies who are below PCR.

Another question is, since the mission of regulators is to identify weakly capitalized companies, should companies that are highly capitalized (based on regulatory formulas) be required to produce modeled results?

Q10: Are the factors in the RBC still appropriate?

Some of the factors used in RBC today are likely to be appropriate, while others are definitely not. Over time, the factor-based approach to RBC has been increasingly challenged by its inability to quickly adapt to new, more complicated types of coverage.

Due to the prevalence of the complicated types of coverage, modeling-type solutions have been incorporated into RBC (C3 Phase I and Phase II, and possibly Phase III). The increasing need to utilize model-based approaches to determine regulatory capital for some types of coverage is probably going to continue.

Q11: Are there areas of the RBC formula that should be modified in the approach (example: more categories of assets, treating assets more granularly, more stochastic analysis?)

RBC today does not necessarily provide adequate relief from capital requirements when a company implements risk mitigation strategies, such as hedging.

There is no ability to capture covariance in certain risks between different products.

To the extent that a risk distribution can be reliably developed, for products where formulaic approaches do not provide an adequate reading of risk, stochastic analyses have a place in determining RBC (e.g., C3 Phase II).

Q12: What is the appropriate methodology to consider interdependencies among risks (E.G. diversification)? Is the square-root covariance adjustment appropriate?

A square root covariance adjustment is a reasonable tool to capture diversification benefits. However, it may be possible to further update RBC to capture more covariance through the use of prescribed correlation assumptions.

On the other hand, a move towards a stochastic based approach that captures the performance of all assets and liabilities on an entity's balance sheet would more accurately reflect the diversification of the risks and preclude the need to utilize the square-root covariance adjustment or covariance matrices.

Q13: What risks should be added or excluded in the RBC calculation?

All material risks should generally be included in a solvency capital assessment. In practice, RBC is not designed to capture liquidity risk or reputational risk. However, these additional risks should be monitored independently.

RBC should also not be designed to cover the risk generated by future new business.

There is a need to reflect effective risk mitigation activities.

There is a need to capture covariance between certain risks.

Q14: Should some risks be accounted for quantitatively but with judgmental factor (e.g. 10% for unidentified operational risk)?

In general, the quantification of risks is preferable. Risks that are difficult to quantify could potentially be handled with judgmental factors that would be applied consistently across all companies.

The quantification of certain risks (e.g., operational risk) is more art than science and could lend itself to a qualitative assessment.

Q15: How should risk mitigation (e.g. reinsurance, hedging) be treated in the determination of capital requirements?

Risk mitigation should be reflected in determining capital requirements. Techniques that are well established risk mitigation programs should be fully reflected. The reflection of other forms of risk mitigation that are less substantiated by experience may need to be subject to some form of a haircut, reflecting the effectiveness of the risk transferred and the ability of the third party to meet its obligations.

It is important that a capital system rewards companies that take risk mitigation actions, otherwise, some companies could be discouraged from executing the actions.

Q16: Should there be off-balance-sheet items? If so, how should off-balance sheet items be considered in the solvency system?

Off-balance-sheet items must be considered to the extent that they commit the company to future obligations and detract from assets available to meet on-balance sheet obligations.

There are additional contingency items that are “off-balance-sheet” (e.g., reputational risk that can drive excess lapses). Such risks cannot be reliably quantified and should therefore be handled via disclosures to the regulator.

Q17: Should internal models be allowed to determine capital requirements?

In the determination of minimum regulatory capital, we do not support the use of internal models in which all assumptions, including the scenarios tested, are internally generated.

Instead, we feel that when internal model-based components to RBC are permitted (such as in RBC C3 Phase I and RBC C3 Phase II), the modeling should always be prescribed as much as possible, especially the scenarios to be evaluated.

The degree to which the use of internal models should be expanded needs to be further determined.

Q18: Should partial modeling allowing company discretion be utilized in the RBC? If so, how?

Partial modeling may be appropriate in the determination of regulatory capital. However, if model-based components to RBC are permitted (such as in RBC C3 Phase I and RBC C3 Phase II), the modeling should always be prescribed as much as possible, especially the scenarios to be evaluated.

Q19: When modeling is used for capital purposes, what safeguards should be considered to the modeling? What requirements should be established with modeling.

When models are used for regulatory capital purposes, they must be thoroughly reviewable by the regulator. Internal or partial models, where the company sets all of its assumptions and scenarios to be evaluated are “black box models” and should not be allowed, even if developed outside of the company.

Regulators should define underlying principles of model quality, controls and documentation. In addition, regulators should have the ability to validate that these principles are being applied appropriately.

Economic scenarios should be prescribed and used consistently by all companies.

Q20: Which particular risks are more appropriately reflected by modeling? Which risks are effectively measured without extensive modeling (e.g. risks where factor determination is credible and sufficient, non-material risks)?

Risks that vary significantly by company and risks that have step function characteristics and are more volatile, and have underlying liabilities possibly moving dramatically from year to year are better handled by modeling. The emergence of risk in these cases often occurs so quickly that standard measures cannot keep up.

Risks that are broadly comparable from company to company and are relatively smooth across the range of scenarios can often be appropriately handled by formula factors.

Non-material risks need not be included in modeling.

Q21: Should the MCR be influenced by an internal model?

A prescribed approach for MCR should be mandated, as it is desirable to have an objective test to enable a quick judgment about a company's position.

MCR should not be influenced by an internal model.

Companies that are barely meeting the formulaic MCR should be required to produce evidence that the MCR is appropriate and that they do indeed have sufficient capital. An alternative to this requirement would be to set MCR at a high enough level so that additional analysis is not necessary to prove a minimum capital level has been achieved.

Q22: With implementation of internal models, does the use of a specified safety level and time horizon become imperative?

The use of a specified safety level and time horizon that is to be used by all companies is imperative when internal or partial models are used.

Q23: Even with limited use of modeling in the current RBC, should that modeling be subject to prior approval by the regulators? What should be designated and/or approved (e.g. the approach- 1,000 scenarios- and key considerations or parameters)?

The stochastic scenarios of key economic and policyholder variables should be generated and prescribed by the regulator (although they may be developed jointly by regulators with input from industry and professional organizations). The approach and principles for modeling should also be designated by the regulator.

Given that there is prescription and guidance, regulators should be able to review internal and partial models. Without prescription and guidance, the modeling should be subject to prior approval.

Consistency in approach, scenarios, and other prescribed assumptions across the states is critical to ensure a level playing field.

Q24: What regulatory expertise is needed for model review? How should regulatory review of models be funded? For regulatory review of internal models, should there be a centralized review function?

Extensive expertise to review internal models would be required. The use of a centralized review function makes sense from a consistency standpoint and in order to minimize cost. Consistency of the review process is critical to implementing a successful control structure. The use of consultants could prove to be problematic because of the potential for different standards to be acceptable to different firms. Funding for the reviews should be provided by the companies who use them.

Q25: What are the “level playing field” implications? What is the impact on small firms? How would a dual system of allowing internal model calculations by some firms impact the competitive marketplace.

In general, all companies should be evaluated in the same manner so that there are no level playing field implications. Smaller firms may lack the financial resources and expertise necessary that are available in larger companies. However, if smaller companies are selling products that have tail risk embedded in them that can only be captured through modeling, they must model these risks. Otherwise, one could conclude that the risks are not being controlled well and a non-level playing field may be the result.

Some companies may be permitted to opt-out of complex modeling due to their size or due to materiality of the risk. In such a case, safe harbors should be set at a level that would be expected to produce a higher capital requirement than produced by models.

Q26: Are the powers in the Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in Hazardous Financial Condition, effectively, capital add-ons?

No comment

Q27: Should capital add-ons be considered in the RBC? Is this a concept that would apply at the MCR as well as the PCR level?

Capital add-ons should not be applied at the MCR level.

Depending on the required capital structure, it may make sense for regulators to have the ability to incorporate capital add-ons at the PCR level in certain circumstances. See question 28.

Q28: What would trigger capital add-ons?

Under a factor-based approach to capital, add-ons would be appropriate in a situation where conditions are more uncertain than anticipated in setting the factors, and therefore a buffer is deemed necessary.

Under a modeling system, the uncertainties should be incorporated into the scenarios tested, thereby reducing the need for add-ons. However, additional deterministic stress tests that demonstrate some type of inadequacy in the modeling approach may point to the need for capital add-ons.

Criteria should be specified for establishing capital add-ons and the add-ons should be applied consistently across all companies.

Q29: Does the leverage ratio in banking have a place in insurance regulation? If so, where?

We do not believe so. Banking liabilities are largely liquid and the leverage ratio in banking is used as a proxy for measuring the risk of liquidity. Insurance company liabilities often include a large portion of illiquid and non-guaranteed risks. Therefore, a simple leverage ratio would not suffice for an appraisal of insurance company liquidity risks.

Liquidity risks need to be measured and monitored separately,

Q30: What changes should be made to RBC exclusions?

No comment

Q31: If the U.S. solvency regime is expanded to explore economic capital, what exclusions should be made to those requirements, recognizing that those might be different from RBC exclusions?

Exclusions from modeling may make sense for small companies or for small lines of business within large companies whose risks are not material in relation to the total risk of the company. It is also possible for large blocks of a company to be excluded if it is considered low-risk.

Q32: What capital requirements should be employed for insurance entities currently excluded from RBC?

No comment

Q33: what proportionality considerations should be given in the U.S.?

Exclusions from modeling may make sense for small companies or for small lines of business within large companies whose risks are not material in relation to the total risk of the company. It is also possible for large blocks of a company to be excluded if it is considered low-risk.

Q34: Is there a need to obtain uniformity in the minimum capital and surplus requirements by state? Should the NAIC recommend a best practice of minimum requirements?

In general, it is desirable to have consistency across the states in order to minimize regulatory cost and to ensure a level playing field.

However, we note that different states may have different minimum requirements to organize an insurance entity and maintain a license that are not related to the minimum capital and surplus requirements under discussion here. The states should be permitted to retain non-uniform standards in these areas.

Q35: What stress tests should be performed by the NAIC?

Due to uncertainties in modeling approaches, it may be appropriate to include macro stress tests that impact multiple risks. Separate stress tests for liquidity risk and business continuity / operational risks may also be appropriate. Any such tests should be uniform across the industry. In order to ensure that the stress tests should be meaningful, they should be developed jointly by regulators, industry and professional organizations.

Q36: What stress tests and reserve tests should be performed by companies? What should be required to be reported to the regulator?

As part of a company's enterprise risk management program, they should do whatever additional testing they feel is necessary to better understand their risks. Regulators should encourage companies to establish such programs as part of their solvency and monitoring assessment activities. Companies should not be required to report these additional tests to the regulator.

Q37: Should the regulator specify stress scenarios to run? If so, which ones? How often should they be done?

Due to uncertainties in modeling approaches, it may be appropriate to include macro stress tests that impact multiple risks. Separate stress tests for liquidity risk and business continuity / operational risks may also be appropriate. Any such tests should be uniform across the industry. In order to ensure that the stress tests should be meaningful, they should be developed jointly by regulators, industry and professional organizations.

Q38: Should the RBC calculation be publicly available?

Only summary results should continue to be available to the public on an annual basis.

Any additional data provided should be accompanied by a standard disclosure discussing the purpose of RBC.

Q39: If internal models are allowed for capital requirement purposes, should information be publicly available?

There should be strong transparency when using models for regulatory capital requirement purposes, perhaps with some limitations to protect confidential company information.

