COMFRAME DEVELOPMENT AND ANALYSIS (G) WORKING GROUP

Comments Received on

U.S. Group Capital Methodology Concepts Discussion Paper

December 5, 2014

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December 05, 2014

BY ELECTRONIC MAIL

Kevin M. McCarty
Chair
ComFrame Development and Analysis Working Group
International Insurance Relations (G) Committee
National Association of Insurance Commissioners

RE: ACE Group Comments on the NAIC U.S. Group Capital Methodology Concepts Discussion Paper

Dear Commissioner McCarty:

Thank you for the opportunity to comment on the NAIC Group Capital Methodology Concepts paper. While we continue to believe that refinement of other tools, such as the ORSA and supervisory college, will provide a more meaningful and effective assessment of a groups' capital and risk management, we recognize that global efforts to develop an ICS are moving forward and therefore we are very supportive of the NAIC efforts to develop an approach to Group Capital that can be readily implemented in the U.S. The consequences of adopting an impractical, inefficient approach to group capital are significant for U.S. consumers, companies and markets. We also welcome the collaboration of the NAIC with the Federal Insurance Office and the Federal Reserve because a united "Team USA" approach will be a much more effective way to ensure that U.S. interests are appropriately reflected in any global standard.

ACE agrees there are pros and cons to both the "RBC plus" approach as well as the "Cash Flow" approach, however, the specific details of either approach are very important. For instance, an RBC Plus approach that contains so many adjustments that it ends up being a market adjusted balance sheet would not be acceptable. Similarly, the specific scenarios to be tested in a cash flow approach also make a big difference. We are confident that our capital levels will be sufficient under any global capital standard but we are concerned about the level of work involved to undertake a whole new balance sheet merely for the purpose of an international standard. We believe a cost-benefit analysis must be undertaken and urge the NAIC to develop a practical assessment of group capital that can be implemented with minimal cost.

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Many of the insurance trades are submitting detailed comments on the two alternative approaches. Rather than repeating many of the points and suggestions made by others, ACE has decided to focus on an aspect of group capital that we think will have significant ramifications for U.S. groups and consumers. An important aspect of any global capital standard is what qualifies as capital. We have expressed concerns over the last two years that various IAIS proposals have an approach to capital resources that is contrary to the U.S. approach and would be very detrimental to U.S. markets. Our comments will elaborate on this concern and provide a rationale for the NAIC and Team USA to respond to international arguments to exclude certain capital instruments that are routinely accepted in the U.S.

This issue is addressed on page 8 of the Annex to the NAIC proposal.

Proposed NAIC Approach – Senior Notes

On consolidation there is ***no net effect of senior notes***, but such notes would continue to be taken into account in entity based capital requirements (emphasis added).

It is unclear what is meant by the above proposal. It appears as if the NAIC intends to treat senior debt issued by a U.S. holding company and downstreamed as equity into an insurance subsidiary (U.S. Senior Debt) as a liability in the Group Capital Model but as capital in the insurance subsidiary's capital model. If so, ACE disagrees and asserts that U.S. Senior Debt should be treated as capital in both capital models. ACE's position is that U.S. Senior Debt should be treated as capital in any Group Capital Model proposed by Team USA.

ACE Summary Position

U.S. Senior Debt should be treated as capital in any Group Capital Model proposed by Team USA based on its structural subordination to policyholder liabilities. While it may be appropriate to limit such capital treatment to a percentage of the group's total capital position (e.g. 25% - 30%) and/or treat the U.S. Senior Debt as a lower grade of capital (e.g. Tier 2 capital), simply concluding that U.S. Senior Debt does not qualify as capital in a Group Capital Model would be inconsistent with long-standing U.S. industry and regulatory practices as well as the capital treatment applied globally by rating agencies. Further, we see no technical or practical reason why excluding U.S. Senior Debt from capital treatment in a Group Capital Model while permitting it in the corresponding insurance subsidiary capital model serves any policy purpose. Such a view would effectively require U.S. holding companies to maintain capital not needed to support policyholder obligations and, in turn, unnecessarily result in higher policyholder prices.

Long-standing U.S. industry/regulatory practices
Raising Capital for U.S. Insurance Groups
Large U.S. insurance groups raise capital via top tier holding companies that are routinely SEC registrants. In 2013, U.S. holding companies completed 66 equity and debt offerings in the following categories:

- 39 senior debt
- 11 common stock
- 7 subordinated debt
- 5 preferred stock
- 4 convertible notes

As illustrated above, U.S. Senior Debt is consistently the preferred option for raising capital in the U.S. This structure insulates the policyholders from the debt related obligations maintained by a holding company associated with the proceeds downstreamed as equity capital into an insurance subsidiary. More specifically, a missed coupon payment by the holding company would not result in a default by the insurance subsidiary. Further, the insurance subsidiary has no legal responsibility to the bondholder and cannot be sued for payment. Consequently, the debt obligations of the holding companies are structurally subordinate to the policyholder obligations of the insurance subsidiary.

Regulatory Treatment of Senior Debt raised by U.S. Holding Companies
Senior Debt proceeds contributed to an insurance subsidiary by its U.S. parent holding company is also typically treated as capital by U.S. regulators based on its ability to absorb insurance losses. This long-standing treatment reflects the U.S. regulators' recognition of the structural subordination that exists between the creditors of the holding company and the policyholders of an insurance subsidiary, the protection of which is the U.S. regulators' (and Team USA's) primary concern.

In this regard, the U.S. regulatory system includes a number of financial controls designed to ensure that policyholder interests are protected and satisfied over the interests of creditors of a holding company. In particular, the U.S. regulatory system places significant restrictions on a holding company's ability to access capital from its insurance subsidiaries. These restrictions include providing prior notice to the regulator on all proposed dividends and obtaining prior

approval if the dividend exceeds a maximum threshold. The computation of the maximum threshold differs by state but generally is the equal to the greater of 10% of the company's policyholder surplus or prior year's net income.

Contrast this to the ability of a holding company to secure dividends from its UK insurance subsidiary. The UK dividend does not require advance approval from the Prudential Regulatory Authority (PRA) and the PRA does not possess the statutory right to prohibit the payment of such dividends. This lack of "veto" authority by the PRA may explain why ComFrame includes a number of contractual subordinating provisions in its requirement for capital treatment. However, such provisions are not needed in the U.S. given the regulator's authority to prohibit capital movements that they determine negatively impact policyholders.

Additional U.S. regulatory controls that reinforce the separation and subordination of parent holding company obligations to the policyholders of its insurance subsidiary include:

- *Holding Company Reports* – insurance groups must file annual reports to provide information on: ownership and control, the background of directors and officers, loan and line of credit arrangements, investments, purchases, sales and exchanges of securities, extraordinary transactions, guarantees, management, service and cost-sharing arrangements, reinsurance arrangements, tax allocation arrangements and financial statements. Changes in these respective items are also included in a monthly filing.

- *Prior Regulatory Approval* - in connection with certain proposed transactions, including a change in control, guarantees, intercompany loans and intercompany service agreements, the terms of which must be fair, reasonable and "arms-length".

- *Minimum Capital Requirements* – required to operate as an insurance company which ensures that an adequate level of capital is maintained in relation to the risks of the insurance company.

- *Financial Statements* – filed quarterly containing both quantitative and qualitative information. The annual reporting package includes actuarial opinions addressing the adequacy of the insurer's loss reserves and management's attestation over its financial reporting internal controls.

Capital treatment applied globally by Rating Agencies

Rating agencies typically treat U.S. Senior Debt as capital in their group capital models. The rating agencies refer to such use of senior debt as double leverage. In the case of S&P, they evaluate the use of double leverage in their group capital model based on local regulation. Where the level of structural subordination is high and regulators allow holding company debt to fund insurance company capital, S&P's tolerance for double leverage will generally rise (i.e. the amount of debt treated as capital in S&P's capital model). Jurisdictions with a high level of structural subordination per S&P include the U.S., Canada and Bermuda. In these jurisdictions, S&P will permit up to 20% of an insurance group's total capital position to consist of holding company senior debt. This is very different than S&P's treatment in Europe which has a low level of structural subordination and the regulator excludes holding company senior debt from group solvency capital. In Europe, S&P does not include any holding company senior debt in its group capital model, which results in a higher issuance of subordinated debt securities (*compared to the U.S. securities market*) at the operating company level.

Other Considerations

ComFrame Treatment

Capital adequacy is addressed in Module 2, Element 5 of the Common Framework for the Supervision of Internationally Active Insurance Groups issued in 2013. This module classifies qualifying capital resources into two categories of capital (core capital and additional capital) based on their ability to absorb losses on a going-concern basis and in a winding-up. Core capital should be comprised of higher quality equity elements (e.g. common share capital and retained earnings) which enable the IAIG to continue as a going concern. Additional capital is intended to include lower quality capital instruments which would enable the IAIG to pay insurance claims in the event of a winding-up. A capital instrument's ability to absorb losses (i.e. pay claims) is assessed based on its permanence, availability, subordination and absence of both encumbrances and mandatory servicing costs. These capital principles have been incorporated into the Instructions for the March 2014 Quantitative Data Collection Exercise (Technical Specifications).

Paragraph 159 of the Technical Specifications provides that qualifying capital resources include capital instruments which: 1) are available, 2) are not undermined or rendered ineffective by encumbrances, 3) are subordinated to the rights of its policyholders in an insolvency or winding-up, and 4) have a level of distribution that is neither tied nor linked to the credit standing or financial condition of the IAIG such that those distributions may accelerate insolvency. Capital instruments meeting these requirements are considered capital by ComFrame. These capital instruments are then classified as either core or additional capital.

Paragraph 168 of the Technical Specifications provides that additional capital features include:

1. An initial maturity of at least five years where the instrument's limited protection as it nears maturity is captured either:
    a. By the notional amount of the capital instrument being amortized on a straight-line basis in the final five years to maturity, or
    b. Due to the existence of a requirement for the IAIG to suspend repayment or redemption if it is in breach of its capital requirement or would breach if the capital instrument is repaid or redeemed.
2. Redemption subject to review or approval from relevant supervisor.
3. No rights to holders to accelerate the repayment of future scheduled principal or coupon payments, except in bankruptcy, insolvency, winding-up or liquidation.

While the application of paragraph 159 to U.S. Senior Debt seems reasonably clear in principle (i.e. U.S. Senior Debt qualifies as a form of capital), paragraph 168 provisions imply that a capital instrument may not qualify as additional capital unless it permits the issuer to "defer interest payments" to the holder or the redemption of the capital instrument is subject to regulatory approval. While the subordination provisions of Paragraph 168 may be necessary in some cases, we do not believe they are necessary when the respective capital instrument is already structurally subordinate (i.e. as is the case of a U.S. holding company issuance). In other words, a capital instrument should not have to be both structurally and contractually subordinated to qualify as additional capital. In jurisdictions outside of the U.S., it is not uncommon for capital instruments to be issued directly by the insurance company. In those jurisdictions that rank debt obligations pari passu with policyholders, the contractual provisions included in paragraph 168 would be necessary to subordinate the insurance company's capital instrument obligations to the rights of the policyholders. Such is not the case with U.S. Senior Debt. Consequently, we believe that ComFrame should treat U.S. Senior Debt as additional capital (admittedly, the IAIS appears to have a different opinion)

Capital Adequacy vs Financial Flexibility

It has been suggested that a justification for this approach of excluding U.S. Senior Debt from a Group Capital Model is that doing so better reflects the capital strength of the U.S. holding company and thereby the insurance group. As support, an example was provided which compared a holding company with a significant amount of senior debt with a holding company maintaining no senior debt. The point was then made that the 2nd holding company was much stronger, from a policyholder perspective, since it was better positioned to raise capital if the

need were to arise. This logic, in our opinion, confuses the concept of capital adequacy with financial flexibility and does not justify a disconnected capital proposal (i.e. capital treatment for entity purposes but not group).

Capital adequacy speaks to an insurance group's ability to meet the needs of its policyholders based on its current level of available capital resources (i.e. assets owned that can be used to pay claims today). Financial flexibility, on the other hand, operates more as a modifier to a company's capital position in that it attempts to measure the company's ability to enhance/ replenish its existing capital position. To this point, financial flexibility considers an insurance group's access to external capital and liquidity sources in addition to its capacity limits (i.e. how much it can raise). A company's capacity is driven by its financial leverage (debt to total capital) and interest coverage ratios (i.e. earnings to interest payments). Insurance groups with higher financial leverage ratios or lower interest coverage ratios will be determined to have less financial flexibility. S&P considers financial leverage ratios greater than 40% or interest coverage ratios less than 4x to be negative factors in its assessment of a company's financial flexibility. Financial leverage ratios less than 20% and interest cover ratios greater than 8x are considered as positive factors. In short, a financial flexibility assessment has more of a qualitative impact on an insurance group's capital position. It would not directly impact the insurance group's capital model computation.

Regarding the above-mentioned example, we would suggest that each insurance group's capital position is the same from a quantitative perspective (i.e. presuming each holding company had downstreamed the same amount of capital into its insurance subsidiary). The fact that one holding company may have secured the downstreamed funds from the debt markets as compared to the equity markets does not impact the amount of capital within the group that backs policyholder obligations. This point is reinforced by the U.S. regulatory regime which protects such policyholders from potential solvency issues that may arise in the parent holding company. While the financial flexibility of the 1st holding company may be lower than the 2nd holding company, that factor, in and of itself, should not result in the respective debt securities being excluded as capital. Instead, we strongly believe for all the reasons mentioned above that a prudent level of U.S. Senior Debt should be treated as capital in any Group Capital Model proposed by Team USA.

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Conclusion

ACE focused our comments on the issues of qualifying capital because we believe there are critical differences in the approach to capital resources taken in the US and Europe which reflect different policy choices and regulatory regimes in the two jurisdictions. We are very concerned that the US could get pulled into supporting an approach that will be very detrimental to the US market without a thorough consideration of all of the ramifications of such change. We thank you for the opportunity to comment and would be happy to further discuss our views regarding these important issues.

Respectfully submitted,

Patricia Henry

Patricia A. Henry

cc: Ryan Workman

Allstate
You're in good hands.

December 5, 2014

Ryan Workman
International Insurance Program Counsel
ComFrame Development and Analysis (G) Working Group
National Association of Insurance Commissioners

Re: U.S. Group Capital Methodology Concepts Discussion Paper

Dear Mr. Workman,

Thank you for the opportunity to comment on the National Association of Insurance Commissioners' ("NAIC") U.S. Group Capital Methodology Concepts Discussion Paper ("DP").

We support the NAIC's efforts to participate in the development of a group capital framework that leverages and seeks to improve upon the existing risk-based capital framework that has been proven highly effective in its two decades of existence.

We support the NAIC's view that the objective of a group capital standard should be to enhance the regulatory toolbox and complement the existing capital framework including information provided through the Own Risk Solvency Assessment ("ORSA") and Form F. We also support the NAIC's primary focus on policyholder protection while recognizing that the introduction of a group solvency assessment would benefit policyholders and contribute to the overall financial stability of the insurance industry.

Following are observations on the proposed group solvency methodologies set forth in the DP. We hope you find our observations useful and we urge you to continue to work collaboratively with your colleagues at the Federal Insurance Office ("FIO") and the Federal Reserve Board ("Fed"). We believe the Fed and FIO would benefit from a deeper understanding of the existing NAIC solvency framework, and then with the help of the NAIC, the three organizations can develop a plan to refine the framework as appropriate to meet the needs and objectives of a group capital framework for the U.S. insurance industry.

In connection with this undertaking, we strongly urge the NAIC to focus on confidentiality and how to create an environment where highly proprietary information can be sufficiently protected so as not to irreparably harm the interests of the underlying insurance companies. In addition, we believe the NAIC should focus attention on how it can more effectively coordinate and integrate the activities of legal entity regulators at the group (or holding company) level to more effectively administer a group capital and solvency framework.

General Observation: Need for a Separate Life and Non-Life Approach

The DP does not specifically address the need for separate applications of a general group solvency approach for life and non-life insurance to address the unique attributes of life and non-life businesses and products. More specifically, while we believe assets could in many cases be valued and evaluated consistently for both life and non-life insurers, the risk inherent in life and non-life insurance contracts are fundamentally different and require separate evaluation and customized risk factors.

In terms of the NAIC's DP we support a combination of the RBC Plus, Cash Flow, and Hybrid approaches. More specifically, the RBC Plus approach would be useful for evaluating the capital and solvency adequacy for non-life insurance whereas the Cash Flow approach could be utilized in evaluating the capital and solvency adequacy of life insurers and for purposes of supplementary stress testing. In addition, a Hybrid Approach could be appropriate as a combination of the RBC Plus and Cash Flow approaches may be best suited to address the unique exposures in life and non-life insurance contracts.

RBC Plus – Specific Considerations for Non-life Insurance

We believe the RBC Plus approach provides a useful example to leverage in developing a solvency framework for non-life insurance. Leveraging the existing risk-based capital framework and modifying it as necessary (e.g., incorporating catastrophe and operational risk) would reduce the cost of the new framework and ensure it is grounded in an approach that has existed for two decades and has performed very well in a variety of extreme events and market conditions. Further, we believe the use of inputs derived from U.S. GAAP provides the appropriate valuation basis for information utilized in the RBC Plus framework as this information is typically audited and considered reliable.

The strength of the RBC Plus alternative is that it utilizes information derived from audited financial statements and updated risk-based factors, both of which will be familiar to both regulators and stakeholders. In contrast to a Cash Flow model that does not have the origins or operating history of U.S. GAAP, the RBC Plus model utilizing U.S. GAAP audited financial information, provides for a level of transparency that cannot be attained using a Cash Flow approach. Moreover, the transparency and understandability attainable using the RBC Plus approach supports investor and policyholder acceptance which is necessary to promote the stability of the insurance industry through the understanding and acceptance of the capital and solvency measurements. In addition, the resulting capital and solvency measurements, which may be both GAAP and Non-GAAP, will become part of the integrated performance and financial condition public reporting of the underlying insurers.

In terms of global comparability, we acknowledge that a RBC Plus approach is not equivalent to the IAIS's Basic Capital Requirement ("BCR") model, however, we consider that of secondary importance as the group capital and solvency model adopted in the U.S. should focus primarily on intra-jurisdictional comparability which we believe can be achieved by the RBC Plus approach. The primary difference between the RBC Plus approach and the IAIS's BCR approach is the valuation basis of the information utilized in the model. More specifically, the U.S. RBC Plus approach would utilize information valued according to the requirements in U.S. GAAP whereas the IAIS's BCR approach would utilize information valued using a Market Adjusted Valuation Approach ("MAVA").

We do not support using the MAVA as it is based on measurements that are neither transparent nor consistent with the contractual terms of the underlying insurance contracts. That is, the MAVA requires the discounting of non-life claim reserves while the underlying contracts prohibit discounting and require that all reserves be discharged on a nominal basis. Additionally, the MAVA requires that claim reserves be valued using stochastic models versus deterministic models whereas the worldwide insurance industry computes ultimate reserves using deterministic models almost exclusively as they provide the most transparent, useful outputs.

We recognize the fundamental challenge of constructing a single global capital and solvency framework and believe that instead of attempting to develop and deploy a single global model, that would not likely be interpreted and applied consistently across the globe, it is more practical to allow the continuation of

jurisdictional approaches together with an understanding of how they compare. Moreover, a principles-based versus a rules-based framework may best support this objective.

Cash Flows – Specific Considerations for Life Insurance and Stress Testing

We support a Cash Flow approach for both the testing of asset sufficiency for life insurance products and for the computation of supplemental solvency measures such as the stress testing of both life and non-life insurance business that is completed in the ORSA. We view stress testing as an important indicator of capital strength and further believe it is a test that is best completed using a cash flow model and a predetermined set of stress factors over defined time periods.

While we support the utilization of a cash flow approach for both life insurance business and supplemental stress testing for both life and non-life insurance we note that the use of cash flow models presents certain transparency and verifiability challenges. Moreover, due to their inherent complexity, the evaluation of internally developed cash flow models can be challenging for regulators as they may not have staff with sufficient expertise to fully understand the interdependencies of model components or the outputs generated. In addition, cash flow model inputs may not be derived from audited information and as such the use of models requires additional expertise to determine whether inputs and assumptions are reasonable, appropriate and whether they have been consistently developed and applied. Moreover, evaluating model outputs takes considerable expertise that can only be developed over time and with sufficient understanding of the underlying models and inputs.

In terms of global comparability, the cash flow approach applied to life insurance would not be equivalent to the IAIS's BCR model, however, we consider that of secondary importance as the group capital and solvency model adopted in the U.S. should focus primarily on intra-jurisdictional comparability which we believe could be achieved for life insurance using a cash flow approach. The primary differences between the cash flow approach and the IAIS's BCR approach for life insurance is the valuation basis of the information utilized in the model. More specifically, the proposed U.S. cash flow approach would utilize information derived where possible from audited U.S. GAAP financial statements whereas the IAIS's BCR approach would utilize information valued using a MAVA which includes application of IAIS prescribed interest rate curves, stochastic modeling of cash flows, and the application of IAIS determined economic assumptions for reinvestment rates, spreads, growth, etc.

In contrast to the development of capital and solvency measures for life insurance, for the supplementary stress testing of life and non-life insurance (typically completed pursuant to the ORSA requirements), we believe it is important to identify a principles-based set of stress factors to be customized and applied to the specific attributes of the insurers life and non-life business. Considerations for life stress factors would include interest rates, market value, mortality, lapses, etc., whereas for non-life the stress factors would include market risk, claim severity, inflation, etc.

Hybrid Approach – Specific Considerations

We believe a Hybrid Approach is reasonable in that it would apply a combination of the RBC Plus and Cash Flow approaches to those products and entities with underlying attributes best suited to each approach. As described above, we believe the RBC Plus approach is best suited to attributes of non-life insurance, whereas the Cash Flow approach is best suited to the attributes of life insurance and stress testing.

We thank you for the opportunity to provide comments on the DP and hope you find the observations helpful.

If you would like to discuss the content of the letter, please contact Kevin Spataro at (847) 402-0929 or Sam Pilch at (847) 402-2213.

Sincerely,

Kevin Spataro
Senior Vice President, Corporate Accounting Research
Allstate Insurance Company

Copy: Sam Pilch, Group SVP & Controller
DiAnn Behrens
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AMERICAN ACADEMY of ACTUARIES

Objective. Independent. Effective.™

December 5, 2014

Kevin M. McCarty
Chair, ComFrame Development and Analysis (G) Working Group
National Association of Insurance Commissioners
Via e-mail rworkman@naic.org

Re: *U.S. Group Capital Methodology Concepts Discussion Paper*

Dear Commissioner McCarty:

On behalf of the American Academy of Actuaries'[1] Solvency Committee, I would like to offer the following comments on the *U.S. Group Capital Methodology Concepts Discussion Paper*, which was recently exposed by the National Association of Insurance Commissioners' (NAIC) ComFrame Development and Analysis (G) Working Group (CDAWG).

We appreciate the working group's efforts in developing the discussion paper. The risk-based capital "plus" (RBC Plus) and cash flow stress testing (Cash Flow) methodologies explored in the paper each offer significant potential as a group capital measure. As the paper acknowledges, though, both also present significant challenges.

In this letter, we outline several advantages and disadvantages of each methodology from the perspective of the actuarial profession and highlight the possible merit of a hybrid approach that combines the RBC Plus and Cash Flow methodologies. Significant work would be required to implement such a hybrid approach and achieving international comparability would be challenging. Nonetheless, we believe that a hybrid approach to group capital could serve to complement the current legal entity approach in the United States.

Our comments are based on the principles that we previously developed to guide the creation of an insurance capital standard. We submitted these principles to the working group earlier this fall and, for reference, attach them to this letter as Appendix A.

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and 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.

RBC Plus

As the discussion paper indicates, the RBC Plus approach would apply U.S. risk-based capital (RBC) factors to U.S. generally accepted accounting principles (GAAP) audited consolidated financial statements. This approach raises some basic conceptual problems.

Prudent Capital vs. Minimum Capital

In order to recommend a single methodology or a combination of methodologies, it is important first to consider whether the methodology or combination can effectively fulfill the capital standard's purpose. The key threshold question is whether the capital standard is intended to establish a minimum required level of capital or, alternatively, a prudent level of capital above the minimum required amount.

A minimum capital requirement sets a threshold for regulatory intervention in a weakly capitalized company. In contrast, a prudent capital standard does not establish such a minimum threshold but instead defines a target amount of capital above the minimum that the regulatory community establishes as an appropriate level for a strong company. A prudent capital requirement, for example, might target an amount of capital that allows the insurer to continue to function as a strong going concern and, therefore, contribute to the overall financial stability of the market.

The RBC system that exists today in the United States is designed primarily to aid regulators in identifying and correcting solvency concerns at weakly capitalized insurers. Rating agencies and other market participants sometimes use RBC for other purposes, but the system is intended to set a *de facto* minimum capital requirement for regulators.

Inherently, a factor-based approach is well suited to the establishment of a minimum capital requirement. While some risks are not effectively measured by the factors used to calculate RBC in the United States, a factor-based approach allows regulators to apply the same factors to every insurer using published, auditable financial data. If regulators adopt RBC Plus at a group level, it could function well as a reference point to aid in the identification of weakly capitalized groups.

As discussed below, if the goal is to create a prudent capital standard, then a methodology that relies on internal models, such as the Cash Flow approach, will produce more reliable results. Factor-based approaches like RBC Plus are limited in their precision and, therefore, cannot produce prudent capital requirements without a large number of false positives and false negatives. The exposure bases to be used in any factor-based approach to group capital requirements would be extremely diverse with respect to underlying risks, creating an inherent limit on the precision that the methodology is capable of achieving. This problem exists for nearly all insurance contract liabilities as a result of differences in products, legal environments, and local culture.

As an example, the personal auto liability loss reserves for a property and casualty company with a national exposure but low coverage limits will have less inherent risk than a book concentrated in litigious states and with high limits. Factor-based approaches cannot easily account for such differences. This problem becomes even more pronounced if the same factors are applied to balances from different jurisdictions.

Consider, for example, the auto-liability coverage: the minimum policy limit for auto liability coverage-bodily injury liability in Germany is €7.5 million, while the equivalent minimum policy limit in Florida is $10,000. If a single factor is used globally, any factor that produces a prudent level of capital for the average risk associated with the exposure base will produce an excessive amount of required capital for those areas in which the risk is lower than the average and an inadequate amount of required capital for areas in which the risk is higher than the average.

This problem is reduced to the extent that the exposure bases are similar. This type of mitigation may be more achievable for some risks than for others. In circumstances in which the market is global and labels are standardized, greater homogeneity is achievable. However, if markets are local and the impact of products, law, and culture are varied, mitigation is difficult. Consequently, it may be possible to have a factor-based approach work for some risks but it is highly unlikely that such an approach will be effective for <u>all</u> insurance contract risks.

Fundamentally, a factor-based approach is a blunt instrument. It is not realistic to expect that granular factors can be designed to take account of every nuance of risk across insurers and jurisdictions. While a factor-based approach can be used to establish a common minimum for U.S. insurers, it would not be an effective means of establishing prudent capital requirements above the minimum.

Delinking RBC from U.S. Statutory Accounting

The factors in the NAIC's RBC formula presume the use of U.S. statutory accounting, which has significant conservatism built into certain of its liability measurements. U.S. RBC is designed to take account of an insurer's material risks. If a risk materializes, the loss is measured on a statutory basis. As a consequence, applying the existing RBC factors to U.S. GAAP parameters would necessitate a comprehensive review of each RBC charge to determine if the GAAP-based capital requirements produce values consistent with regulatory objectives.

Therefore, it is important to consider the amount of conservatism inherent in various aspects of the U.S. statutory accounting principles. This conservatism functions as an implicit risk charge, lessening the amount of RBC that is required by the formula. For example, in the NAIC's RBC formula for property and casualty insurers, the conservative U.S. statutory accounting treatment of agent's balances over 90 days past due renders a RBC charge for these balances unnecessary. Any use of U.S. GAAP in place of U.S. statutory accounting would necessitate an evaluation of whether new risk charges should be introduced to address a generally less conservative accounting basis.

In addition, in constructing a group capital standard it is important to consider whether and to what extent capital is fungible among legal entities, particularly in times of stress. Because statutory accounting and the NAIC's existing RBC framework are entity-based, they do not address this issue.

Potential for Multiple and Possibly Contradictory Standards

Another potential problem results if existing U.S. RBC requirements, based on statutory accounting, continue to be used at an entity level after a group capital standard takes effect. The simultaneous applicability of different factors to different valuation bases could lead to contradictory results. To avoid this outcome, it is important to consider how regulators will use the results and the type of regulatory intervention or other consequences that could result if the minimum requirements are not met.

Calibrating Non-U.S. and Non-Insurance Risks

The factors in the NAIC's RBC formula are calibrated based on U.S. risks. This is true for both assets and insurance contract liabilities. For example, on the liability side, the risk charge applied to personal automobile liability loss reserves is based solely on U.S. experience and does not contemplate risks for other countries' motor insurance products, such as those from annuities mandated by U.K. claim judgments or the short payout tail from countries such as Mexico.

To address this problem, regulators could consider basing the charges for non-U.S. liabilities and assets on the local, non-U.S. capital requirements. The use of local capital standards for non-U.S. business would leverage local expertise and allow local standards to continue to apply without change. This approach would be comparable to the current NAIC RBC treatment of non-U.S. insurance affiliates, which applies charges for such affiliates in the factor covering insurance affiliate investment and (non-derivative) off-balance sheet risk (R0, C0 or H0). The only difference would be to use the local capital standard for the R0/C0/H0 value rather than 50 percent or 100 percent of the foreign subsidiary carrying value. The net result would be similar to an aggregation approach.

A further challenge arises from the potential need to address non-insurance risks. Many groups will include both insurance and non-insurance entities; therefore, a group capital standard must take account of non-insurance risks in some manner. Of course, the capital requirements for non-insurance businesses may be defined by another regulator, but even then, the possibility of correlation between insurance and non-insurance risks may need to be considered in the context of the insurance capital standard. Considerable effort would be needed to reflect non-insurance risks appropriately.

Other Calibration and Comparability Considerations

If work proceeds on an RBC Plus standard, further review of the standard's statistical calibration will be required. In particular, if the standard is to be compared to similar

standards in other jurisdictions around the world, it will be important to ensure that thresholds for regulatory intervention allow comparability across jurisdictions. As such, the base liability, the risk metric, and the time horizon will need to be considered and, possibly, brought onto a consistent basis. Consider, for example, that a 99.5 percent "value at risk" metric with a one-year time horizon is equivalent to a 95.1 percent "value at risk" metric with a 10-year time horizon.

The type of intervention and trigger levels are also relevant. Even if base liability metrics, risk metrics, and time horizons are identical across jurisdictions, comparability still may be difficult if the trigger levels or the nature of the regulatory consequences are materially different depending on the jurisdiction.

Cash Flow Methodology

The Cash Flow approach has an established precedent in U.S. statutory accounting—the concept of stress testing cash flows currently is used to establish U.S. statutory reserve requirements for variable annuities and as part of the capital requirements for fixed and variable annuities. Further, the adequacy of formulaic life insurance reserves is evaluated using a cash flow testing methodology.