Q40: Should the valuation of all assets, liabilities, and capital resources for regulatory capital purposes be completed on a market-consistent or some other basis?

When using a modeling approach, a time period of volatility in the economic and other assumptions must be prescribed. At the end of this time period, a prescribed valuation methodology is necessary for assets and liabilities that continue beyond the time period. The prescribed valuation methodology could make use of conservative statutory asset and liability accounting standards, which would adequately protect customer interests and not introduce inappropriate volatility into an insurance company's capital position.

Alternatively, it may be possible to develop a market consistent valuation approach that would more accurately respond to changing economic conditions and risks. However, we believe that there are substantial shortcomings in both the European (embedded value) market consistent valuation methodology and in the U.S. GAAP (FAS 157/159) fair value methodology. These shortcomings introduce significant, inappropriate and misleading volatility into surplus valuation

calculations, which would be detrimental if used in the determination of a regulatory capital standard.

We believe that further work is needed to study whether a reasonable market consistent approach can be made viable for regulatory capital purposes.

Q41: Should the SMI wait for FASB and IASB to determine valuation requirements for public financial reporting prior to determining valuation for regulatory solvency purposes?

We don't think so. The decisions on appropriate public financial reporting should not necessarily impact statutory reporting. Therefore, the FASB and IASB rules may not be appropriate for gauging solvency.

Given that the FASB and IASB decision may not impact statutory accounting and since it is not clear when the FASB and IASB decisions will be available, it makes sense for the SMI to begin to discuss theory and methodology now. Reconciliations and refinements may be appropriate once the capital and statutory valuation systems are fully developed.

Q42: Should valuation differ between public financial reporting (GAAP) and supervisory financial reporting (SAP)?

SAP should continue to emphasize conservatism, while GAAP typically is trying to get to closer to best estimate results, which is not appropriate for statutory purposes. The two reporting regimes could use consistent methodologies, but with additional margins added to the SAP reporting.

Q43: How should procyclicality be addressed? What counter-cyclical adjustments should be made?

The appropriateness of countercyclical adjustments is an area where further study is needed.

Q44: Should capital resource requirements utilize a tiering structure of capital? Should there be tied assets? If so, how?

We do not see a need for an explicit tiering structure of capital. It should be noted that “tiering” exists in our current structure as we have assets that back conservative reserves and assets that back capital.

There are currently tiered liabilities as well, with bondholders and surplus notes holders subordinated to policyholders.

Assets should generally not be “tied” as this would burden the insurance company with inflexible investment strategies and reduce the available benefits of diversification of investments among products and policyholders.

We do note that there are some instances where assets should be “tied.” Examples include tying assets for closed blocks of policyholders, as required by regulation. In addition, it is important to tie assets to liabilities within countries. We would have a concern with any system that permits assets held in the U.S. to be lower than the liabilities plus required capital in the U.S.

Q45: For group capital assessment, what should the definition of a group be?

For capital assessment, a group situation occurs when multiple entities are under the control of a single entity.

We are particularly concerned with the possibility of offering a credit in one regulated jurisdiction (i.e., international jurisdictions) for regulatory conservatism in another jurisdiction (i.e., U.S.). This creates a non-level playing field, where U.S. regulatory conservatism can effectively be used towards capital requirements in jurisdictions regulated elsewhere.

Q46: What are the benefits of group capital assessment? Drawbacks?

The benefit of a group solvency assessment is better understanding of the impact of items such reputational and operational risk across the group.

Q47: What are the benefits of group capital quantification of regulatory requirements? Drawbacks?

The benefit of group capital quantification is the assessment of the total regulatory capital need of the group. As long as each entity of the group holds adequate capital, there are no drawbacks. However, the benefits of this quantification are of very limited value and the effort to do this quantification may not be cost-justified.

Q48: Should consolidated financial statements be required?

The financial reporting should be prepared and provided to regulators on the same basis as their supervision is performed. So long as capital transactions out of a regulated entity are controlled by the regulator, there is no need for consolidated financial statements to be required.

Q49: What methodologies of calculation should be considered (e.g. consolidation vs. aggregation)?

We prefer aggregation and that all legal entities within the group should be required to meet minimum capital requirements. Consolidation assumes complete fungibility of capital across legal entities, which does not exist.

Q50: How should unregulated entities and non-insurance entities be considered? Do insurance regulators have the expertise to determine the risks of non-insurance entities?

No comment

Q51: Should diversification credits be applied at the group level?

Group diversification credits should not reduce minimum capital requirements at individual legal entities.

Q52: Should group support be implemented? If so, how would fungibility issues be addressed?

We do not feel that group support should be implemented. There does not appear to be an effective or practical means of ensuring that funds will be available and supplied when needed, particularly when cross jurisdictional issues are present. Individual entities should stand on their own to ensure consistent and fair treatment across the industry.

Q53: Should the NAIC consider an approach to group-wide capital requirements that span international jurisdictions?

No – reliance on enforceable guarantees or other such declarations is highly questionable across legal jurisdictions.

Q54: What considerations should be made regarding regulatory arbitrage?

Regulatory arbitrage should be avoided, if at all possible. Insurance is a long term business and the future impact of companies working to find the jurisdiction with the lowest possible capital requirements will ultimately result in a race to the bottom.

Q55: Should the U.S. insurance solvency system be adjusted for systemic risk regulation? If so, how?

No comment

Q56: Should wind-down plans be incorporated? If so, how?

We don't see a particular need for this. However, if developed, such plans should remain confidential between the company and the regulator.

Q57: What further studies regarding capital requirements should be performed and who should perform the studies?

The past effectiveness of RBC should be evaluated. The NAIC should review the characteristic of past insurance company insolvencies in the U.S. and whether RBC did a good job of predicting problems for companies one to three years prior to the insolvency.

If there is a move to partial modeling approaches, a study of the work-effort and cost involved in implementation needs to be made. Field testing before implementation is extremely important.

Q58: Should quantitative impact studies be performed in SMI?

Yes. We are considering replacing a system that has worked very well over a long period of time. We should fully understand the impact of any new system.

Q59: Should SMI revisions be phased in?

Possibly, depending on the nature and extent of the revisions.

Q60: What additional capital requirement or overarching accounting/valuation issues should be considered in the SMI?

No comment

Comments on NAIC Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative

**Submitted by the Group of North American Insurance Enterprises
March 1, 2010**

General Comment

GNAIE encourages the NAIC to look at the strengths and weaknesses of the current RBC system, improving it where necessary; but encourage preserving the strengths of the current system as well.

Generally, we believe the NAIC should look at the overall solvency regime, rather than just the regulatory capital requirements. Regulators should review an entire enterprise for overall solvency, but regulatory capital requirements should not be based on economic or target capital.

GNAIE believes that a solvency regime should define clear, objective and enduring standards on the establishment and implementation of supervisory capital requirements by insurers.

Question 1

Regulatory capital requirements should focus on assuring the adequacy of an insurer's resources to meet its policyholder obligations, with a reasonable level of assurance

Questions 4, 9

GNAIE believes that the focus of capital requirements should be on regulatory minimum solvency levels, not the establishment of market based solvency levels that an insurer may hold to meet its business objectives. It is helpful for regulators, in their overall risk assessment of insurers, to understand and consider the capital management techniques and methodologies used by insurers, however, economic or target levels of capital for individual insurers should not be considered in the determination of capital requirements.

Question 5

GNAIE recommends that a solvency assessment utilize a total balance sheet approach in the assessment of solvency to consider the interdependence between assets, liabilities, regulatory capital requirements and capital resources to ensure risks are appropriately recognized. Caution should be used to avoid layering on of conservatism.

Question 13-15

GNAIE believes that a solvency assessment should reflect the company's assets, liabilities and off –balance sheet items and consider all known material risks having a potential impact on its ability to meet its obligation to policyholders.

A solvency assessment system should reflect all material factors that could influence the possible cash flows during the period that the obligations are fulfilled.

A solvency assessment system should account for the interaction and correlation between risks, and the use of reinsurance, diversification, hedging and other risk mitigation programs of the insurer.

A solvency assessment system should reflect the regulatory environment and the insurer's ability to manage its response to events, as they occur, that could impact the insurer's capital position including the impact of rate and market regulation. Solvency supervision works most effectively within free market conditions where insurers have flexibility to operate and freely manage their response to risks and capital requirements.

The solvency assessment should be operational with the risk profile specific to each insurer.

The insurer's risk management framework should reflect the interaction between solvency and liquidity.

Question 16

GNAIE believes a solvency assessment should reflect off –balance sheet items.

Question 17 - 19

The use of modeling in determining capital requirements should be approached with caution.

A solvency assessment system could allow, where appropriate, for the integration of an insurer's internal models (partial modeling) into the process of calculating required supervisory levels (other than MCR) if such internal models are subject to a rigorous and verifiable process and are supported by sound risk management practices. The use of partial standardized models (e.g. catastrophe loss models) may be appropriate where consistent standards can be applied across the industry by sound risk management practices.

Question 39

A solvency assessment system should encourage insurers to disclose to the public relevant and reasonable information on their risk and capital management practices. Any requirements for public disclosure on the way insurers manage risk should take into account the need to protect proprietary or confidential information.

Question 40

Market consistent valuations for insurance liabilities are not appropriate as there generally is no market for such liabilities and therefore no means to validate models developed to measure them.

Question 46

Solvency standards should work to streamline supervision of insurance groups. Solvency may be reviewed for an insurance group on a group-wide basis by a "group supervisor." This structure could increase the efficiency of regulation for insurance group but it must be considered in relation to legal entity regulation and should not impose additional regulation.

Question 49

We have not taken a final position on group capital requirements. Several GNAIE members believe that the approach used in assessing capital adequacy should be based on how an insurer chooses to operate (legal entity vs. consolidated group.) GNAIE is currently reviewing this proposal. Under this approach, groups who choose to operate on a legal entity basis would not be subject to group wide capital requirements. Groups who choose to operate on a consolidated basis and are evaluated on a group capital basis would still be subject to separate legal entity capital requirements where capital mobility within the group is restricted and/or not fungible.

Question 51

Consideration of the scope and effectiveness of the insurer's risk management framework should be an integral part of the supervisor's assessment of the insurer's solvency

Insurance group supervision should recognize existing risk diversification benefits and capital mobility, if any, within the group.

Question 53

Any solvency framework should encourage harmonization of global supervisory solvency requirements, where appropriate. Harmonized standards minimize potential regulatory arbitrage and inequality.

GNAIE therefore supports the NAIC's review of RBC and other parts of the NAIC solvency regime in light of developments at the International Association of Insurance Supervisors and in other jurisdictions.

Question 60

Any change in the regulatory system should take into account the time to implement and understand the new procedures for both companies and regulatory regimes.

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March 1, 2010

Director Christina Urias
Chair of the International Solvency (EX)
Working Group

RE: Manulife/John Hancock Comments on International Financial Reporting Standards (IFRS) in connection with the Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative

Dear Director Urias:

Thank you for this opportunity to offer Manulife/John Hancock's preliminary comments on the International Financial Reporting Standards (IFRS) in connection with the Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative.

Manulife/John Hancock supports the NAIC's work on the Solvency Modernization Initiative and strongly supports a solvency framework based on a total balance sheet or total financial resources approach. However, we believe that such an approach can only be effective in concert with a sound accounting framework that is not excessively conservative.