Because the Cash Flow approach is based on internal models that can be calibrated to an insurer's actual risks, it offers a possible means of creating a standard that requires a prudent level of capital rather than a minimum. However, like the RBC Plus approach, it has disadvantages that may impact its suitability as a comprehensive, standalone group capital standard.

Comparability Challenges

Among the most significant challenges regulators would face in using a Cash Flow methodology would be achieving comparability of results among companies. A Cash Flow approach is capable of producing comparable results more easily if the risks faced by the insurers tested are comparable. It is more difficult to obtain comparable results for exposures to non-comparable stresses. The basic risk exposures and cash flow patterns for two different insurers, even in the same market, can be challenging to compare. The difficulty may result from differing product mixes, customer base, market environment, policy limits and other terms, underwriting, claims management practices, and reinsurance programs. The potential need to address non-insurance risks adds a further challenge, as it does for the RBC Plus methodology.

In this context, it is important to note that a capital standard aiming for a prudent level of capital, such as the Cash Flow methodology, must by definition aim for a level of capital that takes the distribution of risk into account and provides reasonable protection against low frequency tail risk.

To account for these differences across companies and time, regulators will need to develop a robust set of stress scenarios, all calibrated to a similar level of risk. There is

work currently ongoing at the NAIC that could be leveraged for this purpose. The NAIC's Life Risk-Based Capital (E) Working Group's Stress Testing Subgroup is currently evaluating stress scenarios for purposes of calculating a total asset requirement. In addition, the NAIC's Life Actuarial Task Force is evaluating the use of stress tests to calculate statutory reserves for fixed annuities.

To avoid unnecessary work, regulators and companies also will need to determine which of the scenarios are most relevant to a given insurer group. Developing stress scenarios is not an easy task. They need to reflect the dynamic nature of the underlying environment, human behavior, and technological innovation. In addition, it is unlikely that across-time catastrophic tail risk (e.g., a one-in-20 year or one-in-50 year event) can be reliably parameterized from historical data. This makes comparability of measurement across entities a material concern, especially given the different underlying risk exposures across entities.

Finally, as with an RBC Plus approach, it will be important to consider the fungibility of capital among legal entities.

Internal Models

Though it is difficult to envision a standard for prudent capital that eschews internal models, the use of models to regulate capital inevitably will require significant resources both for regulators fulfilling their oversight responsibilities and companies creating and maintaining the models.

Because of the resources required, any standard based on internal models will create competitive challenges for smaller insurers. The costs may be more difficult for them to absorb. As a consequence, it is likely that a group capital requirement based entirely on internal modeling may not be practical for smaller insurers. This reveals a relative advantage of a system that relies, at least in part, on a factor-based approach such as RBC Plus.

Absence of Audited Balance Sheet

The discussion paper notes that the Cash Flow methodology has the advantage of "accounting independence." There is no need to reconcile accounting systems across markets and jurisdictions in order to stress cash flows. While this is an advantage from one perspective, it is a disadvantage from another. Although accounting systems and requirements differ from country to country, the audit process lends rigor and credibility to financial statements. As such, a system that uses audited figures as its starting point may be desirable.

Combining the RBC Plus and Cash Flow Methodologies

The RBC Plus and Cash Flow methodologies each have disadvantages that may impact their individual suitability as a group capital measure. Therefore, we suggest regulators

consider a hybrid approach that draws from the best features of each methodology. For example, state regulators could use the RBC Plus methodology to establish a minimum required level of capital that applies to all U.S. insurers. The Cash Flow methodology could then be used to establish a prudent capital level above this minimum. We believe such an approach could maximize the advantages of each approach while minimizing the disadvantages.

More generally, allowing a combination of approaches will better position regulators to make the adjustments needed to account for differences across companies and products. The presence of an acceptable, comparable factor-based minimum will give regulators flexibility in any capital requirements that apply above the minimum. In a situation in which all companies start with a common minimum established by RBC Plus, the Cash Flow (or another prudent capital methodology) could be structured to take adequate account of the significant economic differences between the life insurance and property and casualty industries. Similarly, as suggested above, the use of a common factor-based minimum could help regulators to feel comfortable applying the Cash Flow approach to smaller companies in a way designed to mitigate the costs of the internal modeling that the Cash Flow approach would entail.

*****

Thank you for this opportunity to provide our views on the CDAWG's conceptual proposals for group solvency and capital standards. If you have any questions or would like to discuss this letter in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Elizabeth K. Brill, MAAA, FSA
Chairperson, Solvency Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

Cc: Michael McRaith, Director, Federal Insurance Office, U.S. Department of Treasury
Tom Sullivan, Senior Adviser for Insurance, Federal Reserve Board
Jeff Schlinsog, Chair, Financial Regulatory Task Force, Risk Management and Financial Reporting Council, American Academy of Actuaries

Appendix A

American Academy of Actuaries Solvency Committee
Principles for an Insurance Capital Standard

1. A group solvency regime should be clear regarding its regulatory purpose and goals. For example, the purpose could be to protect policyholders, enhance financial stability, ensure a competitive marketplace, provide a level playing field, identify weakly capitalized companies, rank well-capitalized insurers, improve risk management practices and procedures, or some combination of the above. The regulatory purpose and goals will aid in the development of a standard itself, as well as the associated regulatory actions and priorities.

2. Any metrics, information, or other output of a group solvency standard should be useful to all relevant parties, including regulators, management, shareholders, and rating agencies.

3. A group solvency regime should promote responsible risk management in the regulated group and encourage risk-based regulation. For example, a solvency regime should recognize risk-mitigation activities, such as asset/liability matching, hedging, and reinsurance. The actuarial functions are critical in the risk management process and their role should be clearly defined, as it is in the U.S. reserving and solvency framework. Actuaries can and should identify where factor-based systems may miss key emerging risks, set reasonable boundaries around more subjective estimates and modeling and, as appropriate, render actuarial opinions.

4. Methods should recognize and take into consideration the local jurisdictional environments under which members of an insurer group operates, including the local regulatory regime, product market, and economic, legal, political, and tax conditions.

5. A group solvency standard should be compatible across accounting regimes, given the political uncertainties in achieving uniform standards.

6. A group solvency standard should minimize pro-cyclical volatility so as to avoid unintended and harmful consequences on regulated insurance groups, insurance markets, and the broader financial markets.

7. A group solvency standard should present a realistic view of an insurance group's financial position and exposures to risk over an agreed-upon time frame.

8. All assumptions used in any capital or solvency model should be internally consistent.

9. It is more important to focus on the total asset requirement than the level of required reserves or capital on a separate basis. The focus should be on holding adequate total assets to meet obligations as they come due. Whether a jurisdictional standard requires the allocation of these assets to liabilities versus capital/surplus should be irrelevant to the overall solvency regime.

10. It must be demonstrated that the capital held is accessible, including in times of stress, to the entity facing the risk for which the capital is required.

December 5, 2014

Commissioner Kevin M. McCarty
Florida Office of Insurance Regulation
Chairman, ComFrame Development and Analysis (G) Working Group
RWorkman@naic.org; RCalderon@naic.org

Re: U.S. Group Capital Methodology Concepts Discussion Paper

Dear Commissioner McCarty:

The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with approximately 300 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums in the U.S.

We appreciate the opportunity to offer comments on the U.S. Group Capital Methodology Concepts Discussion Paper (the Paper) that NAIC staff prepared for the ComFrame Development and Analysis (G) Working Group. Work occurring within the International Association of Insurance Supervisors (IAIS) on the proposed Insurance Capital Standard (ICS) is critically important to our members, both those that are or will be Internationally Active Insurance Groups (IAIGs) and those non-IAIGs concerned about the possible influence of any ICS on standards applied to them domestically.

Work within Team USA

ACLI members commend the coordination among Team USA that resulted in the IAIS Executive Committee agreement that a GAAP-based valuation approach be tested in parallel with a market-adjusted approach. This is an important approach to examine, with equal consideration, in crafting an ICS that would not discourage long-term investing or the offering of long-term insurance products. Several of our members are working intensely with Team USA on the next step in the development of an approach to ICS that would be workable within the U.S. framework.

We strongly encourage state insurance commissioners and NAIC staff to work in support of a single, good outcome for the U.S. industry and consumers through Team USA's efforts. That is critical to an outcome that is workable for the U.S. We are quite concerned that the Paper could be interpreted to signify a different, separate approach, which could reinforce the view that the U.S. perspective remains fragmented. That is counter-productive. The Paper also seems to divert state regulatory,

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NAIC staff, and industry resources away from the common Team USA work-stream. We urge that you and your colleagues, as well as NAIC staff, work together with other Team USA members to produce a single, unified, workable outcome.

Each Insurance Group Must Be Subject to Only One Standard

The interaction of various existing insurance solvency regimes with regimes under development and with proposed standards is very unclear. The European Union will be implementing Solvency II. The U.S. Federal Reserve must develop rules for non-bank Systemically Important Financial Institutions (SIFIs) and insurers affiliated with thrift holding companies (SLHCs). The NAIC is revising its RBC framework for life insurers and proposing its own methodologies for insurance group capital. At the same time, the IAIS has completed the Basic Capital Requirement and is working on the Higher Loss Absorbency and on the Global Insurance Capital Standard that will be embedded in ComFrame.

As a result, without coordination, domestic non-bank SIFIs, Globally Systemically International Insurers (GSIIs), SLHCs, and IAIGs could be subject to multiple group-wide regimes under two or more group-wide supervisors conforming to fundamentally different standards. Consider, for example, a U.S.-based insurance group subject to Federal Reserve consolidated supervision with substantial insurance operations in the U.S. and other countries. It is unclear how many different capital standards might be applied to that group—it could be subject to a Federal Reserve standard using U.S. GAAP plus factors or stress tests, to a state capital standard on a RBC or cash-flow basis, to an ICS on a GAAP plus adjustments basis, <u>and</u> to an ICS on a market-adjusted basis. Such a result is clearly undesirable from both the supervisory and the industry points-of-view.

We strongly recommend that any insurance group capital standard should stipulate that an impacted insurance group be subject to only one group-wide consolidated regime under one group-wide supervisor, appropriate to its domicile and its status. Consistency of consolidated group-wide regimes to a standard and to each other should be on an outcomes basis until such time as some reasonable solution to accounting and valuation differences has been agreed. Insurance operating entities would, and should, continue to be subject to jurisdictional requirements.

No Application to Subgroups of Non-U.S. Domiciled Groups

The Paper's stated objective is to provide the "conceptual underpinnings of a risk-based group capital standard for internationally active U.S. insurance groups." We believe that the term "internationally active U.S. insurance groups" should be defined to exclude any U.S. insurance group belonging to a larger non-U.S. group that is already subject to group regulation (including group capital requirements) by a respected regulator in another country. For example, a U.S. group that is part of a larger insurance group headquartered in Canada or a European country is already subject to group-level regulation (including group capital requirements) by a consolidated regulator and should not be subject to a duplicative "group" standard that only applies to the U.S. subgroup or company. Otherwise, the larger insurance group could be subject to multiple capital standards, which could undermine effective group-wide supervision from the home country regulator.

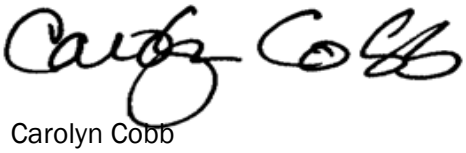
No State Authority to Set Group Capital at the Insurance Holding Company Level

ACLI believes that group-wide supervision in the U.S. is about overseeing that the group's insurers have the financial capacity to meet their obligations as they fall due and should focus on the protection of policyholders. That means that a single lead supervisor assumes the obligations of understanding the insurance group; explaining the insurance group's structure, corporate strategy, financial position, risks, and risk management to other involved supervisors; and coordinating and collaborating with other involved supervisors to achieve efficiency and consistency in risk-based supervisory treatment of insurance groups. We believe that state regulators have that authority, as evidenced by the 2010 amendments to the Model Insurance Holding Company System Regulatory Act (#440). Our members are not prepared to support an authorization for state insurance regulators to set an insurance group capital requirement at the insurance holding company level.

Our technical comments on the listed advantages and disadvantages of the proposed methodologies and on the chart of proposed NAIC approach(es) appear on the following pages.

We would be pleased to discuss these views with the Working Group, at your convenience.

Very truly yours,



Carolyn Cobb

Mariana Gomez-Vock

TECHNICAL COMMENTS ON ADVANTAGES AND DISADVANTAGES

RBC-Plus Advantages: ACLI members question several of the 'advantages' listed on p. 2 of the Paper, as discussed below.

- *"RBC Plus type methodology would be familiar to U.S. state insurance regulators being based on an existing framework for legal entities which has proven to be effective...."*

  Because RBC Plus would require new factors to be developed and use a different accounting base than legal entity RBC, any "familiarity" advantage will be extremely modest, at best. Similarly, while a legal entity RBC approach has been effective, it is premature to know if a group RBC Plus approach with new factors and applied using a different accounting base will be similarly effective.

- *"Largely factor-based methodology should lend itself to verifiable and auditable information...."*

  We are unclear whether this refers to "auditable" consolidated balance sheets with the application of factors subject to examination or to another form of audit. It's also unclear whether there is an expectation that the RBC Plus capital requirement would be required to be audited.

- *"Use of GAAP and leveraging off existing RBC elements should help constrain costs for the U.S. industry and state insurance regulators...."*

  While it is true that the framework for RBC elements exists, we are not convinced that the use of GAAP or "RBC-type" factors will constrain costs for industry and regulators. The development of credible factors will require significant time, thought, and resources. The use of GAAP is also unlikely to constrain costs equally across the industry because non-GAAP filers will need to invest significant resources to convert their financial statements to the proposed adjusted U.S. GAAP valuation basis. For companies that already file GAAP, any cost-containment benefit will be negated by the fact that companies will likely need to maintain statutory accounting for their legal entities.

- Differences in asset classifications among insurance groups create inconsistencies across groups. In a rising interest rate environment, groups with higher proportions of assets classified as held to maturity may have higher asset values and thus higher capital requirements under the RBC Plus.

- *"Segmentation of asset and liability risk categories could build on existing RBC segmentation...."*

  We are concerned that this statement reflects an overly simplistic view of asset and liability segmentation. Segmentation for GAAP is different than for U.S. statutory accounting practices. It may not be easy to translate GAAP for an NAIC factor-based approach that requires segmentation.

- *"Relationship of group RBC results to legal entity RBC requirements is likely to be more intuitive."*

  We believe this statement is premature. Given the complexity involved in developing new factors and using a different accounting basis, it is difficult to imagine that the relationship will indeed be "intuitive."

RBC-Plus Disadvantages: ACLI members see additional disadvantages to the proposed RBC-Plus methodology.

- We believe that for companies not currently required to file consolidated GAAP, there is no incremental benefit (but likely significant incremental cost) to creating an audited (or unaudited) GAAP balance sheet, which will be subsequently adjusted. For non-GAAP filers, the NAIC should preserve the option of allowing non-GAAP filers to begin with an audited set of SAP accounts. The audited SAP accounts could then be subject to an initial set of examinable adjustments to arrive at the proposed adjusted GAAP balance sheet. It is important that the NAIC seek to preserve this option for non-GAAP filers, particularly as it envisions creating a group-wide standard that may eventually have market-wide implications for groups of all sizes. There are U.S.-based IAIGs who are non-GAAP filers, in addition to many other market-participants who may eventually be affected by this standard. In a factor based approach, where factors are applied to specific liabilities to capture risks (*e.g.,* pricing, reserving, mortality/morbidity) appropriate product segmentation will be required to differentiate risk-based capital requirements for insurance companies. Segmentation should be based on a principle of reflecting different risks embedded in products, rather than based on a product's name. This is important because participating products vary widely across jurisdictions.
- If the 'RBC Plus' valuation were to move towards a market-adjusted valuation, it is critical to re-evaluate the discount rate used for best estimate liabilities. We believe developing a sound discount rate will significantly mitigate the inappropriate volatility and procyclicality concerns on long-term insurance products. However, this is a significant effort that will take significant time and many resources to address properly.
- Without significant adjustments, the 'RBC-Plus' approach would cause asymmetrical valuation because, in U.S. GAAP accounting practices, the assets are held at fair value, while the liabilities are held at amortized cost.

Cash flow advantages: No comment.

Cash flow disadvantages: ACLI members see additional disadvantages to the proposed cash-flow methodology.

- While a cash-flow methodology is conceptually very risk-sensitive, that becomes less true as the level of prescriptiveness increases for internal models. The more prescriptive modelling requirements are the less sensitive the model may become to actual risks, which decreases the utility of this approach.
- Cash flow methodology may not be the best methodology to measure all risks, such as catastrophe risk. Other forms of stress testing may work better to measure these risks.

ANNEX 1

Consideration	Proposed NAIC Approach	ACLI Comment
Valuation Method/Approach	Propose analyzing a cash flow approach and an enhanced RBC. [Cash Flow] The cash flows would be stressed to specifications associated with designated probability distributions usable by rating agencies and group supervisors. This would require a prescribed set of assumptions which should be internally consistent. [RBC Plus] An enhanced RBC would be more transparent than the current RBC as it would be associated with designated probability distributions in a similar fashion to those associated with the cash flow approach. Approach must take into account local jurisdictional environments.	ACLI believes that the NAIC should not proceed with either approach independent of the other members of Team USA. Any global capital standard must be flexible enough to be workable across the different, well-established solvency frameworks in place today. For the foreseeable future, such flexibility is an essential precondition to jurisdictions' willingness and political ability to adopt it into law and put it into practice
Risk Sensitivity	Propose to include all material risks including operational risk currently contemplated for RBC. See also note on ORSA. While risk sensitivity is important, any methodology should strive to minimize pro-cyclical volatility.	See comment re ORSA, below. We agree that any methodology must be designed to strive to reduce procyclical volatility.
Accounting Implications	Propose accounting neutral methodology (in practice this means minimal accounting implications).	Any methodology will unavoidably have accounting ramifications.
Aggregation	While the current RBC system would continue at entity level, an RBC Plus methodology could be constructed on a consolidated basis. The NAIC worked hard to keep an aggregated approach in ICP 17 and it would be the starting point in an RBC-based method. However, there is some agreement around attempting to convert RBC.	We request clarification of the last sentence, as we do not understand the meaning or implications of "attempting to convert RBC.
Use of Internal Models	Internal models (and externally crafted models by known providers) are essential to encompass risks such as CAT risk. Models should be approved by supervisors.	We suggest replacing the phrase "internal models" with the phrase "company models" to avoid confusion with Solvency II concepts. We request clarification about whether it is intended that insurers use the company model as approved.
Role of ALM	Should include an explicit ALM mismatch requirement for both Life and P&C. This would facilitate an explicit diversification allowance.	We agree that any insurance capital standard should recognize prudent mitigation of risks.
Diversification	There should be an explicit diversification allowance. Additional considerations should	The prudent mitigation of risk via diversification, reinsurance, hedging, asset-liability management, etc.,

Consideration	Proposed NAIC Approach	ACLI Comment
	include: 1) lines of business considerations and 2) geographical diversification.	should be recognized within any insurance group capital standard. The loss-absorption capacity of participating long-duration products and of adjustable products with non-guaranteed elements must be recognized because for those products, policyholders have agreed to share the risk. Other insurance specific structures and product features, such as policy loans and separate accounts and participating policies, must be addressed appropriately also.
MOCE	Give companies full credit for MOCE.	For the purpose of calculating consolidated capital, an insurance group capital standard should take into account any prudence within an insurer's accounting and valuation bases and should credit as capital such amounts available for loss absorption, while recognizing that such capital may not be available for loss absorption outside of the legal entity holding those amounts
ORSA	Use ORSA tools and Form F to inform risk parameters	We request clarification of this statement. In addition, we are not clear on how industry-wide risk parameters might be derived from ORSA tools.
Senior Notes	On consolidation there is no net effect of senior notes, but such notes would continue to be taken into account in entity based capital requirements.	
Surplus Notes	Surplus notes would be counted as capital as currently *(sic)*.	Surplus notes should be counted as capital.

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December 5, 2014

BY ELECTRONIC MAIL

Kevin M. McCarty
Chair
ComFrame Development and Analysis Working Group
International Insurance Relations (G) Committee
National Association of Insurance Commissioners

RE: Comments of the American Insurance Association on NAIC U.S Group Capital Methodology Concepts Discussion Paper

Dear Commissioner McCarty:

The American Insurance Association (AIA)[1] offers the following comments in response to the U.S. Group Capital Methodology Concepts Discussion Paper (Capital Concepts Paper) issued by the National Association of Insurance Commissioners (NAIC) ComFrame Development and Analysis Working Group (CDAWG) and discussed during the fall 2014 national meeting in Washington, DC.

BACKGROUND

AIA views the capital discussion as one component of the larger regulatory modernization debate currently taking place at the state, national, and international levels. AIA's public policy position on group-wide supervision and the nature and degree of future financial regulation is informed by March 2013 Board-approved group-wide supervision principles that cover (1) the purpose, scope and structure of regulation and supervision; (2) capital assessment and other measures applied to property-casualty insurance companies; and (3) financial reporting and confidentiality of company data. Importantly, our Board has instructed AIA to engage constructively in the capital standards discussions, and, in June 2014,

[1] AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to consumers and businesses across the United States and around the world. AIA members write more than $117 billion annually in U.S. property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums.

directed the internal development of a conceptual approach to an Insurance Capital Standard (ICS) that meets our principles, advances competitive insurance markets around the world, and encourages efficient, effective regulation that protects insurance consumers. Our internal discussions are ongoing, but we submitted public comments to the International Association of Insurance Supervisors (IAIS) on October 14, 2014 (in advance of the Observer Hearing in Amsterdam) that laid out an interim conceptual approach to the ICS that could be applied based on existing jurisdictional standards today. Those comments are attached to this submission as a reference and to provide context. The interim approach is not intended to displace or otherwise interfere with group capital standards that may be applicable to non-U.S. Internationally Active Insurance Groups (IAIGs), but to provide a workable pathway forward in the current regulatory climate while acknowledging the significant challenges that remain. Indeed, given our Board's directive to develop a workable, long-term approach to the IAIS' ICS, we are focusing on shifting from this interim measure to an approach that, over time, will address the numerous constraints that exist in the capital standards discussion and achieve an appropriate balance between prudential oversight and the ongoing ability of companies to manage their respective businesses.

AIA and its diverse member companies[2] have a substantial interest in the ICS, as its development will influence the different local jurisdictional capital standards and approaches that our companies must navigate as they conduct business in those markets. As AIA has sought to adhere to its principles in the ICS discussions, we have emphasized the following aspects of those principles:

- **Single group-wide supervisor**. Group-wide supervision of property-casualty insurance companies should be carried out by a single group-wide supervisor in a manner consistent with the business model, and all participating regulators (including the group-wide supervisor) should act within their respective spheres of authority.

- **Financial regulation and business management.** Assessment of a group's financial condition is a fundamental aspect of group-wide supervision, but regulatory oversight should not be undertaken in a way that undermines the business judgment exercised by the group in managing its risks, particularly decisions on how, when, and where to deploy capital. Where sensitive business strategies and information are shared with a group's regulators, that information should be protected from public dissemination or disclosure.

- **Capital adequacy assessment must incorporate an understanding of the group's perspective**. Group capital adequacy assessment is both a quantitative and qualitative process. Understanding the manner in which a group manages its risks and makes its capital decisions is critical, and the ORSA is an important aspect of achieving that understanding.

- **Capital standard development should be clear to all stakeholders and the result of a deliberative process**. A global group ICS should be transparent in its development, operation, objective,

[2] AIA's membership includes U.S. insurers that write insurance only within the U.S., U.S. insurers that write insurance inside and outside the U.S., and insurers that are U.S. subsidiaries of multi-national insurers. This membership diversity enables AIA to analyze issues from many perspectives and allows us to draw on the global experience and expertise of our companies with many forms of insurance regulation. The diversity has been helpful in AIA's navigation of the ICS discussion, and there may be a point where consensus on some issues cannot be achieved. However, we believe that both the areas on which we reach consensus and the areas where there may be no consensus will help inform the ICS dialogue both here and at the international level.

definitions, scope and relationship to local jurisdictional standards, as well as other capital standards initiatives such as the Basic Capital Requirement (BCR) and Higher Loss Absorbency (HLA). With respect to the latter, additional capital would be required to be held by groups identified as Systemically Important Financial Institutions (SIFIs) or Global Systemically Insurers (G-SIIs), and should not apply to groups that are not so designated. Moreover, time deadlines for developing an ICS should not trump the importance of getting the standard right.

In short, there are a number of complex and recurring issues involved in developing an ICS as a component of group-wide supervision, and AIA's support for the U.S. position and, ultimately, the IAIS ICS will be guided and judged by alignment with our principles.

EXECUTIVE SUMMARY

In providing our comments, AIA assumes that the Capital Concepts Paper is intended as an initial step in developing a unified U.S. approach to group capital, and that the next step would be to navigate the additional issues (for example, the type, nature and extent of valuation adjustments) necessary for the U.S. to contribute to the IAIS ICS process. As such, our comments are based on that assumption, and we reserve the opportunity to further evaluate those concepts as they mature. Viewed in this context, AIA appreciates the narrowing of group capital approaches that the NAIC advances in the Capital Concept Paper to the two outlined proposals. The Paper builds on the September 2014 ICS Forum, where nine approaches were presented for review and discussion. As set forth in more detail below, AIA offers the following points for the NAIC's consideration:

1. Any U.S. group capital approach must not be: (i) a basis for multiple group-wide supervisors, (ii) a justification for subgroup supervision or a material change in group-wide supervisor for U.S.-based IAIGs, or (iii) applied to non-U.S. based IAIGs.

2. Ultimately, if consensus is achieved on a U.S. group capital approach, the NAIC (in conjunction with the Federal Reserve Board and the Federal Insurance Office) must tackle those issues and constraints that are a part of the IAIS ICS development process. Those issues include clear definitions of terms (such as capital and comparability), reconciliation of regulatory objectives, scope and extent of enforcement authority, valuation adjustments and relationship to local jurisdictional standards, degree of regulatory discretion and control, and the appropriate balance of qualitative and quantitative aspects of group capital adequacy assessment. Efficiency and effectiveness of regulation and supervision are key aspects of AIA's principles, and a proliferation of potentially inconsistent and duplicative capital standards undermines those facets.

3. The Dodd-Frank Act (DFA) simultaneously grants federal prudential authority over insurance thrift holding companies and designated insurance SIFIs, and expressly preserves state insurance regulatory authority. Thus, any U.S. insurance group capital approach, even if ultimately adopted by the Federal Reserve in the form of a differentiated capital rule, must give consideration to how it manages to meet "policyholder protection" objectives, even if there is also consideration of "going concern" objectives.

4. Given the identified pros and cons of the two approaches, the NAIC should consider the merits of an RBC Plus (factor-based) approach that is supplemented by the stress scenario test features of a cash-flow approach that are appropriate for property-casualty insurance

companies, and which leverages the recognized capital adequacy assessment benefits of an Own Risk and Solvency Assessment (ORSA). Property-casualty insurance companies have strong concerns that a strict "cash-flow" analysis does not work for their business, but there may be appropriate stress scenario tests that can be employed in conjunction with a group's ORSA that would add value to the factor-based approach, and potentially enhance comparability if consensus can be reached on a common stress severity level.[3]

5. We would strongly encourage the NAIC to ground any capital approach in applicable U.S. law, as well as the Insurance Core Principles (ICPs). An authoritative base will ultimately provide the foundation for a unified U.S. position and a contribution to the IAIS process.

We appreciate the complex constraints that the NAIC faces in developing a consensus U.S. position on group capital. We believe that the NAIC has moved the process ahead by releasing the Capital Concepts Paper. Our specific comments on various aspects of the Paper follow.

DISCUSSION

A. Analysis of Individual Suggested Approaches.

The Capital Concepts Paper acknowledges that both the *RBC Plus* and the *Cash Flow* approaches present difficulties for insurers and regulators. However, using the RBC Plus approach as a foundation and complementing that approach with appropriate stress testing aspects of a cash flow analysis conducted as part of a group's ORSA may overcome the individual shortcomings of a stand-alone approach. In any event, we would encourage the NAIC to have this discussion with interested parties.

1. *RBC Plus* Approach.

a) Development of this approach will require significant commitment of time and resources in order to develop the requisite group risk categories and related risk factors. Group data does not yet exist for risk categories that have yet to be defined; and without that data, appropriate risk factors cannot be developed. Further, the development timeframe contemplated by the IAIS is insufficient for maturation of this approach. It should be added that AIA's internal ICS discussions have also raised the concern that a risk sensitive approach that would meet IAIS current, stated objectives would require significant investment in time and resources.

b) So far, the IAIS discussion papers regarding ICS have not affirmatively indicated a ladders-of-intervention structure, though there have been hints of such an expectation. As this approach is presumably based on required capital levels that trigger regulatory intervention, the ramifications of breaching those levels must be clarified, particularly at this stage when consensus on a U.S. position is being considered.

[3]For ICS purposes, an RBC Plus approach that is enhanced with appropriate stress scenario testing may take more time to develop than the timeline provided by the IAIS. Thus, as referenced, AIA suggests the NAIC consider an interim capital approach that looks to local capital requirements and an ORSA-type review while developing and testing the enhanced RBC Plus approach as it builds consensus in the U.S. To be clear, such an approach would not be proffered as the U.S. position in the IAIS discussions.

c) Adjustments are mentioned in the NAIC paper (both for SAP filers and for risk factors/categories), but there is no detailed discussion of what those adjustments may be, what resources/time will be needed to calibrate the new factors, and whether the necessary data elements are available. And given the concern over IAIS' expressed desire to assess IAIG capital adequacy by using market-adjusted financial statements, there has been sharp disagreement among industry about the nature of the "adjustments."

d) A factor-based (RBC Plus) approach does not use an internationally consistent balance sheet because of differences in accounting standards. Different balance sheet presentations may lead to inconsistent groupings of data, which may in turn result in risk categories and risk factors that will eventually be inconsistent across jurisdictions once a U.S. position is established.

e) Group risk factors must be developed to reflect differences in local products and risks, in order to develop a factor-based approach that can be risk-sensitive to differentiate among groups. AIA members have also emphasized that a group capital standard must also reflect the impact of diversification, which is a fundamental aspect of the property-casualty business model.

2. *Cash Flow* Approach.

a) This approach relies heavily on the use of internal models, so there is regulatory concern about loss of control and difficulty of validation. Though AIA has not taken a formal position on cash flow analysis, discussions with AIA member companies suggest that ORSAs are already conducted and that companies use internal models for planning purposes. The ORSA and internal models are tools with which regulators are familiar. From the industry perspective, therefore, the challenge will be to find a balance between regulatory validation and company-supplied assumptions and parameters for the models.

b) As noted in 1(e) above, the risks of the property-casualty sector are more localized (e.g., catastrophe risks and differing legal environments among jurisdictions). Thus, developing appropriate scenarios that would provide consistent severity and consistent stress of cash flows across jurisdictions and across product lines would be challenging.

3. *Consideration of a Foundational Use of RBC Plus, Supplemented by ORSA-based Stress Tests*.

The advantage of the RBC Plus approach is that it is a factor-based approach, for which the IAIS has already shown a preference. Also, the RBC concept is familiar to the U.S. insurance industry, although this approach will increase compliance burden on the insurance industry in developing group-level factors. The Cash Flow approach is advantageous because it does not rely on any particular accounting system. It may be worthwhile for the NAIC and its colleagues on "Team USA" to consider whether the RBC Plus proposal might be an appropriate foundation, leveraging the strengths of the Cash Flow approach through supplemental appropriate stress scenario testing and the qualitative capital adequacy assessment features of a group's ORSA.