Manulife/John Hancock also supports the goal of convergence towards a single set of high quality global accounting standards. Furthermore, we believe that a sound accounting system is a critical foundation on which a solvency framework must be built. However, we have serious concerns that, as currently structured, IFRS is not a sound accounting system on which to build.

We believe that the Proposed Insurance Standard of IFRS Phase II would:

- Misrepresent our business results and threaten the ability of North American insurers to offer affordable, long-term guaranteed products, such as life insurance, annuities and long term care insurance, which are less common in Europe;
- Represent a problematic basis on which to measure financial results and ultimately assess solvency for current inforce products; and

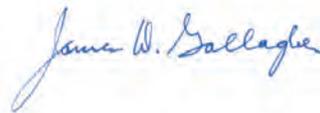
- Reduce our ability to invest in longer-term investments, including corporate bonds, infrastructure, private debt and other forms of credit that are essential to our economy, and that have generally not been provided by the banking sector.

In summary, we believe that the current International Accounting Standards Board (IASB) proposals are seriously flawed and will have significant unintended negative consequences for the North American insurance industry, our customers, the capital markets, investors and regulators.

Manulife/John Hancock is currently engaged in an extensive and detailed analysis of the negative implications of adopting the Proposed Insurance Standard of IFRS Phase II in its current form. This analysis will be completed shortly and we look forward to sharing it with the NAIC leadership and the International Solvency Working Group.

Thank you again for this opportunity to express our concerns about IFRS. We look forward to working with you on this critical issue and stand ready to be a resource.

Sincerely,

A handwritten signature in blue ink that reads "James D. Gallagher". The signature is written in a cursive style with a large initial "J" and "G".

James D. Gallagher

**Responses to Questions in
the NAIC's
"Consultation Paper on Regulatory Capital Requirements and Overarching
Accounting/Valuation Issues for the Solvency Modernization Initiative"**

Robert W. Klein, Ph.D.
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Q1: What is the purpose of regulatory capital requirements?

The principle purpose of regulatory capital requirements should set a benchmark level of capital for each insurance company that is designed to limit its default probability or "value at risk" at an appropriate level determined by regulators to provide an adequate level of safety for policyholders. Further, it should enable regulators to identify companies with inadequate capital for safety purposes so they may take appropriate corrective actions. Ideally, regulatory capital requirements should encourage insurers to properly manage their financial risk.

Q2: What is the driver of capital levels held by companies? What determines how much capital a company actually holds (e.g., rating agencies, market, regulation, etc.)?

In my opinion, market forces and rating agencies are the principal drivers of the capital levels held by insurance companies. Also, according to principles of financial risk management, firms may hold additional capital for a number of reasons such as to send positive signals to financial markets and provide a source of internal financing. I believe that regulatory capital requirements come into play for companies that are not otherwise motivated to limit their risk within acceptable levels or that encounter financial distress.

Q3: Do rating agencies' motivations and output differ from regulators'?

Yes. The mission of rating agencies is to develop opinions of the financial strength of insurance companies. This is a different mission than that of regulators and gives them greater flexibility than that possessed by regulators. The failure to meet requirements set by regulators has more potentially serious consequences, such as the triggering of specific regulatory actions. This needs to be considered in the development of regulatory capital requirements.

Q4: Should the US Regulatory Mission be modified to include evaluation of economic or target capital? ...to include financial stability?

I do not believe the US regulatory mission should be modified to include evaluation of economic or target capital. Financial stability should be a consideration but not a determinant of regulatory standards.

Q5: What is a “total balance sheet” approach? How should that approach impact U.S. regulatory requirements?

A total balance sheet approach considers recognizes the interaction between an insurer’s assets, liabilities, regulatory capital requirements and capital resources. Ideally, it should consider all relevant factors that may materially affect an insurer’s financial risk. Further, I believe regulators should take a forward-looking view of an insurer’s financial risk and not rely solely on historical or current accounting values. I believe these concepts should be incorporated in US regulatory requirements.

Q6: What is the capital level at which companies cannot operate in the market? At what level of capital should regulators become concerned (PCR)? At what level of capital should regulators take over (MCR)? Compared to these levels, at what level is the U.S. solvency system (which includes conservative accounting and RBC)?

I believe that regulators should be concerned and investigate companies that fail to meet a “PCR” level and take appropriate regulatory actions if warranted. The failure to meet an “MCR” level is more serious and may warrant more severe regulatory actions. The appropriate regulatory posture should be governed by where these levels are set and how they are determined. Higher levels should be accompanied by greater regulatory discretion. I am not aware of any comparisons of US regulatory requirements and EU standards for similarly situated companies by I suspect that the capital levels produced by RBC are closer to an MCR than a PCR.

Q7: What mechanism should be used to determine solvency action and control levels? Are the multipliers that are currently used to define the solvency control levels appropriate?

Under the current US RBC approach, the mechanism and multipliers used to determine company/regulatory action levels are somewhat simplistic but not necessarily inappropriate. If RBC requirements become more stringent, then the current approach will need to be reconsidered.

Q8: How should the U.S. define its RBC levels using statistical safety level and time horizon definitions? What is the appropriate risk measure?

I believe that US regulators should use some form of a VaR or TVaR measure of risk. The specific safety level is a matter for discussion but a 99.5% level would seem to be within the range considered appropriate based on US and international opinions. I believe the time horizon should extend beyond one year.

Q9: Does economic (or target) capital evaluation have a role in the U.S. solvency framework? If so, what? Should a company's own economic evaluation relate to regulatory requirements? Should a company's own economic evaluation impact RBC or be considered outside of RBC?

I do not believe that economic or target capital evaluation should have a role in the US solvency framework. However, I do believe that companies should be encouraged to use internal capital models and they should be given some weight in regulators' assessment of an insurer's capital adequacy and financial risk management from a regulatory (safety) perspective.

Q10: Are the factors included in the RBC still appropriate?

If US regulators continue to use a formula approach to RBC, then the factors in the formula need to be reevaluated and updated.

Q11: Are there areas of the RBC formula that should be modified in the approach (example: more categories of assets, treating assets more granularly, more stochastic analysis)?

Expanding the areas in the RBC formula or treating them in a more granular fashion could be an improvement but I question whether refining this kind of platform is ultimately the best approach. I believe that use of either standard or company internal capital models should be given serious consideration. Inclusion of more dynamic components in the current RBC platform would be a step in the right direction but an intermediate solution.

Q12: What is the appropriate methodology to consider interdependencies among risks (e.g., diversification)? Is the square-root covariance adjustment appropriate?

I do not have any specific recommendations on how to improve the consideration of the interdependencies among different risks within the current formula. Under the current approach, the covariance adjustment either assumes that two risks are either uncorrelated or highly correlated when the truth may lie somewhere between those extremes. There may be methods to reflect the true correlations between different risks informed by empirical analysis.

Q13: What risks should be added or excluded in the RBC calculation?

I believe that there is a limit to the risks that can be reasonably incorporated into the RBC formula. The most obvious omissions are consideration of catastrophe risk, liquidity risk, credit spread risk, and the effect of company size. Foreign exchange risk is an issue but probably has not been a significant cause of insurer insolvencies. Factors might be developed for each of these risks, although incorporating cat risk into the RBC formula is difficult. US regulators might wish to consider alternative approaches to assessing the

adequacy of insurers' cat risk management. I am uncomfortable with the use of factors for more qualitative risks such as operational risk and reputational risk.

Q14: For each missing risk, should the risk be treated quantitatively or qualitatively? Should some risks be accounted for quantitatively but with a judgmental factor (e.g., 10% for unidentified operational risks)?

See answer above.

Q15: How should risk mitigation (e.g., reinsurance, hedging) be treated in the determination of capital requirements?

I believe risk mitigation should be considered in capital requirements but it is difficult to see how this could be done (beyond its current consideration) in the existing RBC formula. A model approach to capital requirements would lend itself more to consideration of risk mitigation.

Q16: Should there be off-balance-sheet items? If so, how should off-balance sheet items be considered in the solvency system?

Regulators should evaluate the risks associated with off-balance sheet items but there are probably limits to how this can be incorporated into regulatory capital requirements. Some off-balance sheet risks might be better addressed with expanded financial monitoring that extends beyond capital requirements.

Q17: Should internal models be allowed to determine capital requirements?

Companies should be allowed to use internal models in regulatory assessments of their capital adequacy subject to appropriate regulatory standards.

Q18: Should partial modeling allowing company discretion be utilized in the RBC? If so, how?

No.

Q19: When modeling is used for capital requirement purposes, what safeguards should be considered to the modeling? What requirements should be established with modeling?

I would look at the standards being developed by the EU for modeling as a starting point in thinking about appropriate safeguards that might be employed in the US. Standards should address model design, the risks incorporated in a model and the parameters used among other components.

Q20: Which particular risks are more appropriately reflected by modeling? Which risks are effectively measured without extensive modeling, (e.g., risks where factor determination is credible and sufficient, non-material risks)?

I believe that it would be better to develop a modeling approach to manage an insurer's financial risk rather than use a formula for some risks and modeling for others.

Q21: Should the MCR be influenced by an internal model?

I would be very cautious about allowing the MCR to be influenced by an internal model.

Q22: With implementation of internal models, does the use of a specified safety level and time horizon become imperative?

Yes.

Q23: Even with limited use of modeling in the current RBC, should that modeling be subject to prior approval by the regulators? What should be designated and/or approved (e.g., the approach — 1,000 scenarios — and key considerations or parameters)?

I believe that prior approval of models is problematic. With appropriate and clear standards, ex post evaluation may be more realistic. Over time, the development and enforcement of standards, combined with evaluation of models submitted, should give greater guidance to companies on what will and will not pass regulatory muster.

Q24: What regulatory expertise is needed for model review? How should regulatory review of models be funded? For regulatory review of internal models, should there be a centralized review function?

Clearly, regulators will be challenged at the outset in terms of the expertise needed to evaluate regulatory models. Risk modeling in insurance requires specialized skills in finance, economics and mathematics and training in their application to an insurance enterprise. Centralizing this function (or at least allowing regulators to use centralized reviews) would have significant advantages. Regulators could also use the service of independent consultants that were free of conflicts of interest. Ultimately, the industry will need to fund model review (e.g., insurers could be charged a fee to have their models reviewed).

Q25: What are the “level playing field” implications? What is the impact on small firms? How would a dual system of allowing internal model calculations by some firms impact the competitive marketplace?

Much depends on the rules that are established. If the standards for internal models are stringent and smaller companies are allowed to use a standard model, this could diminish any un-leveling of the playing field.

Q26: Are the powers in the Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition, effectively, capital add-ons?

It appears that one could make such an inference.

Q27: Should capital add-ons be considered in the RBC? Is this a concept that would apply at the MCR level as well as the PCR level?

Yes to both questions. Both models and formulas are imperfect and allowing regulators some discretion to require a specific insurer to hold more capital than standard regulatory requirements is appropriate.

Q28: What should trigger capital add-ons?

A specific response to this question is beyond the scope of what I can address here. As a general principle, regulators should have the authority to require a company to hold additional capital when it is consistent with safety objectives and there are no better alternatives.

Q29: Does the leverage ratio in banking have a place in insurance regulation? If so, where?

I am not enthusiastic about creating a leverage ratio requirement for insurance companies. Arguably, leverage issues are more complex for insurance companies than banks. Leverage ratios are used in early warning systems where regulators can use their discretion as to whether leverage is an issue for a particular company.

Q30: What changes should be made to RBC exclusions?