If the NAIC considers a capital standard approach, it must take into account the following issues:

- Modifications, such as adapting the cash flow approach to accommodate appropriate stress scenarios for property-casualty risks, will be necessary.
- Regulators must consider whether a new set of quantitative metrics can be derived from this approach.
- Decisions must be made on whether regulatory validation of internal models is needed and, if so, how to effectively integrate that validation process with minimal impact on the management of the IAIG.
- An overarching concern will be the extent and nature of adjustments and related volatility.
- The NAIC's capital approach should be based on the ICPs and federal law (DFA).

4. Interim Approach

Development of an acceptable approach would need to be evolutionary, requiring significant lead-time to develop, test, and implement. In the meantime, an interim model may be necessary while the approach is being developed. The interim conceptual approach discussed in AIA's October 14th comments identifies risk categories based on a legal entity listing for the group that describes all subsidiaries and affiliates of the insurance group. A determination of capital would be based on the aggregation of required capital for regulated entities and for risks not otherwise captured. In the U.S. this interim approach would provide regulators with a way to become comfortable and adapt to a group capital construct while building consensus on the longer-term approach. For U.S. companies in particular, DFA introduces federal prudential supervision for a segment of the industry that runs parallel to state insurance regulation.

This interim approach could be used to develop an initial view of a group's regulatory capital needs based on local capital requirements that are already in place in the U.S., while preserving the ability to look at the financial state of the individual legal entities. This interim approach is not intended to displace group capital standards that may already be in place for non-U.S. IAIGs, nor is it intended to displace existing risk-based capital standards applied by the states. It is simply a method to calculate group capital under current law – without any adjustments. To the extent applicable group capital standards exist, such an interim approach would not be needed.

Because aggregation can help in identifying and isolating a legal entity source of financial weakness within an IAIG, it is of value in those jurisdictions, like the U.S., that regulate insurance at the entity level. Again, as noted at the outset of our comments, some AIA members are already subject to group-wide supervision, including a regulatory view of group capital. In those instances, the interim approach would not apply in deference to the group-wide regulatory perspective already in place.

Finally, and importantly, it provides a glide path for U.S. consideration of an enhanced RBC Plus approach, which will hopefully lead to a unified U.S. position going forward on the IAIS ICS initiative.

B. Fundamental Challenges in Making a Contribution to the IAIS ICS Process.

To successfully develop an approach initially as a U.S. group capital construct and to ultimately contribute to the IAIS development process, "Team USA" must address other constraints and issues. Those constraints include, for example:

- **Definitions:** The lack of clear and consistently defined terms (for example, comparability, capital, and "risk-based") continues to introduce confusion and misconceptions into the broader capital standards discussion. The U.S. group capital construct must clearly define key terms and clarify how those terms enhance the ability of supervisors to assess capital adequacy.[4]

- **Clear Regulatory Objectives:** Identifying, balancing and articulating upfront the regulatory objectives of a capital regime will be fundamental to gaining support for this approach. Too often, long-held regulatory philosophies, such as protecting the policyholder or preserving the financial strength of the holding company, have been viewed as competing philosophies. The "Team USA" leadership may need to consider if the two philosophies can be harmonized. The additional regulatory interest in developing a capital standard that reflects comparability and risk sensitivity has further complicated the discussion of regulatory objective. A U.S. group capital approach should clarify the regulatory objective.

- **Incorporation of Risk Diversification:** Diversification of risk is a basic premise behind the property-casualty business model. Thus, any proposal must incorporate an approach that effectively reflects the diversification of risk.

- **Parameters of Authority and Consequences of Capital Breach:** Understanding the extent of regulatory authority and its legal and practical limitations should guide decisions on the effective use of an ICS. If a goal of developing an ICS is to create a ladders-of-intervention mechanism for IAIGs, that expectation must be stated. Given the limitations of unilateral action on the members of a group, Team USA leadership should consider the possible impact of breaching an ICS level and the additional action that may be necessary to address that breach.

- **Valuation Adjustments:** A decision must be made about the extent/nature/type of valuation adjustments that will be the starting point for assessing group capital. There is a strong split of opinion about using local accounting rules or using a market-based approach. The Team USA leadership must be transparent as to how it resolves this conflict in views in arriving at a U.S. position. Any approach that this process yields should clearly reflect how local valuation standards are incorporated.

- **Balance of Regulation and Company Management of its Business**: The degree of regulatory discretion/control desired over the group should be tempered by the realization that business and capital decisions rest with the management of the group, and not regulators.

- **High-Level Capital Adequacy Assessment and the Role of Capital Standards:** When assessing the capital adequacy of a group, there must be a balance in the use of quantitative and qualitative assessment tools.

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[4] For example, capital instruments should be defined and treated as qualifying capital resources when they are issued in jurisdictions like the U.S., whose local regulatory system and market practices consistently treat them as subordinate to policyholder liabilities. In particular, we believe that senior debt issued by a U.S. holding company and contributed as equity to an insurance subsidiary should be treated as capital in any group capital assessment, given the structural subordination of the debt obligation to the policyholders. This structural subordination is reinforced by the U.S. regulatory system, which requires approval of dividends from an insurance subsidiary to the holding company. Concluding otherwise would be inconsistent with long-standing U.S. industry/regulatory practices and the capital treatment applied globally by rating agencies.

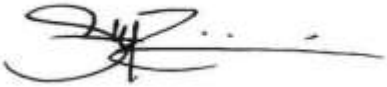
- **Data Needs and Requirements:** Ongoing updates and maintenance of data will be necessary in order to sustain an approach over the long term.

CONCLUSION

The Capital Concept Paper has provoked thoughtful discussion and moved the U.S. debate forward, and the NAIC CDAWG is to be commended for its efforts. AIA appreciates the opportunity to provide feedback. As our comments stress, the Paper was a needed initial step, but there is much work yet to be done to first develop consensus within the U.S. and then to continue the U.S. leadership needed to guide the IAIS to a workable ICS. The pathway is littered with complex issues that will challenge the patience of all the participants and constituencies of Team USA. Many of those issues – notably, the proper scope, parameters, and balance of authority needed to carry out global group-wide supervision of distinct, yet competitive international insurance firms – will recur in the ICS debate, and in other concurrent group-wide supervision discussions. Guided by our principles, AIA and its members stand ready to contribute to these discussions. The steady development of vibrant, competitive insurance markets depends on a positive regulatory outcome.

Respectfully submitted,

Respectfully submitted,



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cc: Ryan Workman

Attachment

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October 14, 2014

BY ELECTRONIC MAIL

Mr. Michael R. McRaith
Director, Federal Insurance Office
U.S. Department of the Treasury
Chair, IAIS Technical Committee

Ms. Elise Liebers
Senior Director
Financial Regulatory Affairs, International Policy & Market Surveillance
National Association of Insurance Commissioners
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RE: Comments of the American Insurance Association on IAIS Draft Insurance Capital Standard (ICS) Principles

Dear Chairman McRaith and Acting Chairman Liebers:

The American Insurance Association (AIA) is providing this written submission in advance of the International Association of Insurance Supervisors (IAIS) October 20, 2014 Observer Hearing on the development of a group insurance capital standard (ICS). AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to consumers and businesses across the United States and around the world. AIA members write more than $117 billion annually in U.S.

property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums.

AIA's membership includes U.S. insurers that write insurance only within the U.S., U.S. insurers that write insurance inside and outside the U.S., and insurers that are U.S. subsidiaries of multi-national insurers. This membership diversity enables AIA to analyze issues from many perspectives and enables us to draw on the global experience and expertise of our companies with many forms of insurance regulation.

AIA and its member companies have a substantial interest in the ICS, as its development will influence the different local jurisdictional capital standards and approaches that our companies must navigate as they conduct business in those markets. In the United States, many insurance companies will continue to be subject to state-based regulation, while others may be subject to national (federal) prudential supervision under the Dodd-Frank Act because their organizational structure includes a depository institution holding company, or because of their designation as a systemically important financial institution (SIFI).

Given AIA's diverse membership, property-casualty oriented perspective and commitment to constructive engagement with the IAIS, we thought that it would be helpful to report on our internal discussions and progress on a proposed conceptual approach to the ICS and to provide feedback on the IAIS ICS Principles. As part of the Comprehensive Framework for the Supervision of Internationally Active Insurance Groups (IAIGs) ("ComFrame"), the ICS is an important component of group-wide supervision. In this context, establishing clear lines and scope of authority among supervisors will continue to be key issues to address as the ICS is developed. For this reason, AIA has included some background on its engagement in the group-wide supervision discussion.

We have also been working cooperatively with the American Council of Life Insurers (ACLI) and the Reinsurance Association of America (RAA) in a continuing effort to present a united U.S. industry voice on the ICS.

I. AIA APPROACH TO THE ICS INITIATIVE

A. AIA's Group-Wide Supervision Principles

Implementing effective and efficient group-wide supervision that employs the right balance of regulatory enforcement and forbearance in deference to a group's management of its own risk and business plan is a daunting challenge. That challenge is made even more difficult where multiple jurisdictions, lines of authority and regulatory approaches are involved, and where the failure of a group with diversified financial institutions may produce consequences not only for that group's customers, but could also be the catalyst for instability across the financial spectrum.

As the global, national and local regulatory discussions advanced, AIA developed a set of principles designed to help guide our policy position in these intersecting forums as initiatives were being developed. In establishing principles, AIA sought to ensure that any regulatory outcomes in the area of group-wide supervision be directed primarily at understanding group-wide business models and perspectives, and preserve the ability of insurance companies to compete effectively and facilitate the growth of private markets. Perhaps more important, underlying those principles was a fundamental policy of constructive engagement by AIA in regulatory reform discussions that would (and will) shape the ability of our member companies to conduct business in the United States and around the world.

Over time, as the debate evolved within and outside the U.S., we refined our principles, which were approved by the AIA Board in March 2013 and are attached to this submission. The AIA principles are organized into three broad categories:

1. The purpose, scope and structure of regulation and supervision (principles 1 – 7);
2. Capital assessment and other measures applied to property-casualty insurance companies (principles 8 – 10); and
3. Financial reporting and confidentiality of company data (principles 11 – 17).

As discussed in the AIA principles document, there should be a clear recognition that the property-casualty insurance business model, regulatory framework, and company management and investment practices largely shield regulated property-casualty insurance companies from being a source of systemic risk. The principles document also recognizes the need for an equally clear distinction between the type and degree of supervision that is applied to financial firms that are designated as systemically important, as opposed to other financial firms. AIA's principles document further clarifies that regulators should not be constrained from proposing solutions "that would mitigate or prevent" the ability of companies – whether engaged in insurance or any other type of financial product or service – to conduct business that is not transparent to regulators or the financial markets.

As the capital standards initiatives advanced both internationally and within the U.S in the wake of the Financial Stability Board's (FSB) July 2013 directive to the IAIS, and as the NAIC and states tackled the issue of U.S. group-wide supervision, the AIA Board asked for a distillation of those tenets – consistent with our principles – that are at the heart of the capital discussion. They are:

1. Group-Wide Supervision of Property-Casualty Insurers. Supervision of insurance groups should focus on understanding the relevant insurance business model and the interaction of business activities across the enterprise that give rise to enterprise risk. The property-casualty insurance business model operates on an "inverted cycle of production" where premiums are collected in advance

from each policyholder to fund claims for those policyholders having claims, thereby promoting increased financial stability. Appropriate quantitative and qualitative aspects of group-wide supervision rely on an understanding of this model.

2. Group-Wide Supervisor. All group-wide supervision of insurance should be exercised only by a governmental agency consistent with, and no broader than, the legal authority under which the agency acts. Supervisory roles and responsibilities should be non-duplicative, and should not be confused with regulatory enforcement authority that may be exercised by individual regulators with respect to legal entities operating within their respective jurisdictions. Consistent with that principle, although there may be a number of legal entity regulators for different companies within an insurance group, there should be only one group-wide supervisor.

3. Transparency and Clear Delineation of Group-Wide Supervisory Responsibilities. The process for designating the group-wide supervisor of a multi-jurisdictional group of regulated insurance companies should be clearly established and understood by all stakeholders. A number of factors may determine the group-wide supervisor, but those factors should be discussed among all stakeholders with an aim towards consensus. The insurance group should play a principal role in determining the group-wide supervisor as part of the stakeholder process. Coordination should occur through the group-wide supervisor, with an emphasis on regulatory efficiency. In any event, the process and delineation of regulatory and supervisory responsibilities should minimize any overlap or inconsistency, and not increase the potential for conflict. Recognizing that the process and delineation of responsibilities should not cause regulatory conflict, it should also show due respect for those jurisdictions that have an authoritative basis for the establishment or designation of the group-wide supervisor. In cases where there is no stakeholder consensus or there is a conflict among two or more regulators as to who should exercise group-wide supervision, a transparent process for obtaining consensus or resolving the conflict should be established in advance.

4. Group Financial Supervision is Not Systemic Risk Regulation. Insurance group supervision should <u>not</u> be confused with enhanced regulation that may be applied to diversified nonbank financial companies that are determined to be systemically important financial institutions (SIFIs). The SIFI designation process is based on an assessment of quantitative and qualitative risk-related considerations designed to identify <u>only</u> those activities of nonbank financial companies that might threaten the financial stability of the U.S. for domestic SIFI determinations, or more broadly, for G-SII determinations.

5. Role and Fungibility of Capital. Capital requirements in a group setting may have multiple objectives such as policyholder protection and/or as a means to encourage effective enterprise risk management. For groups determined to be systemically important, capital may also serve as a disincentive to engage in systemically risky activities. Any regulatory proposal for maintaining group capital requirements should clearly identify the regulatory objective and be transparent in its formulation. Fungibility (or lack thereof) of capital, particularly in stress situations, should be part of the group capital assessment process.

6. Group Capital Assessment and ORSA. Evaluation of group capital adequacy is fundamentally a matter that takes into account the risks arising from the business underwritten by the insurance group, the interaction of the affiliates within the insurance group structure, the risk appetite of the group, group diversification benefits, and the group's strategy for managing (i.e., mitigating, transferring, or hedging) its risks. Sound financial supervision should begin with the internal assessments by insurance groups – such as the group's Own Risk and Solvency Assessment (ORSA) – of their financial condition and enterprise risk. The ORSA should be a primary tool by which the group-wide supervisor assesses the management of risk and the adequacy of group capital. Supervisors should be careful to ensure that the assessment of capital adequacy does not become a regulatory substitute for management judgment.

7. **Group Capital Standards Development**. Understanding that the FSB has directed the IAIS to meet certain time deadlines for completing its work on the BCR, ICS, and HLA, and that the IAIS is adhering to those deadlines, the development of group capital standards should be advanced with full consideration of the underlying issues, including the principles herein. The development process should also consider any adverse consequences that might flow, including increased costs of capital, reduced ability to deploy capital to provide insurance capacity, and the introduction of volatility to insurers' balance sheets (and the consequent deterrent effect on investment).

8. Confidentiality. In order to promote full and interactive communication with supervisors, the protection of confidential information and trade secrets cannot be open to any doubt, debate or question. Where information is collected and shared among different jurisdictional or functional regulators, confidentiality and privilege protections that attach to that data must be preserved. Consistent with the foregoing, confidentiality agreements entered into as part of a group-wide supervisory process should be binding on all recipients of confidential information.

In sum, AIA's policy on group-wide supervision and development of a global insurance capital standard emphasizes the following points:

- Group-wide supervision of property-casualty insurance companies should be carried out by a single group-wide supervisor in a manner consistent with the business model, and all participating regulators (including the group-wide supervisor) should act within their respective spheres of authority.

- Assessment of a group's financial condition is a fundamental aspect of group-wide supervision, but regulatory oversight should not be undertaken in a way that undermines the business judgment exercised by the group in managing its risks, particularly decisions on how, when, and where to deploy capital. Where sensitive business strategies and information are shared with a group's regulators, that information should be protected from public dissemination or disclosure.

- Group capital adequacy assessment is both a quantitative and qualitative process. Understanding the manner in which a group manages its risks and makes its capital decisions is critical, and the ORSA is an important aspect of achieving that understanding.

- A global group ICS should be transparent in its development, operation, objective, definitions, scope and relationship to local jurisdictional standards, as well as other capital standards initiatives such as the BCR and HLA. With respect to the latter, additional capital required to be held by groups identified as SIFIs or G-SIIs should not apply to groups that are not so designated. Moreover, time deadlines for developing an ICS should not trump the importance of getting the standard right.

B. Challenges to the Development and Implementation of an Effective ICS

AIA recognizes that the development of an ICS is evolutionary and that, even internally, there are a number of challenges that will need to be discussed and worked through in order to refine the approach. Those constraints are:

1. Unlike financial market based products, the risk for property-casualty insurance products is generally local, and products with similar names in different jurisdictions can sound similar, but the risks could be substantially different. Therefore, the risk factors will have to be developed for each jurisdiction, which would likely take more time than the current timeframe and require substantial resources (there may be historical information issues in some jurisdictions as well).

2. As discussed at the IAIS, the use of internal economic capital models is important to understand, and should be defined by appropriate principles that allow for regulatory validation, but avoid the usurpation of business assumptions.

3. The purpose of capital will have to be defined, which can be challenging as different jurisdictions have different views on who should be protected by

capital, and most jurisdictions have additional mechanisms, other than an individual company's capital, to protect policyholders in at least certain lines of business.

4. In the areas of accounting and valuation, there is no international consensus on the appropriate accounting regime as IFRS is not complete (and not adopted consistently globally), and US GAAP and IFRS are unlikely to be brought together in a single system in the near future.

5. There are varied solvency regimes/regulatory objectives. Jurisdictions are unlikely to choose to conform their current regimes immediately for a number of reasons, not the least of which is the potential for additional costs to policyholders. Adopting the ICS in a jurisdiction would also mean abandoning approaches customized for local exposures, which were created after extensive time, effort and (at times) local political compromise.

6. Fungibility of capital will have to be addressed.

7. Group-wide diversification will need to be explicitly considered in determining the capital standard, and as part of the overall capital adequacy assessment process.

It will take time to work through these different challenges, and to determine the best outcome for all stakeholders. AIA believes that it is important to have these conversations and to recognize that the ICS may evolve over time. As we have noted, getting the ICS done by a particular deadline is less important than ensuring that it works for all stakeholders.

C. AIA Efforts on an ICS Conceptual Approach: An Interim Report

This past June, based on these principles, the accelerating capital discussions, and the overriding view that AIA be a productive part of those discussions, the Board directed AIA to work with the member companies on an acceptable conceptual approach to the ICS, and to report back to the Board on its progress this November. Since then, AIA staff and senior member company representatives have been meeting regularly to work through the issues and develop a concept that can be shared with our Board.

While, as noted, there are significant constraints to overcome, thus far, we have discussed an ICS interim conceptual approach that identifies risk categories based on a legal entity listing for the group that describes all subsidiaries and affiliates of the insurance group. A determination of capital would be based on the aggregation of required capital for regulated entities and for risks not otherwise captured. That capital determination would include:

1. An aggregation of regulatory capital (founded on the standard for regulatory intervention) for all insurance subsidiaries based on each jurisdiction's requirements;
2. An aggregation of required capital for all other regulated entities (e.g., bank capital); and
3. A determination of required capital for group risks that are not part of regulated entities.[1]

In addition, each group would be required to complete an ORSA based on management's view of the risks impacting (or potentially impacting) the insurance group, with appropriate stress scenario testing employed to evaluate that view and to assess group capital.

Within the conceptual framework of an ICS, there should be clear separation between IAIGs and G-SIIs for purposes of applying capital measures. Capital tools such as HLA are designed to address systemically risky activities of a G-SII, and therefore are not appropriate for IAIGs. To this end, in the U.S. as part of the Dodd-Frank Act domestic SIFI designation/screening process, the FSOC instituted (by rule) a three-stage process for determining whether a non-bank financial company should be designated as a SIFI. The first stage identifies total consolidated asset size ($50 Billion or more) plus one of five additional metric thresholds that are SIFI indicators (based on public information).[2] The IAIS should consider whether a series of similar quantitative metric thresholds might be a useful way to screen companies across the financial services spectrum, rather than the current sector-by-sector approach.

II. ICS DEVELOPMENT MUST BE CONSISTENT WITH FUNDAMENTAL PRINCIPLES GOVERNING GROUP-WIDE SUPERVISION

Finally, AIA has reviewed the IAIS's ICS Principles for consistency with AIA's principles and the direction of our interim conceptual approach to the ICS. Below we have provided some commentary on the Principles for the IAIS's consideration.

<u>ICS Principle 1</u> – The ICS is a consolidated group-wide standard with a globally comparable risk-based measure of capital adequacy for IAIGs and G-SIIs. The standard incorporates consistent valuation principles for assets and liabilities, a definition of qualifying capital resources and a risk-based capital requirement. The amount of

[1] For jurisdictions that employ a group capital standard, the aggregation may not be necessary, but the concept would be consistent with an approach that reflected capital across the enterprise.

[2] Those additional metric thresholds are: (a) $30 billion in *gross notional credit default swaps outstanding* for which the group is the reference entity; (b) $3.5 billion in *derivative liabilities* (in accordance with Accounting Standards Codification 815); (c) $20 billion in *outstanding loans borrowed and bonds issued;* (d) a minimum *leverage ratio* of total consolidated assets (excluding separate accounts) to total equity of 15 to 1; and (e) a minimum *ratio of short-term debt (maturity of less than 1 year) to total consolidated assets* (excluding separate accounts) of 10%.

capital required to be held and the definition of capital resources are based on the characteristics of risks held by the IAIG irrespective of the location of its headquarters.

AIA believes that a globally comparable risk-based measure can be achieved without the creation of a new accounting construct. We encourage the IAIS to review our interim conceptual approach. In addition, ICS Principle 1 should be consistent with ICS Principle 5 and leave no room for confusion. ICS Principle 5 emphasizes comparability under existing national regulatory regimes on an outcomes basis.

<u>ICS Principle 2</u> – The main objectives of the ICS are protection of policyholders and to contribute to financial stability. The ICS is being developed in the context of the IAIS Mission, which is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability.

AIA recognizes that capital requirements in a group setting may have multiple objectives such as policyholder protection and/or as a means to encourage effective enterprise risk management. For groups determined to be systemically important, capital requirements may also serve as a disincentive to engage in systemically risky activities. For ICS purposes, AIA believes the ICS should be used to assess the capital needs of the insurance activities within the group. It should not be used to assess the capital needs of non-insurance activities because that determination is more appropriately performed by the applicable supervisors for those activities. AIA believes that providing the proper amount of capital to meet insurance obligations will, by definition, contribute to the stability of the overall group.

ICS Principle 3 – ICS is the foundation for HLA for G-SIIs. Initially, the BCR is the foundation for HLA for G-SIIs.

AIA believes the objectives of an ICS are different from the objectives of HLA and should not be referenced interchangeably. It is premature to make a determination of the ICS relationship to the HLA, given the need to first develop a representative, risk-sensitive approach to ICS, obtain relevant data, and apply sufficiently rigorous testing to evaluate the utility of a proposed ICS.

ICS Principle 4 –The ICS reflects all material risks to which an IAIG is exposed. The ICS reflects all material risks of IAIGs' portfolios of activities taking into account assets, liabilities, non-insurance risks and off-balance sheet activities. To the extent that risks are not quantified in the ICS they are addressed in ComFrame.

AIA believes the ICS should reflect all material risks of the **insurance activities** within an IAIG. Insurance supervisors do not have the necessary training, experience or legal authority to assess the capital adequacy of activities that are under the jurisdiction of non-insurance supervisors. Consequently, the ICS should be a component of a robust quantitative and qualitative assessment of all material risks of an IAIG, with such assessment being performed on a multi-jurisdictional basis with assistance from supervisors with jurisdiction over the non-insurance activities.

ICS Principle 5 – The ICS aims at comparability of outcomes across jurisdictions and therefore provides increased mutual understanding and greater confidence in cross-border analysis of IAIGs among group-wide and host supervisors. Applying a common means to measure capital adequacy on a group-wide consolidated basis can contribute to a level playing field and reduce the possibility of capital arbitrage.

AIA agrees with comparability of outcomes, recognizing however that a suitable methodology for achieving comparable results will take some time to develop, due to local jurisdictional requirements and lack of enforceability. Determining a group's capital adequacy must necessarily take into account the fungibility of capital, given local jurisdictional limits on capital transfers.

ICS Principle 6 – The ICS promotes sound risk management by IAIGs and G-SIIs.

AIA supports ICS Principle 6. The ICS should recognize (and credit) proper mitigation of risks and prudent behavior.

ICS Principle 7 – The ICS promotes prudentially sound behaviour while minimizing inappropriate procyclical behaviour by supervisors and IAIGs. The ICS does not encourage IAIGs to take actions in a stress event that exacerbate the impact of that event. Examples of procyclical behaviour are building up high sales of products that expose the IAIG to significant risks in a downturn or fire sales of assets during a crisis.

While procyclicality is more of a concern for life insurance companies, AIA supports the concept of minimizing procyclical behavior. We suggest deleting the examples, as they are not appropriate for an overarching principle. We appreciate the reference to stress scenario events, as we have identified appropriate testing as a key component of our interim conceptual approach.

ICS Principle 8 – The ICS strikes an appropriate balance between risk sensitivity and simplicity. Underlying granularity and complexity are sufficient to reflect the wide variety of risks held by IAIGs. However, additional complexity that results in limited incremental benefit in risk sensitivity is avoided.

AIA agrees with ICS Principle 8. Navigating the balance successfully in light of different jurisdiction approaches make this perhaps the most important principle to follow.

<u>ICS Principle 9</u> – The ICS is transparent, particularly with regard to the disclosure of final results.

As drafted, ICS Principle 9 is confusing as it seems to focus on disclosing the results of the ICS. Instead, AIA would suggest that this principle be revised to focus on transparency of the methodology and calculation of the ICS.

<u>ICS Principle 10</u> – The capital requirement in the ICS is based on appropriate target criteria which underlie the calibration. The level at which regulatory capital requirements are set reflects the level of solvency protection deemed appropriate by the IAIS.

AIA believes that the ICS should develop and evolve into a risk management tool for supervisors that allows for a capital adequacy assessment that includes quantitative input and qualitative evaluation of a group's enterprise risk management through ORSA and other means (such as consideration of internal economic capital models) by which supervisors can obtain the group's view.

<u>CONCLUSION</u>

AIA appreciates the opportunity to provide input on the IAIS's ICS principles and to describe our policy development process on the ICS and group-wide supervision. Both ComFrame and the ICS (as an element of ComFrame) are important initiatives, and AIA is committed to serious and constructive participation. We hope that the IAIS will consider our interim conceptual approach to the ICS as the standard matures, and look to AIA and its member companies as a resource when working through the issues that will inevitably arise.

Respectfully submitted,

J. Stephen ("Stef") Zielezienski
Senior Vice President & General Counsel

Phillip L. Carson
Associate General Counsel & Director
of Financial Regulatory Policy

Attachment

Liberty Mutual Insurance

Corporate Finance
175 Berkeley Street
Boston, MA 02116
(617) 357-9500

December 5, 2014

Commissioner Kevin McCarty
Chair, ComFrame Development and Analysis Working Group
National Association of Insurance Commissioners
(Sent By Email to Ryan Workman)

Re: Liberty Mutual Insurance Group Comments – NAIC U.S. Group Capital Methodology Concepts Discussion Paper

Dear Chair McCarty:

Liberty Mutual appreciates this opportunity to comment on the U.S. Group Capital Methodology Discussion Paper that the ComFrame Development and Analysis Working Group ("CDAWG") has put forth. We commend the efforts the NAIC is making to develop "group capital concepts that would be appropriate for U.S. based internationally active insurance groups" and are committed to working with CDAWG going forward to develop these concepts further.

Liberty Mutual supports the fundamental goal of enhancing group wide supervision, including provisions that will allow for assessment of capital adequacy. Strong risk assessment and management practices are the most critical considerations for insurer solvency. A good understanding by insurance supervisors of the overall capital position of an insurance group is important, as well.

Though very open to assisting in the development of all three options, we do prefer the Cash Flow Stress Testing approach over the RBC Plus approach. The Cash Flow approach will produce a more accurate indication of an insurer's capital position with a lower margin of error than what would result from the RBC Plus calculation.

RBC Plus Will Work If Certain Issues Are Addressed

The RBC Plus approach offers a familiar framework to both state insurance regulators and the U.S. industry and is an approach that we could support after some additional work. We want to emphasize that this

approach for a capital standard should only be used in the context of a minimum capital standard as opposed to a prescribed or target capital standard. While we agree that the RBC Plus approach would need to have additional risk factors incorporated (as compared to the existing legal entity RBC) to capture all risks that are inherent for an insurer, we believe that such a factor-based approach would produce an outcome with a significant amount of uncertainty. Given that it is a standard approach applied across all U.S. insurers, it cannot incorporate all company-specific risks and diversification benefits. To this point, we encourage the exploration of non-factor based elements, such as partial internal models, in order to capture unique risk such as catastrophe risk exposure.

We support the use of a U.S. GAAP balance sheet as a starting point because it allows for an audited consolidated balance sheet and minimizes the assumptions and interpretations that come with making adjustments necessary to achieve a "comparable" balance sheet. There needs to be consideration given to how an insurer with both P&C and Life business would apply the RBC Plus approach, reflecting the differences today in the existing legal entity RBC formulas. We welcome additional discussion around the segmentation to be used in this approach; otherwise integrating foreign operations into a factor-based approach would pose challenges in lining up products across jurisdictions.

Liberty Prefers Cash Flow Stress Testing Option

We favor the cash flow approach because it closely aligns with the internal models that many insurers already utilize and eliminates the valuation and accounting differences across the global jurisdictions. We understand this could be a time-consuming undertaking for those insurers who do not use internal models, as well as the regulators who would need to get comfortable with each insurer's model. However we believe that the accuracy of the outcome produced by a cash flow approach would be far better than what is produced by the RBC Plus approach. It may be necessary to allow for certain adaptations to the cash flow approach based upon size, type and complexity of insurance groups to reduce the burden of requiring such an approach for those companies that do not already use internal models.

We believe the stress testing approach could incorporate a standard set of events that covers all major types of stresses realistically expected to cause a significant impact on a property and casualty insurer. This event-set could include natural catastrophe events, market (credit and equity) events, economic events (e.g. prolonged severe inflation), reserve deficiencies, and other underwriting events (e.g. premium declines, CR increases). Market risk stress testing would be comparable across companies as all companies are subject to similar economic conditions. Underwriting stress tests would also be similar across property and casualty insurers. Although catastrophe exposures would differ across companies, such events could be specified at a certain probable maximum loss.

Capital Resources Definition Critical

As any of these options are developed further, there must be more clarity around how available capital will be determined. This is just as critical as development of the capital requirement itself. The incorporation of senior notes as available capital remains a significant issue to us and others in the industry. The language in Annex I that currently reads: "On consolidation there is no net effect of senior notes, but such notes would continue to be taken into account in entity based capital requirements," must be clarified as to the treatment of senior notes at the group level. When looking at group solvency as it pertains to policyholder protection, senior notes issued by the holding company are contributed to insurance entities while regulators must

approve any future dividends back to the holding company. In this regard, policyholders are protected from any obligations the holding company may have to debt holders, in the case of a default on the senior notes.