It seems reasonable to continue to exclude very small companies and captive insurers. It is not so clear to me that specialty insurers such as title companies, risk retention groups, financial guaranty companies and mortgage guaranty companies should be excluded. There is a public interest in ensuring that these specialty companies hold adequate capital. There may be issues involved with extending RBC to these companies but relying on fixed minimum requirements for these firms seems inadequate.

Q31: If the U.S. solvency regime is expanded to explore economic capital, what exclusions should be made to those requirements, recognizing that those might be different from RBC exclusions?

I do not support the concept of incorporating economic or target capital in the US regulatory regime.

Q32: What capital requirements should be employed for insurance entities currently excluded from RBC?

Something beyond fixed minimum requirements is needed. Even simple formulas that consider a company's size relative to some measure of its risk exposure would be better than reliance on a fixed minimum requirement.

Q33: What proportionality considerations should be given in the U.S.?

It is difficult to give a specific response to this question here. Solvency II provides a starting point for proportionality considerations that might be adopted in the US. However, I would be cautious about granting too much leeway to specialty companies.

Q34: Is there a need to obtain uniformity in the minimum capital and surplus requirements by state? Should the NAIC recommend a best practice of minimum requirements?

Uniform fixed minimum requirements would be desirable but I would not expend the effort needed to achieve consensus on what they should be. Recommendations on best practices would seem to be more feasible.

Q35: What stress tests should be performed by the NAIC?

The concept of stress testing makes sense. The specific stress tests that might be performed by the NAIC are beyond the scope of what can be addressed in a short response.

Q36: What stress tests and reverse stress tests should be performed by companies? What should be required to be reported to the regulator?

Q37: Should the regulator specify stress test scenarios to run? If so, which ones? How often should they be done?

I believe that it makes sense for regulators to specify some scenarios, e.g., a given interest rate shock. To specify which scenarios is beyond the scope of what can be addressed in this response.

Q38: Should the RBC calculation be publicly available?

A company's RBC calculation need not be publicized but the results should be made public (as they currently are).

Q39: If internal models are allowed for capital requirement purposes, should information be publicly available?

No. Regulatory review of company internal model analysis should be sufficient.

Q40: Should the valuation of all assets, liabilities, and capital resources for regulatory capital purposes be completed on a market-consistent or some other basis?

I agree that market-consistent accounting is desirable but not always appropriate for all insurer assets and liabilities. I think the IASB is taking a prudent course.

Q41: Should the SMI wait for FASB and IASB to determine valuation requirements for public financial reporting prior to determining valuation for regulatory solvency purposes?

Yes.

Q42: Should valuation differ between public financial reporting (GAAP) and supervisory financial reporting (SAP)?

I believe that insurance regulators should retain the ability to diverge from GAAP.

Q43: How should procyclicality be addressed? What counter-cyclical adjustments should be made?

Q44: Should capital resource requirements utilize a tiering structure of capital? Should there be tied assets? If so, how?

Q45: For group capital assessment, what should the definition of a group be?

The definition of a group should consider affiliated firms within the same holding company that are in a position to affect each other through their transactions.

Q46: What are the benefits of group capital assessment? Drawbacks?

The benefit of group capital assessment is that it considers the risk posture of a group that can affect any of its members. Access to group capital can be a plus, but not assured. Hence, regulators must consider what guarantees the group can provide to any of its members.

Q47: What are the benefits of group capital quantification of regulatory requirements? Drawbacks?

Q48: Should consolidated financial statements be required?

Yes.

Q49: What methodologies of calculation should be considered (e.g., consolidation vs. aggregation)?

Consolidation.

Q50: How should unregulated entities and non-insurance entities be considered? Do insurance regulators have the expertise to determine the risks of non-insurance entities?

Q51: Should diversification credits be applied at the group level?

Q52: Should group support be implemented? If so, how would fungibility issues be addressed?

I believe that group support should be considered when there is a legally enforceable parental guaranty.

Q53: Should the NAIC consider an approach to group-wide capital requirements that span international jurisdictions?

This could be problematic if group guarantees are not enforceable across international jurisdictions.

Q54: What considerations should be made regarding regulatory arbitrage?

Regulators should attempt to discourage regulatory arbitrage across jurisdictions. However, regulators in any given jurisdiction should resist the temptation to lower standards that they believe are appropriate.

Q55: Should the U.S. insurance solvency system be adjusted for systemic risk regulation? If so, how?

I do not believe that insurers generally impose significant systemic risks with some exceptions, e.g., financial guaranty insurers. Insurers are exposed to systemic risk created by other firms. Coordination among different regulatory authorities to deal with systemic risk issues would be desirable.

Q56: Should wind-down plans be incorporated? If so, how?

Q57: What further studies regarding capital requirements should be performed and who should perform the studies?

The effectiveness of the current and alternative systems for determining capital requirements should be evaluated. Early warning systems should be periodically tested and potential improvements identified. It would be desirable to study the timing and nature of regulatory interventions with high-risk and distressed insurers but this would require access to confidential information. Both academics and regulators could be involved in such studies.

Q58: Should quantitative impact studies be performed in SMI?

Yes. This was done in the initial implementation of RBC.

Q59: Should SMI revisions be phased in?

Some consideration of phase-in should be considered, especially for more “radical” changes. While the need for regulatory improvements is persistent, insurers’ ability to adapt to new regulatory requirements must be considered.

Q60: What additional capital requirement or overarching accounting/valuation issues should be considered in the SMI?



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March 1, 2010

The Hon. Christina Urias, Chair, and Members
Solvency Modernization Initiative Task Force
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
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By E-Mail

Dear Commissioner Urias:

NAMIC is a trade association with approximately 1,400 insurers in the United States and Canada. These members, 1,300 of which are domiciled in the United States, comprise a complete spectrum of companies, from the very smallest to the very largest mutual property-casualty insurers. NAMIC regularly participates in NAIC committee activities and deliberations. The Task Force's evaluation of the current regime for regulation of insurers' capital requirements is, therefore, of great interest to NAMIC members.

Our resources at this time of year are limited for responses to the "Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative," therefore our responses here are selective. Any directional or substantive decisions that may occur as a result of this consultation, we would hope, will once again be exposed for the interested public's input.

As a general preface to our selected responses made here, we appreciate the reasons for existence of the SMI effort and believe a review of regulatory tools of other jurisdictions is appropriate. At the same time, we observe that the state regulatory system in this country appears to have acquitted itself well in the capital-market tumult that began in 2008. Perhaps stress of even greater magnitude will occur in the future, yet the endurance of the property-casualty industry suggests that no abrupt departure to another mode of solvency regulation importunes. Instead, refinement of current regulation of insurers' capital requirements may be a more rational decision.

We respond below to selected questions posed in the consultation paper:

1) To provide a foundation for legal sanction against reckless or incompetent or dishonest management of insurers. Whatever the cause of an insurer's deteriorating capital condition, government must have reason and structure for intervention to preserve capital of the insurer in question.

2) Multiple factors motivate capital levels held by insurers, especially the amount and nature of risks underwritten. Management's intent with respect to how it will be regarded by the market and by regulators is another. This may be interpreted in part as appetite for risk with the understanding that, *ceteris paribus*, greater risk may bring greater reward.

3) Rating agencies sell information to investors, policyholders, and others, and their motivations should be regarded as different, even though their analyses and concerns with respect to claims-paying ability may be similar. Regulators have responsibility to policyholders and the public for conduct of a regime that prescribes detailed oversight intended to prevent insurers' failures and to act in the case of incipient failure.

4) Economic or target capital needs to be distinguished from regulatory capital for purposes of this question. What best serves purposes of oversight? As to "financial stability," we are not aware this is well defined. For many property-casualty insurers, it should be understood that "stability" may vary according to the vagaries of claims and judgments made on the property-casualty insurer.

5) The admitted asset system currently in use seems to have worked well and would appear to avoid some of the severe volatility that may result from the total-balance-sheet approach.

6) When the probability, factoring in lag time, of the underwriter being unable to pay claims rises to a material level, the insurer probably can not operate. If the trend, in other words, reasonably projects to a time in the near future when claims of policyholders and creditors can not be met, intervention is required.

7) The graduated scale currently used is reasonable. In any event, the scale or method used needs to be understood in common by regulators and regulated insurers.

8)

9) Economic or target capital may be the appropriate quantity. It should be understood that it must be carefully defined in a practical manner that is understood by regulator and regulated. To the extent this question suggests that individual insurers' models, approved or not, with diverse inputs, algorithms, and methods for calculating economic capital, will provide a satisfactory regulatory intervention scheme, is very probably severely misguided.

10) The question is not clearly stated.

11) Probably so; perhaps it is appropriate to commission a study for this purpose.

13)

14) With good criteria, judgment or qualitative standards may be appropriate.

- 15) Recognition would be appropriate, especially with respect to reinsurance. Quantitative recognition requires study.
- 16) Immaterial risks need not be monitored, unless it is shown that they vary with other risks in such a way that they become material.
- 17) Here we assume that the phrase “capital requirements” refers to regulatory capital requirements. With that assumption, we pose the question whether individual models, even though approved by the regulatory authority, are a sufficiently transparent device for precipitating what can be legal action against the insurer. Individual models, as suggested by Dr. Vaughan, have a place in solvency regulation, but individual models as a foundation for litigation raises any number of questions as to open and accessible process. We understand that judgment of the regulator will always be a factor in intervention, but the *deus ex machina* aspect of internal models would seem to qualify them more as factors in judgment rather than determinative points.
- 18) Reasonable criteria for would require that such computations be open, uniform, and understood by all parties. Partial modeling would seem to invite awkward dispensation or some form of departure from uniformity.
- 19) The discipline described here provokes a host of difficult questions which become still more difficult with the size and complexity of the company or group. It must be asked whether this discipline can be achieved at any reasonable cost for a practical system.
- 20) For property-casualty insurers, financial risks of the portfolio are probably easiest to model.
- 21) Perhaps, but only if the model is proved superior to a common system, *ceteris paribus*, over a long period.
- 22) It would seem so.
- 23) Almost certainly.
- 24) Rather sophisticated expertise, including finance, econometrics, and insurance are requisite. Consistent with current examination practice, the regulated entity should pay.
- 25) To the extent that models are used—reservations are stated in a number of responses above—proportionality would be the guide, with standard models to be used for smaller, less complex companies. With respect to the marketplace, over the long term, it will sort out those companies—and regulatory jurisdictions—where models are used competently.
- 26) Yes.
- 27) Question is not clear.

28) As a general proposition, capital add-ons are appropriate when there is prospect of legitimate claims not being honored in the near future, which condition may originate in management failure or in ambient conditions that affect capital of the insurer. A connection with the trend test may be the best indicator for such action.

29) Property-casualty insurers are different from banks. The RBC system is preferable.

30)

31) If such a judgment for economic capital is made and is practical, that may suggest broadening application of capital requirements.

32)

33) A first priority is recognizing the cost of compliance for smaller insurers—these companies typically experiencing disproportionate cost.

34) It is curious that this consultation concerns itself with state minimum capital requirements, which relate primarily to formation of insurance entities and not to the capital required to support a growing risk-bearing entity. There is probably no reason to seek such uniformity.

35)

36) Those concerned with the nature and adequacy of its portfolio and, still more important, those concerned with the lines it underwrites.

37) No, but in financial examinations of domiciliary insurers' risk processes, there should be inquiry as to what scenarios are run and how often. Departure from best practice should be remedied.

38) Retention within the regulatory system is most appropriate.