Internal Models Should Be Reviewed, Not Approved

While the use of internal models will be permissible in both options, we caution against supervisors getting into the business of approving company models, which may lead to companies having to use models that do not reflect the risk profile of the company and do not align with how management operates the business. We instead recommend that supervisors review company internal models to ensure that across all insurers, risks considered are consistent, and models are properly calibrated, and subject to careful testing.

Again, we appreciate this opportunity to comment and look forward to working with you to develop a group capital methodology that works for the U.S. system of solvency regulation.

Sincerely,

John Doyle
Senior Vice President and Comptroller

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December 5, 2014

Commissioner Kevin McCarty
Chair of ComFrame Development and Analysis Working Group
National Association of Insurance Commissioners
Sent Via Email Transmission: rworkman@naic.org

Re: NAMIC Comments – U.S. Group Capital Methodology Concepts Discussion Paper

Dear Chair McCarty:

The National Association of Mutual Insurance Companies (NAMIC) appreciates the opportunity to comment on the U.S. Group Capital Methodology Concepts Discussion Paper.

NAMIC is the largest property/casualty insurance trade association in the country, serving regional and local mutual insurance companies on main streets across America as well as many of the country's largest national insurers. 1,400 member companies serve more than 135 million auto, home and business policyholders, and write more than $196 billion in annual premiums that account for 50 percent of the automobile/homeowners market and 31 percent of the business insurance market. More than 200,000 people are employed by NAMIC member companies.

Generally, the CDAWG Concepts Paper represents the first attempt to capture the concepts discussed internationally in a manner that is consistent with the existing U.S. RBC approach. After reviewing and commenting on several BCR and ICS drafts proposed by the IAIS, the CDAWG effort is a welcome change. We support the continued NAIC efforts. As a concepts discussion paper, there remain a number of details that need to be addressed, and NAMIC is prepared to assist the working group in its development of a viable approach that could be implemented in the U.S. Our initial thoughts on the paper and additional details that could assist in a more thorough analysis are discussed below.

1. **Confirm the protection of legal entity capital from required fungibility in the final proposal and in any model laws or regulations.**

This is the first discussion paper we have seen discussing international group capital requirements that recognizes the importance of preserving the legal entity capital structure. The paper states:

> ". . . some proponents of group capital requirements may argue that 'excess capital' residing at the legal entity can be freely moved to the holding company to allow for better capital mobilization. However, the U.S. state insurance regulators continue to maintain that legal entity supervision takes precedence over any group capital needs."

This does not eliminate all concerns about regulatory demands for fungibility between legal entities, but it is a strong statement on this issue and is movement in the right direction.

A view of capital at the group level can result in both over- and under-estimation of the capital needs of a particular legal entity. Both potential views present solvency risks. Without a clear view into each legal entity capital situation the group supervisor will fail to appreciate the strengths and weaknesses posed by the overall group. No "calculation" of group capital should result in mandated fungibility of capital across legal entities. At most, a group capital requirement should be an "indicator" that would generate supervisory discussion through the use of existing tools, like supervisory colleges, ORSA, risk focused exams etc., about the solvency of the legal entities consistent with the U.S. "windows and walls" approach to group supervision. We recognize that state regulators appreciate the importance of the supervision at the legal entity level. NAMIC will work with CDAWG to assure that any model law/regulation or other proposal includes clear and uncomplicated language assuring that legal entity capital is not at risk of regulatory-imposed fungibility.

2. **Determine actuarially how the proposed confidence levels for both the RBC Plus and Cash Flow approaches will map to existing RBC action levels.**

One of the key differences in the IAIS approach to group capital and the current U.S RBC approach is the adherence to calculated confidence levels as the capital goal instead of decades of solvency regulatory experience. In the proposed RBC Plus approach CDAWG suggests using a consolidated balance sheet and setting the capital requirement to attain a specific confidence level (e.g. 99.5% VaR or 90% TVaR). We all need a better understanding of how the proposed confidence levels for group capital would map to the current RBC requirements for legal entities. For example, we wonder if the current U.S. RBC Company Action Level approximates a 99.5% VaR confidence level. Before the NAIC decides to incorporate any confidence level for group capital, it will benefit regulators and interested parties to understand what the change in calibration will mean for the U.S. insurers impacted. To date, no actuarial study we are aware of has estimated how current RBC action levels translate under the proposed confidence levels. This information is vital to any assessment of the proposal. Since the existing U.S. RBC structure has successfully predicted impairment/insolvency concerns for insurance companies, drastic increases, whether intentional or unintentional, are not necessary. An official actuarial comparison of the existing and proposed measurement tools is needed. We request that the NAIC commission such a study before finalizing any group capital proposal.

3. **For the RBC Plus approach:**
   a. **Develop a cost-effective accounting approach for companies that file on a statutory–only basis**

      The concept discussion paper recommends the use of U.S. GAAP as the valuation tool for the calculation of the RBC Plus capital requirement. The paper notes that an alternative approach is required for companies that do not file on a GAAP basis. While we understand the reason for suggesting the use of U.S. GAAP, we do not agree with the international concern about statutory accounting (SAP).

      SAP is the only accounting method in the U.S. that is required of all insurers. SAP is directly derived from GAAP, but it is specifically designed to be more conservative than GAAP. SAP has a solvency view focused on the balance sheet rather than a going concern view focused on the income statement. Its goal is to ensure a company has assets available to pay policyholder obligations when they become due. While a primary objective of GAAP accounting is to provide important financial information to the investing community to make informed decisions on a going concern basis, SAP reporting was designed from the outset with solvency and regulatory purposes in mind and has a long history of highly effective use. SAP is the valuation basis and source of segmentation for U.S. RBC. All of these factors make SAP the ideal valuation tool for any capital requirement applicable to U.S. companies.

We acknowledge that SAP may not be familiar to international supervisors, so we recommend that the CDAWG proposal address the treatment of both GAAP and SAP. Any global approach to group capital will need to recognize that there are various forms of accounting standards used throughout the world. There is no one best starting point, but all standards can reach a common outcome. The focus of a global capital standard should be on the desired "outcome" rather than the starting point. Once the calibration issues are resolved, we would be pleased to assemble a team of mutual company accounting experts to assist CDAWG in creating a methodology using statutory financial statements as a starting point to reach the common outcome desired.

b. **Confirm the factors that will be selected and the changes anticipated to existing RBC**
In the RBC Plus section of the concept discussion paper, CDAWG indicates that they propose starting with RBC-type factors as a starting point, but indicate that adjustments and additions would be necessary to recognize risks not currently reflected in U.S. RBC. In the last few years we have added catastrophe risk factors, operational risk factors and are investigating changes to investment and reinsurance risk factors. Most of these changes were a direct result of international discussions about the need for more consistent capital standards and not as a result of failings in our current system. If there are additional adjustments and additions we request that they be identified and justified so that we can better understand the CDAWG proposal.

c. Identify the impacts on audit requirements
The proposal does not specify whether an audited consolidated balance sheet at the group level is required for non-GAAP filers. Does the working group anticipate changes to the audit requirements? Will the consolidation be required over all life and property-casualty entities within a holding company? More information on the intentions of the working group will help in our future analysis.

e. **Clarify confidentiality protection**
The details of U.S. RBC filings currently include confidentiality protection. While there is no mention of confidentiality of the information in the proposal, we would suggest that the next draft of this document include confidentiality to clarify the intention to protect the group capital information as the legal entity RBC information is protected.

4. For the Cash Flow approach:

This approach includes elements of Cash Flow stress testing many companies use in their ERM programs and is similar to the process life insurers use to calculate principle-based reserves. The tools used in these contexts are not intended to generate a specific capital requirement for regulatory purposes. For this reason there is variation among companies in internal capital models both in the level of sophistication and the incorporation of the information into corporate-wide decision-making. Internal capital models provide a unique and useful tool for individual companies. If these models are to be used for regulatory purposes we need to be careful to preserve the rights to unique models that reflect the needs of each organization employing the model, or they will potentially lose the value they provide for companies.

Outside of catastrophe modeling, there is less consistency in the use of internal models for property-casualty companies. Stressing property-casualty scenarios can be more complex than for

life products. The complexity and cost of developing the Cash Flow approach for property-casualty writers is also a consideration.

Based on the information in the concept discussion paper, our members initially express more familiarity with the RBC Plus approach for property-casualty insurers. It is more consistent with current RBC practices and is somewhat more predictable. NAMIC members also report that the RBC Plus approach is more consistent with the current A.M. Best BCAR, although we are also informed that the rating agencies are moving away from using a factor-based approach in their analysis. We are willing to further discuss the Cash Flow approach to explore more details around cost effective ways it might be applicable for property-casualty writers.

As CDAWG develops the details of its capital proposal we recommend strong advocacy with the Fed and FIO and collaboration with the industry to advance its proposals. With the NAIC leadership in this arena, the U.S. may be able to convince other IAIS member countries to support an alternative view to that currently advanced by the European regulatory community, changing the international standard. At a minimum, we need to be sure that any group global capital standard will have the necessary flexibility to accommodate the U.S. approach. Without a well-reasoned NAIC approach, companies supervised by multiple jurisdictions (federal or foreign) may have multiple group capital standards to satisfy. It is not clear how the various proposed standards will interact (*e.g.* Solvency II, U.S. Federal Reserve capital rules, NAIC framework, and IAIS framework). Multiple standards would create greater costs and confusion and can be avoided. Any insurance capital standard should stipulate that an insurer is to be subject to only one group-wide consolidated standard.

Finally, should any group capital requirement be breached, it should trigger a discussion between the group's supervisory college and the group about its capital situation, but should not require specific remedial actions to be taken by either regulators or the group. Any group capital level should only be used as an “indicator” that would generate discussion of supervisors through the use of existing tools (i.e. supervisory colleges, ORSA, risk-focused exams, etc.) applied to a solvency evaluation. At the end of the day solvency is the real goal for quality supervision, not capital levels.

Thank you for your consideration of these comments on this matter of importance to NAMIC members and their policyholders.

Sincerely,

Michelle Rogers
Director of Financial and Regulatory Policy
National Association of Mutual Insurance Companies

Alternative proposal

- We support the objectives of the IAIS; policyholder's benefit and protection, and contribution to global financial stability, and would like to make a proposal which is consistent with these objectives.

＜Key Points＞

✓ It does not require international adoption of a particular accounting standard.

✓ Comparability will be achieved by requiring insurers in different jurisdictions to apply consistent stress scenarios, calibrated to the same confidence level.

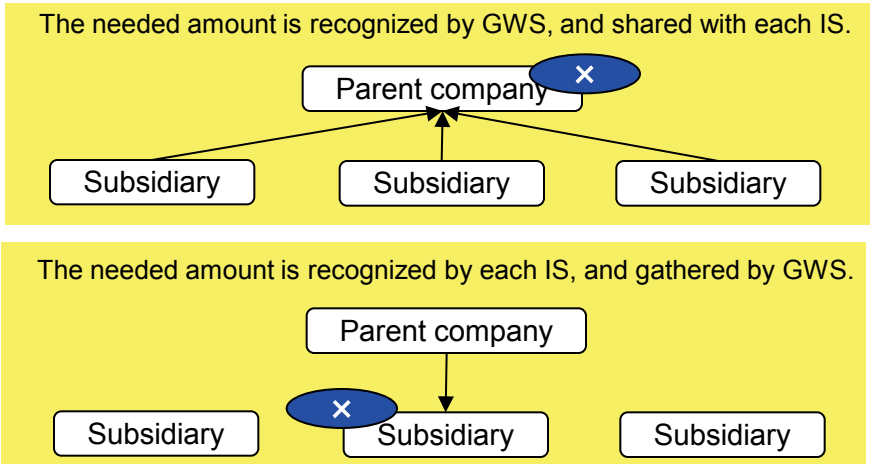
October 10th, 2014
Nippon Life Insurance company

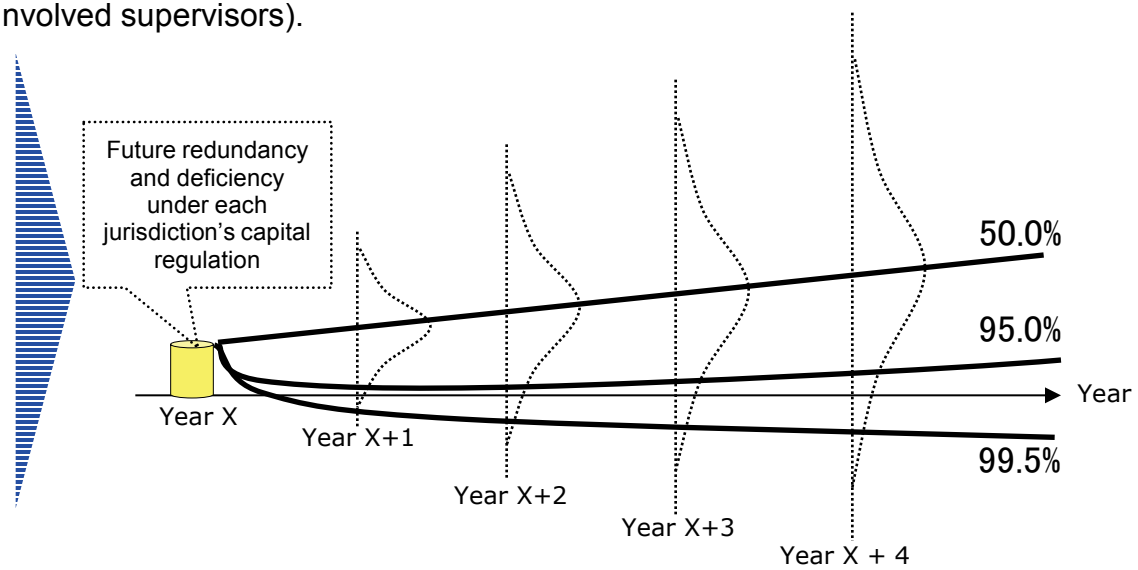
Alternative proposal

- How about considering an approach to reconcile “comparability among insurers in the same jurisdiction” with “comparability among the IAIGs”?

<Image>

- Future redundancy and deficiency under each jurisdiction’s capital regulation that are calculated based on various confidence levels are shared between GWS (Group wide supervisor) and ISs (Involved supervisors).





<Advantages>

- ✓ Global comparability can be ensured to a certain extent.
  - The difference in timing of risk detection between each standard can be reduced by looking at future periods. Assessment based on various confidence levels can be possible.
  - Comparability will be achieved by requiring insurers in different jurisdictions to apply consistent stress scenarios, calibrated to the same confidence level.
- ✓ It does not require international adoption of a particular accounting standard.
- ✓ The possibility and degree of group-support can be shared between GWS and ISs.
  (Necessary measures can be considered in advance for the purpose of protection of policyholders in its own jurisdiction.)
- ✓ It can capture the effects of a change in management policies. (After-the-fact check is also possible).
- ✓ It is consistent with the standards already put in place and fine-tuned in each jurisdiction which are understood fully by supervisors and insurers.
- ✓ Different confidence levels can be applied to near future and distant future respectively.
  (Such an approach will not prevent insurers from providing customers with long-term protection and making long-term investments in capital markets, as pointed out in the Asia Pacific region. (Please refer to the Asia Pacific Financial Forum Interim Report (including ANNEX H))
- ✓ It is consistent with the ORSA framework. (ICP16.15)

Alternative proposal： Draft Technical Specification

＜General principle＞

Proportionality	✓ Proportionality principle should be followed.
Substance over form	✓ In order to fairly present the reality of an entity, economic reality of a transaction should be reflected in addition to legal form.