39) Such material can be highly proprietary and is best left within the company and the regulatory sphere.

40) The tumult in the capital markets strongly present in 2008 and 2009 suggests that there should be latitude for application of judgment. The accommodation made by the NAIC and states for certain structured securities held by insurers is a reasonable example. Inflexible requirements may be counterproductive with respect to the amplitude of cycles, as is describe in Paragraph 99.

41) That is a reasonable approach. To do otherwise very probably courts later conflict.

- 42) It can not be presumed that GAAP and SAP, which have somewhat different purposes, will converge; therefore valuation may differ.
- 43) It is present, and it can aggravate trends to a dangerous extent. Part of the answer is judgment; another part may be dampening. A very simple example would be use of retrospective averages; other numerical techniques can be linked to causes of procyclicality and be superior.
- 44)
- 45) Separate legal entities united under common management and including one or more insurance entities.
- 46) For the combined entity, a diversity benefit with respect to capital needs, sharing of common services, financial mass. With respect to drawbacks, the more different and risky a non-insurance entity is, the greater the probability of capital inadequacy or the dramatic horrors displayed in the AIG insolvency.
- 47) Seems the same or very similar to 46).
- 48) In most cases, yes.
- 49) The Swiss style of aggregation would seem to make more sense.
- 50) They may provide capital support or aggravate risk; there is no easy answer. Insurance regulators themselves may not have expertise to determine risks of non-insurance entities.
- 51) Probably so, although the complexity of regulation is intensified.
- 52) In other answers and consultation, we express doubt about group support being built into regulation, especially when the entities are distributed internationally.
- 53) See above.
- 54)
- 55) No. Insurers do not appear to be propagators of systemic risk. They may be subject to it, however. Perhaps it is true that property-casualty insurers operate in some degree with an effect that is counter to systemic risk, until capital insufficiency occurs.
- 56)
- 57)
- 58) It may be necessary.

59) Any major revisions found appropriate should indeed be phased in, although this is certainly a matter of judgment.

60)

Respectfully,

A handwritten signature in black ink that reads "Wm D. Boyd". The signature is written in a cursive style with a horizontal line under the "m" in "Wm".

William D. Boyd
Financial Regulation Manager

Stephen W. Broadie
Vice President, Financial Policy

March 1, 2010

Kris DeFrain, FCAS, MAAA, CPCU
Director, Actuarial and Statistical Department
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2662

Re: Comments on Consultation Paper on Regulatory Capital Requirements and Overarching Valuation Issues for the Solvency Modernization Initiative

Dear Ms. DeFrain:

The Property Casualty Insurers Association of America (PCI) appreciates the opportunity to make initial comments on the issues raised in the Solvency Modernization Initiative's Consultation Paper on Regulatory Capital Requirements and Overarching Valuation Issues. PCI's more than 1,000 member property/casualty insurance companies represent the broadest cross-section of insurers of any national P/C trade association. PCI members write over \$180 billion in annual premium in the U.S., 37.4 percent of the nation's property/casualty insurance.

General comments

We are impressed by the amount of the work that you and other NAIC staff have done in drafting this paper. The number and breadth of the questions it asks illustrate that this paper should be the beginning of a lengthy process. The paper deals with a series of extremely complex issues, and will take some time for all of us to work through. The paper, and the International Solvency (EX) Working Group's March 11-12 interim meeting at which regulator and industry comments will be discussed, should be the beginning of our discussions of these issues.

We also note that the consultation paper asks no questions about what parts of the U.S. solvency regulatory system may have outlived their effectiveness. PCI believes that this should be a part of the discussion as well.

This comment letter does not attempt to answer each of the 60 questions specifically. Rather, we have arranged our comments so they refer to the issue areas into which the questions are grouped. We hope that as these issues are more thoroughly considered we will have additional opportunity to develop more detailed responses.

Goals of a Regulatory Solvency System (questions 1-4)

- We believe the purpose of regulatory capital requirements is policyholder protection, recognizing that required capital levels cannot completely prevent insolvencies. These levels should cause minimal infringement on a free, competitive insurance market.
- Drivers of company capital levels include market conditions, rating agencies and individual companies' own perceptions of what is appropriate to the business they are writing.
- Regulators should certainly be interested in company economic capital levels, but should not prescribe anything other than minimum capital requirements.

Risk-Based Capital (RBC): Calibration, Factors, Square-Root Formula (questions 5-12)

- Regulators should be concerned (question 6) if company capital levels are dropping toward RBC action levels. No action should be required, however, until the company action level is breached or triggers in the hazardous financial condition regulation are met.

- Generally, we believe that the risk-based capital system has worked as a minimum capital standard. Perhaps the first step in review of the RBC formulae is to find out what confidence and time horizon levels the current action levels imply.

Risks to be addressed: Quantitatively or Qualitatively (questions 13-16)

- The property/casualty RBC formula should consider catastrophe risk, and probably liquidity risk as well. These factors must be developed carefully, however, and the work of the P/C RBC Task Force's Catastrophe Risk Subgroup shows that this is not a simple task.
- With respect to question 14, we believe that "plugged" numbers should be avoided wherever possible. It is not possible to handle all risks through capital charges.

Partial or Full Internal Models (questions 17-25)

- We think the NAIC should consider the use of internal models to develop company minimum capital requirements. There are many problems that must be solved, however, for this to occur. Some of those issues include:
 - Regulators must be able to approve and supervise models appropriately, and we are concerned that this expertise does not yet exist;
 - The use of internal models should not discriminate against smaller insurers; and
 - Differential standards for similar companies should be avoided.

Stress Testing (questions 35-37)

- We agree that the concept of stress testing may be meritorious and should be considered, but the NAIC should not perform them, since the NAIC is not a regulator. Proportionality is extremely important here, since one-size-fits-all tests will not work.

Supervisory reporting and public disclosure (questions 38-39)

- With regard to internal models, it will be critical to avoid disclosure of proprietary information.

SMI Focus Areas: Insurance Valuation and International Accounting (questions 40-44)

- The SMI should wait for the FASB and the IASB to finish their work on the Insurance Contracts Project before making decisions on valuation issues.
- We believe it is preferable for statutory accounting to start with GAAP valuation, but regulators shouldn't lock themselves into a bad decision.
- The concept of procyclicality should be addressed carefully. We believe that the property/casualty industry is already procyclical, generating higher capital in good times for use in the inevitable bad times. The industry's experience during the financial crisis is a good example – despite the loss of \$70 billion in surplus in 2008 companies remained strong and protected their policyholders.
- From our standpoint, tiering of assets is probably preferable to nonadmitting assets.

Group Capital (questions 45-53)

- The definition of a group should generally depend on how the group is managed.
- Diversification effects, both positive and negative, and the group support concept should be carefully considered.
- Consolidated financial statements should not be required.

Systemic Risk (questions 55-56)

- The property/casualty solvency regulatory system should not be adjusted for systemic risk, because P/C insurers in general are not generally systemically risky.
- With regard to pre-insolvency wind-down plans, the current rehabilitation/liquidation system seems to be sufficient.

Studies and implementation (questions 57-59)

- As we mentioned earlier, the current confidence levels and time horizons of the RBC action levels should be studied.
- Qualitative impact studies of effects on the industry of significant changes in the SMI should be undertaken.

- SMI revisions should be phased in, and obsolete parts of solvency regulation should be detected and removed.

PCI looks forward to further discussing this paper during the March 11-12 SMI interim meeting and to working with the NAIC as the SMI process continues.

Sincerely,

A handwritten signature in black ink, appearing to read "Step W Brodie". The signature is written in a cursive style with a large initial "S" and a distinct "W".

Stephen W. Brodie



February 24, 2010

Corporate Headquarters

One State Farm Plaza
Bloomington, Illinois 61710-0001

Director Christina Urias, Chair
International Solvency (EX) Working Group
National Association of Insurance Commissioners

Via E-Mail

Dear Director Urias:

State Farm appreciates the opportunity to provide comments on the Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative. Our comments are attached to this cover letter. To summarize State Farm's comments:

- We believe regulatory capital requirements should focus on assuring the adequacy of an insurer's financial resources to meet its policyholder obligations, with a reasonable level of assurance. They should enhance regulators' ability to identify companies approaching capital inadequacy.
- We support maintaining the current RBC tool (with appropriate updates) for this purpose as it is risk focused, flexible, consistently applied across the industry, transparent, cost effective, easy to use and understand, difficult to manipulate, and applied at the individual company level.
- Regulators should be more concerned with the 'sufficiency of capital' rather than the 'efficiency of capital' and, therefore, economic or target levels of capital for individual insurers should not be considered in the determination of capital requirements. However, it is helpful for regulators, in their overall risk assessment of insurers, to understand and consider the capital management techniques and methodologies used by insurers.
- The use of modeling in determining capital requirements should be approached with great caution. The use of partial standardized models (e.g. catastrophe loss models) may be appropriate where consistent standards can be applied across the industry. The use of company developed internal models to determine capital requirements will not provide the necessary level of consistency (level playing field) across the industry. We also do not believe it would be cost effective to develop and maintain the modeling level of expertise in each insurance department necessary to effectively regulate such a process.

A formulaic approach, such as RBC, is a more consistent and effective way to regulate for minimum solvency levels.

- To the extent possible, the same accounting model should be used for general financial reporting and solvency/regulatory reporting purposes. Adjustments to RBC or its successor can be made to include an appropriate level of prudence depending on the accounting model used and, therefore, such prudence does not need to be added into valuations for statutory financial reporting. Additionally, market consistent valuations for insurance liabilities are not appropriate as there generally are no markets for such liabilities and, therefore, no means to validate models developed to measure them.
- Group capital requirements should not be imposed upon insurer groups. All insurance entities within the insurer group should meet their minimum capital requirements and this should be the primary focus for solvency regulation. Capital is not automatically fungible between affiliates and should not be treated as if it were. Group support is not appropriate as there does not appear to be an effective or practical means of ensuring funds will be available and supplied when needed. Therefore, group capital assessment, to the extent it leads to quantification of group capital needs, is of limited value. Group solvency assessment, however, is appropriate for determining the level of group contagion, reputational, operational risk, etc. to which individual group members are subject.

Our detailed responses to the consultation paper questions are included in the attachment. We plan to attend the SMI meeting in Phoenix and are prepared to expand on our comments as needed. We look forward to working with you and the Working Group on this important initiative.

Sincerely,



William R. Sergeant, CPA, CPCU, CLU, ChFC, FLMI
Director, Office of Accounting Policy
State Farm

Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative

State Farm Responses

Purpose of Regulatory Capital Requirements – Goals for a Regulatory Solvency System

1) What is the purpose of regulatory capital requirements?

Regulatory capital requirements should focus on assuring the adequacy of an insurer's financial resources to meet its policyholder obligations, with a reasonable level of assurance. Capital requirements should enhance regulators' ability to identify companies approaching capital inadequacy, which will help maintain confidence in the insurance industry. As with the current RBC tool, regulatory models used to calculate minimum capital requirements should be risk focused, flexible, consistently applied across the industry, transparent, cost effective, easy to use and understand, difficult to manipulate, and applied at the individual company level. Regulatory capital requirements should not be used in rate regulation or to calculate a target or optimal level of capital upon which companies would be expected to operate. Regulatory solvency assessment should also consider the liquidity needs of the company based on the products they write.

2) What is the driver of capital levels held by companies? What determines how much capital a company actually holds (e.g., rating agencies, market, regulation, etc.)?

Many different factors can influence the level of capital held by insurers. Organizational structures (e.g. mutuals or reciprocals) may limit the ability of companies to raise additional capital which may lead such organizations to hold more capital than comparable stock companies. Management's risk appetite and performance objectives (marketing, growth, etc.) also will influence capital levels. Generally, the level of capital held by companies should reflect the risks they face (including the volatility in the lines of business written and the locations and jurisdictions of the risks insured) and their ability to effectively mitigate those risks. Expectations from rating agencies and others must also be considered.

3) Do rating agencies' motivations and output differ from regulators'?

Rating agencies, with their short term view, are primarily focused on assessing a company's claim paying ability for a given ratings period, rather than a longer term assessment of the probability of continued solvency. However, rating agencies can provide useful information for investors and customers when comparing companies. In contrast, regulatory capital and other solvency measures (such as RBC) should not be used for competitive ranking purposes as they should be focused on a company's ability to meet policyholder obligations into the future.

4) Should the US Regulatory Mission be modified to include evaluation of economic or target capital? ...to include financial stability?

It would be useful for regulators in their overall risk assessment of insurers to understand and consider the capital management techniques and methodologies used by insurers. But, defined calculations or methodologies for such measures should not be required or imposed by regulators.

Risk-Based Capital (RBC): Calibration, Factors, Square-Root Formula

5) What is a “total balance sheet” approach? How should that approach impact U.S. regulatory requirements?

A total balance sheet approach considers all assets, liabilities and capital and their interdependence and inherent risks, in the evaluation of the capital resources required. Caution should be taken to avoid excess conservatism in the situation where conservative capital requirements are layered on top of conservative required reserves and conservative asset valuations.

Certain liabilities such as surplus notes can and should be considered available capital to meet policyholder obligations. A “capital charge” approach such as RBC is preferable compared to a deduction approach (such as non-admitted assets) to minimize differences between financial reporting for solvency purposes and general purpose financial reporting.

6) What is the capital level at which companies cannot operate in the market? At what level of capital should regulators become concerned (PCR)? At what level of capital

should regulators take over (MCR)? Compared to these levels, at what level is the U.S. solvency system (which includes conservative accounting and RBC)?

The determination of the appropriate regulatory intervention levels should consider whether there are sufficient resources to meet policyholder obligations at a reasonable level of assurance. The rate of financial deterioration of the company and the time needed to either rehabilitate the company or wind down the company prior to insolvency should also be considered.

In rate regulated environments, the inability of companies to raise rates can significantly impact their ability to improve their financial position.

7) What mechanism should be used to determine solvency action and control levels? Are the multipliers that are currently used to define the solvency control levels appropriate?

Experience with RBC over the last 15 years should provide evidence about how well the current control levels have worked. For any new framework, an attempt should be made to calibrate it to past experience.

8) How should the U.S. define its RBC levels using statistical safety level and time horizon definitions? What is the appropriate risk measure?

Consistent statistical safety levels and appropriate time horizons should be used for all risk factors to the extent possible. There may be risk areas where unusual tail distributions may lead to consideration of different safety levels. Time horizons may need to differ by line of business. Consideration of different safety levels (from the current RBC formulae) may be appropriate.

9) Does economic (or target) capital evaluation have a role in the U.S. solvency framework? If so, what? Should a company's own economic evaluation relate to regulatory requirements? Should a company's own economic evaluation impact RBC or be considered outside of RBC?

It would be useful for regulators in their overall risk assessment of insurers to understand and consider the capital management techniques and methodologies used by insurers. But, defined calculations or methodologies for such measures should not be required or imposed

by regulators. An entity's internal calculations of capital needs should never be the sole determinate of regulatory capital requirements. Such an approach would result in inconsistent application of requirements across companies. In addition, the sparseness of historical data about severe events requires modeled loss distributions to be built from extrapolated data. Applying these in an economic capital model then, can only provide modest levels of credibility.

10) Are the factors included in the RBC still appropriate?

As it currently operates, the P&C R-5 Underwriting Risk – Written Premium factor does not work well when companies have inadequate rates as the premium level understates the actual risk exposure. There are small areas (e.g. MEAF) where the current approach may have some issues, but for the most part, the current RBC factors are appropriate for their intended purposes. Simple models that are easy to understand, such as the current RBC approach, are more intuitive and appeal to a wider financial audience.

11) Are there areas of the RBC formula that should be modified in the approach (example: more categories of assets, treating assets more granularly, more stochastic analysis)?

The differences between P&C and Life should be validated to ensure they are still necessary. Health business is not consistently treated between P&C and Life companies which write health business. Additionally, consideration should be given to expanding the asset classes for which RBC factors can be developed.

12) What is the appropriate methodology to consider interdependencies among risks (e.g., diversification)? Is the square-root covariance adjustment appropriate?

Further research is needed.

Risks to be addressed: Quantitatively or Qualitatively

13) What risks should be added or excluded in the RBC calculation?

The most glaring deficiency of the P&C RBC calculation is the absence of a Catastrophe Exposure risk calculation. Adding some provision for liquidity would also be appropriate. It may also be appropriate to consider the effectiveness of risk mitigation efforts. A regulatory risk could be added to address the impact of differences between jurisdictions' rating laws. The ability of companies to take timely corrective action through rate adjustments can be significantly different between prior approval systems compared to file and use systems. A capital charge could be developed to recognize the added risk present in prior approval states.

14) For each missing risk, should the risk be treated quantitatively or qualitatively? Should some risks be accounted for quantitatively but with a judgmental factor (e.g., 10% for unidentified operational risks)?

For Catastrophe Risk exposure, the use of standard commercially available catastrophe models with a defined level of safety (e.g. 1 in 100 years) could be used to incorporate such risk into the RBC formula. A liquidity measure should assure a P&C company holds marketable securities equal to its policyholder obligations (unearned premium and claim reserves). Potentially a charge for the effectiveness of risk mitigation measures could be developed similar to the Life RBC C-4 charge.

15) How should risk mitigation (e.g., reinsurance, hedging) be treated in the determination of capital requirements?

Risk mitigation strategies that transfer risk to a third party should be fully considered. Appropriate tests for risk transfer should be in place for reinsurance. There should be ample consideration of the effectiveness of the risk transfer and the ability of the third party to meet their obligations.

16) Should there be off-balance-sheet items? If so, how should off-balance sheet items be considered in the solvency system?

For capital assessment purposes, consideration of off-balance sheet items will depend on the risks they pose to the company. These may be handled primarily through disclosure requirements.

Partial or Full Internal Models

17) Should internal models be allowed to determine capital requirements?

No. Company developed internal models are useful for insurers and should be encouraged and considered by regulators in their overall solvency assessment. The sparseness of historical data about severe events requires modeled loss distributions to be built from extrapolated data. Applying these in an economic capital model then, can only provide modest levels of credibility. Further, their use in setting capital requirements would result in inconsistent requirements across companies. The sophistication and effort needed to properly evaluate potentially diverse internal models for such use would not be cost effective regulation. The use of internal models allows for judgment to potentially influence outcomes at a time when financial rigor is required. However, results from internal models that differ from RBC results may be useful for regulators in evaluating the need for potential corrective actions.

18) Should partial modeling allowing company discretion be utilized in the RBC? If so, how?

Partial modeling may be appropriate where new or unique product design or features make the existing RBC factors ineffective if it can be implemented in a consistent manner. The use of commercially available standardized partial models, with limited company discretion, such as catastrophe modeling for P&C lines, can be effective and should be considered for use in RBC.

19) When modeling is used for capital requirement purposes, what safeguards should be considered to the modeling? What requirements should be established with modeling?

No amount of safeguards can level the playing field when different capital requirements or standards are applied to similar companies which would result if internally developed company models were allowed. It would not be cost effective to maintain the modeling level of expertise in each insurance department necessary to effectively regulate such a process. We do not believe it is the NAIC's role to provide such services on behalf of individual departments.

The use of standard models applied consistently across all companies may be effective if they are updated and maintained on a timely manner. The difficulty in using standard models, either partial or full, is how to apply them consistently across companies.

20) Which particular risks are more appropriately reflected by modeling? Which risks are effectively measured without extensive modeling, (e.g., risks where factor determination is credible and sufficient, non-material risks)?

Catastrophe exposure risk would most effectively be measured using standard catastrophe exposure models. Because most risks can be quantified by credible and sufficient factors leads one to realize that the RBC platform can continue to be most effective. In this light, consideration should be given to expanding the asset classes for which RBC factors can be developed

21) Should the MCR be influenced by an internal model?

No, because MCR is to be used for regulatory intervention, it should be as objective as possible to enable quick judicial approval of regulatory orders. A bright line test in this regard is essential.

22) With implementation of internal models, does the use of a specified safety level and time horizon become imperative?

Yes. To the extent internal models are used, it would help bring some measure of consistency across companies.

23) Even with limited use of modeling in the current RBC, should that modeling be subject to prior approval by the regulators? What should be designated and/or approved (e.g., the approach — 1,000 scenarios — and key considerations or parameters)?

Yes. Limited use of modeling in RBC should be standardized to the extent possible with disclosure of company specific parameters and discretionary features.

24) What regulatory expertise is needed for model review? How should regulatory review of models be funded? For regulatory review of internal models, should there be a centralized review function?

We do not believe regulatory evaluation of models for defining capital requirements would be cost effective. Regulators and examiners should have a working knowledge of modeling parameters and methodologies sufficient for a general understanding of the use of such models by insurers. Regulatory review of models should be funded by those companies who desire to use modeling.

25) What are the “level playing field” implications? What is the impact on small firms? How would a dual system of allowing internal model calculations by some firms impact the competitive marketplace?

Different capital requirements for similar companies, which would result from the option to use approved company developed internal models, is generally not appropriate. Smaller firms may lack the financial resources and expertise necessary to effectively utilize models and large companies may find their use on a large scale to not be cost effective.

Regulators should be more concerned about a company’s ‘sufficiency of capital’ rather than its ‘efficiency of capital’.

Capital Add-ons, Leverage Ratios, RBC Exclusions and Proportionality

26) Are the powers in the *Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in Hazardous Financial Condition*, effectively, capital add-ons?

The powers granted under the Hazardous Condition model can be considered capital add-ons; however they lack specificity and transparency.

27) Should capital add-ons be considered in the RBC? Is this a concept that would apply at the MCR level as well as the PCR level?

No, capital add-ons should only be considered if internal models are allowed for minimum capital requirements.

28) What should trigger capital add-ons?

If capital add-ons are limited to minimum capital requirements using internal models they should be triggered by events that demonstrate the potential inadequacy of the internal model to appropriately set capital requirements.

29) Does the leverage ratio in banking have a place in insurance regulation? If so, where?

Recognizing the risks inherent in borrowing, an additional charge could be added to RBC based on the nature (subordination, call provisions) and duration of any borrowings.

30) What changes should be made to RBC exclusions?

We are not aware of any reasons to expand exclusions.

31) If the U.S. solvency regime is expanded to explore economic capital, what exclusions should be made to those requirements, recognizing that those might be different from RBC exclusions?

The need for comprehensive economic capital models for small insurers and small lines of business may not justify the cost and expertise needed to implement and maintain such processes. Small company and small line of business exemptions should be considered.

32) What capital requirements should be employed for insurance entities currently excluded from RBC?

No comments.

33) What proportionality considerations should be given in the U.S.?

No comments.

34) Is there a need to obtain uniformity in the minimum capital and surplus requirements by state? Should the NAIC recommend a best practice of minimum requirements?

The minimum capital and surplus requirements to organize an insurance entity and maintain a business license is not related to capital requirement necessary to operate as an insurer. Such minimum capital and surplus requirements are rightly a function of each states corporation laws and need not necessarily be uniform.

Stress Testing, Supervisory Reporting and Public Disclosure

35) What stress tests should be performed by the NAIC?

The NAIC on behalf of state regulators could help establish uniform stress tests to be used by the industry.

36) What stress tests and reverse stress tests should be performed by companies? What should be required to be reported to the regulator?

Stress testing should be an integral part of an Enterprise Risk Management program. Such programs should be encouraged by the regulator as part of their ongoing solvency monitoring and assessment activities. Regulators should promote the use of uniform stress testing standards for industry use. A minimal suite of standard stress tests should be required.

37) Should the regulator specify stress test scenarios to run? If so, which ones? How often should they be done?

Yes, a minimal suite of standard stress tests, such as the New York 7 used in life insurers cash flow testing, should be required annually.

38) Should the RBC calculation be publicly available?

Yes. The current RBC program for P&C insurers uses publicly available formulas applied to publicly available financial statement information. Any data should be accompanied by a standard disclaimer describing the intent of the RBC data.

39) If internal models are allowed for capital requirement purposes, should information be publicly available?

We do not support the use of company developed internal models for regulatory capital requirements. However, if they are used, they should be as standardized as possible. Transparency is especially important if differing standards are applied. Public release of modeling information may involve release of proprietary information which would be problematic. Additionally, public release of information related to solvency could be hazardous to insurers that need to take action.

SMI Focus Areas: Insurance Valuation and International Accounting

40) Should the valuation of all assets, liabilities, and capital resources for regulatory capital purposes be completed on a market-consistent or some other basis?

Market consistent valuations for insurance liabilities are not appropriate as there generally are no markets for such liabilities and therefore no means to validate models developed to measure them. Insurance liabilities generally are extinguished through settlement with policyholders and therefore valuations should be based on estimated contract fulfillment costs (settlement cost).

Assets held specifically to meet insurance liabilities should be valued based on their intended use (e. g. amortized cost if intended to be held to maturity). Alternatively, other methods such as the Canadian Asset and Liability Method may be appropriate for the valuation of insurance liabilities.

41) Should the SMI wait for FASB and IASB to determine valuation requirements for public financial reporting prior to determining valuation for regulatory solvency purposes?

To the extent possible, the same accounting model should be used for general financial reporting, solvency/regulatory and tax reporting purposes. Regulators, representing policyholders, are primary users for insurer's financial reports and as such should attempt to influence the IASB and FASB in their deliberations of a new accounting standard for insurance contracts to ensure the final standard provides appropriate decision useful information for all users including regulators and not just investors. Tax reporting

requirements will influence company stakeholders and may not align with regulator's views. Therefore, the consideration of valuation issues will likely need to evolve and adapt as time passes and knowledge is gained.

42) Should valuation differ between public financial reporting (GAAP) and supervisory financial reporting (SAP)?

With appropriate disclosure information, the valuation measures could be the same for both public financial reporting and supervisory reporting. Yet, some options being discussed for general purpose statements may prove to be less valuable for regulatory purposes than others, potentially necessitating a separate SAP valuation model. Adjustments to RBC or its successor can be made to include an appropriate level of regulatory prudence, depending on the accounting model, and therefore such prudence does not need to be added into valuations for SAP financial reporting. However, the implications to tax reporting and global operations need to be considered as well.

43) How should procyclicality be addressed? What counter-cyclical adjustments should be made?

We believe RBC does a good job of measuring risk through cycles. So capital requirements based on RBC follow movement in risk. This points out the need to focus on the sufficiency of capital and not the efficiency of capital. Should counter-cyclical adjustments be needed, perhaps an AVR type of concept can be developed. More research is needed on this issue.

44) Should capital resource requirements utilize a tiering structure of capital? Should there be tied assets? If so, how?

In some regards, tiered capital already exists with life companies' AVR.

Surplus notes should continue to be used to meet capital requirements without limits due to their regulatory restrictions on interest and repayments provisions.

Under all circumstances the portion of capital and surplus relating to affiliate holdings and carried on the parent's books should be recognized to have limited utilization for risks imbedded specifically in the parent company.

Group Capital

45) For group capital assessment, what should the definition of a group be?

The definition of insurer group should recognize the highest tiered insurer(s) under common ownership or control and all downstream subsidiaries or affiliates of each regardless of whether they are insurers or not. For assessment purposes the regulator may need to look further into the holding company system (beyond the defined insurer group) to gauge contagion and other risks. The regulator should have the ability to review and/or approve any material upstream transactions and currently has the ability to evaluate any downstream investments or transactions involving the regulated insurer(s). In the U. S., there are sufficient regulators for other financial institutions including banks, broker dealers, etc.; therefore, group supervision (including capital assessment) should not include those entities. Unregulated entities, however, could be included in supervisory oversight.

46) What are the benefits of group capital assessment? Drawbacks?

Group capital assessment (as quantified) has limited regulatory value. Group capital requirements should not be imposed upon insurer groups. Such requirements may limit a company's ability to appropriately protect its capital from exposures such as mega-catastrophes. Group support should not be required. All entities within the insurer group should meet their minimum capital requirements and this should be the primary focus for capital regulation. Capital is not automatically fungible between affiliates and should not be treated as if it were, thereby making this group capital assessment an exercise of limited value. Insurer groups spanning multiple domiciliary jurisdictions accentuate the potential limited fungibility of capital.

47) What are the benefits of group capital quantification of regulatory requirements? Drawbacks?

With group capital assessment having limited value, establishing group capital requirements would be inappropriate. One drawback to quantification on a group basis is it may lead to the assumption that capital is fungible within the group when it may, in fact, not be. Additionally, diversification benefits may be difficult to quantify. See Question 46.

48) Should consolidated financial statements be required?

Consolidated financial statements should not be required.

49) What methodologies of calculation should be considered (e.g., consolidation vs. aggregation)?

We do not believe group capital requirements should be imposed. To the extent group capital quantification is needed for assessment purposes, aggregation would be preferable as it is a more straight forward calculation based on individual company capital requirements. It may be very appropriate for management to evaluate capital needs for an organization on a group basis, but at times of crisis a regulator may not have access to enterprise capital and the sufficiency of entity level capital will be critical.

50) How should unregulated entities and non-insurance entities be considered? Do insurance regulators have the expertise to determine the risks of non-insurance entities?

Insurance regulators should consider all downstream entities in terms of balance sheet valuations and any affiliates, particularly unregulated entities, for potential off balance sheet obligations. It is more difficult to determine the risk any non-insurance entities pose to the insurer. Close examination should be made of any financial safeguards in place.

51) Should diversification credits be applied at the group level?

Diversification credits will likely be part of companies' economic capital models, which may be of interest to regulators. We do not believe group capital requirement should be imposed and group capital assessments have little regulatory value, therefore, diversification credits should not apply.

52) Should group support be implemented? If so, how would fungibility issues be addressed?

Risk can be offloaded from one entity to another within a group, just as an entity can offload that risk outside the group, e.g. reinsurance. This should reduce its minimum capital requirements as long as appropriate counterparty capital risk charges are included in RBC.

These risk transfer mechanisms allow for an entity to be reimbursed when there is a transferable loss regardless of financial strength. Group support, by definition, however doesn't provide reimbursement until the company is in an impaired status. This strikes us as imprudent – particularly recognizing that what might impair one entity might impair the entire group leaving little resource to actually deliver on the agreement. Group support should not be implemented. There does not appear to be an effective or practical means of ensuring funds will be available and supplied when needed particularly when cross jurisdictional issues are present. Individual entities should 'stand on their own' to ensure consistent and fair treatment across the industry.

53) Should the NAIC consider an approach to group-wide capital requirements that span international jurisdictions?

No. International jurisdictional issues would further complicate and hinder the ability of the regulator to take appropriate rehabilitative action should it be needed.

Regulatory Arbitrage, Systemic Risk, Impact Studies and Implementation

54) What considerations should be made regarding regulatory arbitrage?

Establishing regulatory capital requirements should not be a race to the bottom. Eliminating the potential for group support in the U. S. should relieve this issue.

55) Should the U.S. insurance solvency system be adjusted for systemic risk regulation? If so, how?

No. Recent studies (such as those presented at the NAIC Systemic Risk Panel in San Francisco) suggest the U.S. insurance industry does not pose systemic risk to the U.S. economy. However, insurance regulators could have the ability to review unregulated affiliates that can create additional risk including any off balance sheet obligation for insurance affiliates.

56) Should wind-down plans be incorporated? If so, how?

The nature of insurance and its supporting operations do not qualify an entity as being too big to fail or too interconnected to fail and so wind-down plans would not be appropriate. Affiliated unregulated businesses could qualify, however, and perhaps should have similar wind-down requirements. Wind-down plans would most likely be impractical to maintain and implement based on the dynamic economic nature and climate in which companies operate. The guaranty fund mechanisms throughout the states help fulfill this responsibility.

57) What further studies regarding capital requirements should be performed and who should perform the studies?

No comments.

58) Should quantitative impact studies be performed in SMI?

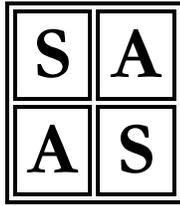
Whatever changes are brought about should be field tested and back tested over time before adoption. This is especially important should the use of modeling be incorporated.

59) Should SMI revisions be phased in?

A phased in implementation may be needed depending on the extent and nature of the changes.

60) What additional capital requirement or overarching accounting/valuation issues should be considered in the SMI?

No comments.



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Stephen N. Steinig, President

February 26, 2010

To: Director Christina Urias, Chair of the International Solvency Working Group

Re: NAIC Consultation Paper on Regulatory Capital Requirements

Attached are my comments on selected questions in the Consultation Paper. My comments are in the context of these overall observations on the subject of U.S. solvency regulation of insurance companies.

1. Solvency regulation of the U.S. insurance industry has been extraordinarily successful, with an extremely small number of insolvencies over the years. The record that state insurance departments have compiled, under the NAIC umbrella, is far stronger than the corresponding record for the banking industry. This record of success suggests that any dramatic change in the regulatory system be taken only with care and a high degree of confidence that the change is an improvement.
2. The international accounting, supervisory, and actuarial organizations have become forceful advocates for more uniform global approaches to all aspects of financial and insurance regulation. What can be overlooked in the momentum toward such change is that we don't have a global insurance industry; we have international companies which own insurers in different markets around the world. Insurance companies in Europe and Asia have different markets, different products, different distribution systems, different asset and liability profiles and different histories and cultures of insurance regulation. As a result of this, optimal solvency regulation is not necessarily the same in all countries. Greater international uniformity is a desirable goal, but it should not be the driving purpose of further improving solvency regulation in the U.S.

3. It is wonderful that the SMI has turned to all interested parties in seeking input on its sixty questions. At the same time, on many particular aspects of the RBC process, the NAIC has much better data and a much broader overview than any one company or observer as to which portions of the formula are currently working well and which need repair.

My responses to specific questions follow.

Sincerely,

Stephen N. Steinig, FSA, MAAA

1. What is the purpose of regulatory capital requirements?

To make certain that all licensed insurers have sufficient capital to fulfill their liabilities with a high degree of probability in light of the risks inherent in their assets and liabilities over a wide range of potential future circumstances.

As a byproduct of this purpose, RBC has been designed to separate weakly capitalized companies from all others. Its purpose is not to be a finely tuned tool for measuring and analyzing risk for companies throughout the spectrum of financial strength. RBC should remain a tool for the NAIC and state regulators; it should not be converted into a tool for rating agencies or company managements.

8. How should the U.S. define its RBC levels using statistical safety level and time horizon definitions? What is the appropriate risk measure?

The time horizon should be comparable to the time horizon in existing RBC regulation, which is a long-term horizon essentially for the lifetime of the inforce liabilities. The “one year test” being adopted in Europe is not appropriate, no matter how high the statistical safety level. Note that the standard suggested by the CEA in ¶28, that the value of remaining future obligations at the end of the one year time horizon is a “best estimate value with a moderate level of confidence such as 75%.” That doesn’t sound like a strong solvency standard, even if the one year standard is 100%.

9. Does economic (or target) capital evaluation have a role in the U.S. solvency framework? If so, what? Should a company’s own economic evaluation relate to regulatory requirements? Should a company’s own economic evaluation impact RBC or be considered outside of RBC?

A company’s economic capital evaluation should be outside of RBC and not be considered as a regulatory requirement. “Economic capital” is a concept, not a defined quantity. Two companies with identical balance sheets in all particulars would make different determinations of their economic capital due to different assumptions about the future and different targets for safety and ratings from the agencies. So long as the NAIC maintains a Company Action Level and a Mandatory Control Level (whether as is, or more specifically calibrated to defined risk levels), it is defining its PCR and MCR; PCR does not have to carry the label “economic capital” to be meaningful. PCR defines the level of capital above which regulators need not give special or supervisory attention to a company’s capital. In general, most company managements would set their target capital, ie, their economic capital, at a still higher level.

11. Are there areas of the RBC formula that should be modified in the approach (example: more categories of assets, treating assets more granularly, more stochastic analysis)?

12. What is the appropriate methodology to consider interdependencies among risks (e.g., diversification)? Is the square-root covariance adjustment appropriate?

One of the basic philosophical underpinnings of RBC is that its chief purpose is to identify poorly capitalized companies which should receive regulatory attention with increasing degrees of severity (as described in ¶23). For the great majority of the industry, with RBC ratios well above those which bring regulatory involvement, RBC is not designed to be a management tool which provides guidance as to risk management practices, signals subtle shifts in the strength of a company's capital position, etc. So long as this remains the philosophy, there is no need to modify RBC's broad approach. It is certainly not necessary for RBC to have the degree of granularity or refinement that a company might want in its own approach to determining economic capital and capital adequacy.

At the same time, continued development of RBC to incorporate stochastic testing with prescribed scenario parameters for selected risks not measurable by simpler techniques is a beneficial expansion and improvement of RBC. But note that stochastic approaches, especially if not subject to tightly defined parameters, would result in company-specific approaches that are more difficult to monitor and verify.

The covariance adjustment is broad and simplistic, and it may not stand up well in modern risk theory. But it does the job, and its simplicity is a virtue. Companies might want to do something more refined in their own economic capital analyses, but the greater sophistication might not be needed in RBC.

NAIC has not wanted to rate companies nor to see RBC ratios used in a competitive manner; there are regulatory restrictions prohibiting such use. The simplicity (and perhaps even over-simplicity) of the RBC formula is a virtue in that regard – knowledgeable observers know that the purpose of RBC is to distinguish poorly capitalized companies from others, and not to rank companies. Refining and “improving” the formula to move closer to the sophistication and discreteness of the industry's best economic capital formulas would probably result in more widespread abuse of RBC for competitive purposes, without necessarily improving its regulatory performance.

17. Should internal models be allowed to determine capital requirements?
18. Should partial modeling allowing company discretion be utilized in the RBC? If so, how?
19. When modeling is used for capital requirement purposes, what safeguards should be considered to the modeling? What requirements should be established with modeling?

The discussion of the use of full or partial internal models in this section of the Consultation Paper, Paragraphs 48-57, is excellent and provides the appropriate guidance and cautions to answer Questions 17-19. In general, standardized models should suffice, without companies needing to tailor models. But words like ‘standardized’ and ‘tailored’ are not always clear. A good standardized model would specify many or all of the model parameters and many key assumptions (such as interest rates). But each company would input its product design, its asset portfolio, its distribution of business by age, gender, and amount, etc. So is the end result a standardized model or a tailor made internal model? The label makes no difference.

The guiding philosophy should be what formula and/or modeling approaches best fulfill the U.S. Regulatory Mission statement stated in Paragraph 17. And the answer to this question should be based on pragmatic considerations looking at the available alternatives for determining the magnitude of risk, component by component and overall, and the ability of regulators to control and monitor the process of solvency regulation. Stochastic models and internal models should be utilized in RBC only when simpler alternatives are deemed unacceptable, not merely because they are more sophisticated and precise.

The best possible management approach to analyzing and quantifying risk and setting minimum and target levels of capital is not necessarily pragmatic for an industry wide regulatory capital standard, and regulators should not allow themselves to be “seduced” into thinking that the most sophisticated models and approaches which particular companies or consultants are using are automatically practical, necessary or desirable for regulatory purposes.

Note that it is rare for a company to have fully integrated internal models; normally, each major business unit or product grouping has its own model. A required capital system built upon internal models will have more integration issues than the existing RBC approach.

If the result of the SMI Project is to maintain RBC on a dominantly formula and standardized model basis, a company’s internal models could come into play if the company’s RBC ratio triggered regulatory action. Those internal models could be used by the regulators to gain additional insight into the company’s risk position (and perhaps guide the regulators to less severe supervisory involvement).

38. Should the RBC calculation be publicly available?

No, the RBC calculation should not be publicly available, as it has not been in the past. In fact, the current disclosure in the Blank of Total Adjusted Capital and the Authorized Control Level should perhaps be replaced, to reduce abuse of RBC ratios, to disclosing only whether or not their RBC results trigger regulatory attention (in other words, a yes/no disclosure) and, if it does, what level of attention.

40. Should the valuation of all assets, liabilities, and capital resources for regulatory capital purposes be completed on a market-consistent or some other basis?

Valuation should not be on a market-consistent basis. The current bases used by NAIC for different liabilities and assets are preferable to market-consistent. Market-consistent has cachet at the moment. On the surface, it appears like the only logical basis – how can anything other than market-consistent represent a proper value? But the fact is that life insurance company products remain generally long term and an accounting basis that assumed the entire block of liabilities could be cashed out all at once and all assets sold at current market values distorts the financial condition of the company rather than illuminates it. Market-consistent accounting would be much more volatile than current accounting and not serve the purposes of regulators or the insured public. Counter-cyclical adjustments would probably be deemed appropriate and necessary by both the industry and the regulators, and such adjustments would to some extent undo the market-consistent accounting, an example of why one should not go to market-consistent accounting in the first place. Note that in the 2008 end of year financial turmoil, even the most ardent advocates of market-consistent accounting, in the U.S. and in Europe, recognized that it didn't work under that circumstance.

Regulatory (statutory) accounting has served the public, the regulators, and the industry too well to be discarded in favor of rules developed by accounting authorities who are deeply committed to the philosophy that essentially the same accounting rules can serve all industries and, in particular, all financial industries. Such a philosophy has much to commend it from a theoretical point of view, but it is essentially untested. U.S. GAAP for life insurers is an earlier attempt to apply standard accounting theory and practice to the insurance industry; its legacy is highly questionable. Life insurance regulators, actuaries and financial experts have many reasons to believe life insurance merits its own accounting rules because of its differences from other financial and non-financial industries.

41. Should SMI wait for FASB and IASB to determine valuation requirements for public financial reporting prior to determining valuation for regulatory solvency purposes?

There might be some advantages to waiting, just to understand the insurance accounting landscape fully before determining valuation for regulatory solvency purposes. But the SMI should not be overly influenced by FASB and IASB since the purpose of their accounting rules is so clearly dominated by wanting to get measures of earnings to follow certain paradigms and so heavily addressed to the needs of the investor community. The objectives and audience of statutory accounting is quite different and merits different accounting. Overall, I would argue against waiting.

42. Should valuation differ between public financial reporting (GAAP) and supervisory financial reporting (SAP)?

SAP should be based on its own needs and objectives, which are quite different than public financial reporting. There is advantage in having only one valuation basis, so that if SAP and GAAP differed in only a few small areas, it would be beneficial for them to be brought together. But given the vast differences between GAAP and SAP, they should each be allowed to go their own way, under the guidance of their separate regulatory authorities.

43. How should procyclicality be addressed? What counter-cyclical adjustments should be made?

There should be no changes in RBC mechanics to reflect procyclicality. Following a terrible mortality spike, mortality doesn't necessarily get better than normal, it is more likely to only return to normal. A significant recession which causes poorer experience with respect to bond default rates, equities, mortgage foreclosures, etc. can be expected, based on past history, to be followed by a period of recovery, but exactly when that recovery will begin and how fast it will proceed cannot be specifically predicted.

At the extreme, procyclicality advocates seem to be suggesting that required surplus be increased in good times and decreased in bad. This means that if a company has surplus exactly equal to its required surplus at both times, it is equally strong (has a 100% ratio) both at the top of the cycle and immediately after a major hit! This doesn't make sense to me.

Rather than adjusting RBC, regulators should have the flexibility to adjust their response to companies triggering regulatory action, when such action is warranted. In addition, in periods of severe capital shrinkage, sensitivity tests can be used to evaluate the impact of different degrees of recovery.

For portions of the RBC calculation which are done by stochastic methods, the parameters specified by the NAIC could recognize cyclicity by specified assumptions for such factors as the level of interest rates, the shape of the curve, and asset defaults, ie, when current conditions are at an extreme, the stochastic assumptions could assume a return to normality over some specified period. But this is very different than simply suggesting less surplus is required at the bottom of a cycle.

44. Should capital resource requirements utilize a tiering structure of capital? Should there be tied assets? If so, how?

Generally not. These distinctions do not fit the insurance world as well as the banking world, and the way in which the RBC formula reflects a large number of different assets categories is a stronger basis for recognizing asset differences than a tiered structure.

55. Should the U.S. insurance solvency system be adjusted for systemic risk regulation? If so, how?

56. Should wind-down plans be incorporated? If so, how?

Systemic risk means much more than being very large and having a lot of assets and a large number of customers. It is not clear that any insurance company represents systemic risk to either the rest of the industry or to the economy as a whole. There is exposure to systemic risk that others bear, particularly reinsurers and counter-parties. This could be reflected in an RBC formula (and more easily in a formula than in stochastic testing) by increasing the RBC factor with respect to reinsurers and counter-parties to a higher level than is derived simply by looking at historical performance and averages. Perhaps this component of systemic risk could be reviewed only in a sensitivity test rather than the basic calculation.

There should be no adjustments for systemic risk regulation in other parts of RBC at this time and wind-down plans should not be incorporated. As the appropriate actions to monitor and control systemic risk throughout the financial industry comes into sharper focus via national legislation and FSB findings, the NAIC can better consider the implications for insurance solvency standards.

60. What additional capital requirement or overarching accounting/valuation issues should be considered in the SMI?

The NAIC's thinking as to how to prevent use of RBC in ways for which it was not intended, such as by rating agencies and in misleading publicity, would aid the achievement of an optimal approach to RBC for regulatory purposes without the pressure of having it serve other masters as well.