Interest rates	✓ Each insurer makes a decision in a reasonable manner, and GWS and ISs of each jurisdiction verify its appropriateness.
Assets Rate of return on each asset class, asset allocation, asset component ratio, etc.	
Insurance liabilities New contracts, policyholders dividend ratio, persistence rate, incidence of insurance event, expense ratio, etc.	
Capital Shareholders dividend rate, etc.	
Changes in management policies	✓ In principle, changes in management policies are not reflected. – Only those changes in management policies which are already decided or implemented at the inception of analysis period are reflected.

Alternative proposal： Draft Technical Specification

＜Risk scenarios＞

Selection of risk events Mortality risk, survival risk, medical risk, price fluctuation risk, credit risk, etc.	✓ Each insurer makes a decision in a reasonable manner, and GWS and ISs of each jurisdiction verify its appropriateness.
Confidence level	✓ The IAIS makes a decision. － E.g. Different confidence levels are applied to near future and distant future respectively. （Such an approach will not prevent insurers from providing customers with long-term protection and making long-term investments in capital market.））

＜Future redundancy and deficiency under capital regulation＞

Future redundancy and deficiency under capital regulation	✓ GWS and ISs of each jurisdiction make a decision based on capital regulation for solo entities in each jurisdiction. － The level of required capital does not necessarily need to be the level for supervisory intervention.

＜Analysis period＞

Analysis period	✓ The IAIS makes a decision. －E.g. The period which is needed for the effects of a change in management policies to be verified.

Alternative proposal ： Technical Specification①

＜Example of a template that will be reported by each country（December 2013）＞

The assumption for future redundancy and deficiency under capital regulation

Figures are based on required capital of Solvency margin ratio of 200%.

Future redundancy and deficiency under capital regulation（billion $）

【country A ●● insurance company】

		2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Confidence level	Main scenario ：50.0%	2,000	2,100	2,200	2,300	2,400	2,500	2,600	2,700	2,800	2,900
	Risk scenario A ：95.0%	500	450	400	350	300					
	Risk scenario B ：99.5%	100									

【country B ●● insurance company】

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・
・

【Country C ●● insurance company】

・
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・

Alternative proposal ： Technical Specification②

＜An example of a format which is compiled by GWS based on report from each country (December 2013) ＞

【Main scenario：confidence level 50.0%】 Future redundancy and deficiency under capital regulation（billion $）

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Country A	2,000	2,100	2,200	2,300	2,400	2,500	2,600	2,700	2,800	2,900
Country B	10,000	10,500	11,000	11,500	12,000	12,500	13,000	13,500	14,000	14,500
Country C	5,000	5,250	5,500	5,750	6,000	6,250	6,500	6,750	7,000	7,250
Group total	17,000	17,850	18,700	19,550	20,400	21,250	22,100	22,950	23,800	24,650

【Risk scenario A：confidence level 95.0%】 Future redundancy and deficiency under capital regulation（billion $）

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Country A	500	450	400	350	300					
Country B	2,500	2,250	2,000	1,750	1,500					
Country C	1,250	1,100	950	800	650					
Group total	4,250	3,800	3,350	2,900	2,450					

【Risk scenario B：confidence level 99.5%】 Future redundancy and deficiency under capital regulation（billion $）

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Country A	100									
Country B	500									
Country C	250									
Group total	850									

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STEPHEN W. BROADIE
VICE PRESIDENT, FINANCIAL POLICY

December 5, 2014

Mr. Ryan Workman
International Insurance Program Counsel
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Comments on NAIC Group Capital Methodology Concepts Discussion Paper

Dear Ryan:

The Property Casualty Insurers Association of America (PCI) is pleased to comment to the NAIC's ComFrame Development and Analysis (G) Working Group on its Group Capital Concepts Discussion Paper. PCI represents more than 1000 insurers that account for 40% of the total U.S. home, auto and business insurance market. PCI members write insurance and reinsurance throughout the world. Among our members are companies designated as systemically important and globally systemically important, as well some that potentially would be subject to enhanced supervision as internationally active insurance groups.

PCI supports the NAIC's efforts to work with the industry, Federal Insurance Office (FIO) and Federal Reserve Board to produce a unified U.S. position regarding the International Association of Insurance Supervisors' (IAIS) proposed Insurance Capital Standard (ICS). The NAIC and other U.S. members of the IAIS should be clear, however, that in order to be adopted in the United States the ICS will have to be appropriate for the U.S. insurance market and regulatory system, recognizing our strong emphasis on policyholder protection and robust tools such as our state guaranty funds, statutory accounting and reporting requirements, and other parts of the solvency regulatory system that has served us well over time. In particular neither an ICS nor any other U.S. group capital system should require groups to carry unnecessary additional capital.

We are not at the point where we can endorse a specific group capital proposal. Indeed, given the strong record of the U.S. state-based regulatory system through the financial crisis and the difficult period following it, we are not convinced that a group capital requirement is necessary or appropriate. Given that caveat, however, we have the following comments on the Discussion Paper.

In general

PCI agrees that policyholder protection should continue to be the primary goal of insurance regulation (p. 1). In developing a group capital standard, it is critical to avoid placing the protection of other stakeholders (creditors, shareholders, etc.) at the same level as policyholder protection. This standard should not aim at protecting financial stability – that is done through the supervision of systemically important insurance groups, with the recognition that traditional insurance and reinsurance activities do not create systemic risk.

RBC Plus

Of the concepts addressed in this paper, the "RBC Plus" concept appears most properly applicable to property/casualty insurers.

- It is appropriate that the basic concepts continue to be based on current legal-entity RBC.
- We strongly agree that valuation of insurer assets and liabilities should continue to be based on U.S. SAP and GAAP accounting concepts, and property/casualty loss reserves should continue to be undiscounted without risk margins. We agree with the U.S. Financial Accounting Standards Board

that discounting and risk margins do not improve the clarity and decision-usefulness of insurance valuation standards, and comparability should not be sought for its own sake.

- There are at least two critical unanswered questions in the paper's RBC Plus discussion, however:
    - Calibration of the ultimate standard is critical. The standard should be a minimum capital standard rather than a "target" standard, and 99.5% VaR/one year is significantly too high.
    - Regardless of what calibration level is used, breach of the requirement should trigger supervisory college discussions with the group, but not specific, one-size-fits-all mandatory regulatory or company actions. It is impossible to determine in advance what actions (if any) might be required, and members of the supervisory college would certainly be able to coordinate actions under their existing legal entity authority (using tools such as the Hazardous Financial Condition Model Regulation) if they believe such actions are needed.

Cash Flow

PCI believes that the RBC Plus approach is probably more appropriate for property/casualty insurers than a cash flow approach. We appreciate the fact that the cash flow approach appears to be accounting and valuation-agnostic. We are concerned, however, that it would require prior approval of internal model parameters by regulators. This appears to be a significant additional cost without corresponding benefit to property/casualty companies.

Exposure of Final Proposal

PCI recognizes the extremely short timeframe that the NAIC, FIO and Federal Reserve Board are trying to respond to. Although the ICS is intended to apply only to internationally active insurance groups, however, we are concerned that there is a high likelihood that attempts will be made to apply the ICS to all insurance groups. Given the potential significance of this proposal to all of our members that operate in group form, PCI urges the NAIC and all other members of "Team USA" to expose their final proposal to broad industry and public comment before it is presented to the IAIS.

If you have any questions or comments, please contact me at your convenience. PCI looks forward to continuing to work cooperatively with the Working Group.

Sincerely,

Stephen W. Broadie

December 5, 2014

Mr. Kevin McCarty
Insurance Commissioner, Florida Office of Insurance Regulation
Chair, NAIC ComFrame Development and Analysis (G) Working Group
200 East Gaines Street
Tallahassee, FL 32399

Re: U.S. Group Capital Methodology Concepts Discussion Paper

Dear Commissioner McCarty:

I am writing to you on behalf of Aegon NV and its United States operations, which operate under the Transamerica brand. Although the Aegon group is headquartered in the Netherlands, the United States is Aegon's primary jurisdiction with respect to operations, premium, revenue, and shareholder base. Consequently, we have great interest in the proposed U.S. Group Capital Methodology Concepts Discussion Paper (DP), exposed by the ComFrame Development and Analysis (G) Working Group (C-DAWG) on November 16. We particularly welcome the opportunity to comment on these proposals at the conceptual stage prior to formal development work.

The Discussion Paper describes two proposals that are currently being explored by the NAIC. The first, "RBC Plus," involves the creation of an RBC-like framework to be employed in conjunction with U.S. GAAP balance sheet. The second, "Cash Flow," involves a construct based on life insurance asset adequacy-testing concepts.

Aegon and Transamerica support the development of a group supervision regime within the U.S. that includes an appropriate capital standard. We also support the development of global insurance capital standards. However, any new capital standard must create appropriate incentives and must not favor certain categories of insurers over others. We recognize that the creation of a global standard is a very challenging process given the widely different starting points around the globe. This is why we continue to support efforts to achieve gradual convergence of regimes over time.

The Discussion Paper, while providing some helpful background, leaves unanswered fundamental questions about the NAIC's objectives in seeking comment about these proposals at this time. If the intent is to promulgate a group capital standard regardless of the outcome of the IAIS's global Insurance Capital Standard (ICS) work, we suggest that a more logical path would be an aggregation approach based on existing statutory requirements. If, however, the NAIC's intent is to explore concepts that might be acceptable to other IAIS Members, we believe that the Cash Flow concept holds more promise, although both approaches face significant challenges. Accordingly, we recommend more targeted consideration of concepts that leverage elements from each of the RBC Plus and Cash Flow proposals.

In the paragraphs below, we share several key observations about the proposed approaches and how they might impact the U.S. insurance market and align with capital standards being developed internationally.

1. We object to the proposed scope of application

While the Discussion Paper indicates that the group capital requirements would apply to "internationally active U.S. insurance groups" and to "U.S. based internationally active insurance groups," it does not provide a precise definition of those terms.

Transamerica supports the development of a group supervision regime within the U.S. state-based system that includes a properly constructed and calibrated capital requirement, provided that such a regime applies to *all* insurers. We are understandably alarmed, however, by the prospect of a fundamentally separate and distinct group capital standard that would apply *only to internationally active insurance groups* (IAIGs) from which solely domestic players would be exempt.

Such a scope of application would create a distorted U.S. insurance market that would potentially tilt strongly and unfairly against IAIGs. The Discussion Paper identifies no meaningful public policy rationale for such an outcome, nor is any such rationale clear to us. Rather, a strong incentive would be created for U.S. insurers to retreat from international activity, perversely leading to greater risk concentrations within the U.S. We strongly recommend against this path.

2. We have misgivings about a U.S. group-level solvency framework that differs from legal entity standards

Both of the proposed methodologies differ profoundly from the existing state-based regime that uses statutory accounting and legal entity U.S. Risk-Based Capital. These differences amplify our concerns about scope.

The real-world impact of a group regulatory capital framework would go well beyond the Discussion Paper's notion that it could "enhance the regulatory toolbox" and "provide insight into…weaknesses." In practice, a regulatory capital framework creates disincentives (and limited incentives) of varying degrees. The collective influence of regulators, consumers, rating agencies, analysts, and producers *compels* insurers to manage to such a framework. Accordingly, the regulatory framework impacts the offering and pricing of products, the investments companies make, and the strategies they undertake to manage risks. A regulatory solvency framework is never benign; it has real consequences.

Accordingly, it is difficult to see how the proposed creation of a *second* regulatory capital framework—one that is potentially much different than the existing framework—constitutes sensible regulation. The risk of subjecting insurers to conflicting incentives and disincentives is high. Moreover, the Discussion Paper's proposed hybrid approach would involve *both* the "RBC Plus" and "Cash Flow" approaches, i.e. *two* new frameworks.

If the NAIC is interested in pursuing a group capital standard but is uninterested in adopting the ICS being developed by the IAIS, the logical path would be to pursue an aggregation approach that maximizes the use of existing local regimes. This would reduce the risk of conflicting incentives and avoid the burden of creating, administering, and complying with a group-level regulatory

framework that is significantly different than the existing U.S. legal entity framework. An aggregation approach would also be conceptually similar to the existing Insurance Group Directive ratio used in Europe. It is not clear to us why the Discussion Paper does not explore such a possibility.

3. We oppose the creation of a "U.S. ICS" that would be fundamentally different than an ICS developed by the IAIS

We support the aim of truly global insurance capital standards, while recognizing that this is likely to be unachievable within the unrealistic timeframes set forth by the Financial Stability Board and the IAIS. Accordingly, it continues to be our view that a longer-term plan is needed for regimes to achieve greater convergence over time.

The Discussion Paper appears to propose a halfway measure by suggesting the creation of a group capital standard that is different not only from existing legal entity requirements, but also from the ICS currently being developed by the IAIS. Indeed, the Discussion Paper suggests that the U.S. standard would "provide outcomes consistent with group capital standards being developed internationally." It does not suggest that the U.S. standard would be equivalent to such standards.

We do not believe that the public interest is served by the creation of a "U.S. ICS" that is fundamentally different than the ICS that is developed by the IAIS, for the following reasons:

- **A U.S. ICS is very unlikely to produce "consistent outcomes" beyond the broad policy objectives of protecting policyholders and promoting financial stability.** Insurance accounting is fundamentally about quantifying uncertain contingent events that may occur many years in the future. For a large life insurance group, the accounting basis alone can make billions of dollars of difference. Capital requirements involve assessing the variability of those uncertain outcomes and can amplify accounting differences. It is not possible for specific outcomes to be "consistent" while the underlying building blocks are fundamentally different.

- **A U.S. ICS would risk creating exceptional burdens for international insurance groups.** It is possible that *both* the ICS developed by the IAIS and a "U.S. ICS" could apply to international groups: one standard at a global group level and the other standard at a national subgroup level. These requirements would be *in addition* to legal entity requirements. The resources needed to develop, manage, and report on all of these regulatory bases would be extraordinary, and it is difficult to see how the public interest would benefit from such a multiplication of frameworks and requirements.

- **A U.S. ICS would reduce the NAIC's influence within the IAIS.** We support the involvement of the NAIC, the Federal Reserve, and the Federal Insurance Office in the work of the IAIS, and we further encourage "Team USA" to develop concrete and credible proposals that can gain support from other IAIS Members. The pursuit of a "U.S. ICS" would send an unwelcome signal to other jurisdictions regarding the NAIC's investment in the activities of the IAIS.

We encourage the NAIC and other members of "Team USA" to participate vigorously and actively in the IAIS process, committing to ensure that the end product is something all jurisdictions can embrace.

4. The appeal of the "RBC Plus" approach is limited by the proposed use of U.S. GAAP as the accounting basis

Within the ongoing ICS work, we support consideration of various approaches to both valuation and capital requirements. We believe that best practices exist within various regimes, including the U.S. regime.

In that context, we welcome the many similarities between the "RBC Plus" approach and the existing U.S. framework. We can support a factor-based approach particularly in the context of a minimum capital requirement. We agree with the Discussion Paper that a factor-based approach may need to be supplemented by other techniques in order to appropriately capture certain risks such as asset-liability mismatch.

We have reservations, however, about the proposed use of U.S. GAAP as the underlying accounting basis. While the use of U.S. GAAP may be appealing to certain companies that are subject to Federal Reserve oversight, it is likely to present a significant deterrent for gaining international support. Some likely concerns include the following:

- **U.S. GAAP is a regional standard.** While the current U.S. GAAP model for short-duration contracts is broadly consistent with existing accounting in most jurisdictions, general purpose accounting for long-duration life insurance contracts differs significantly by jurisdiction around the globe. The prospect of adopting the specific U.S. accounting standard would be unwelcome in most jurisdictions.

- **U.S. GAAP is not universally applied even within the U.S.** At present, only publicly traded companies are required to prepare financial statements using U.S. GAAP. Mutual and mutual holding companies, privately held firms, and foreign-based public companies using unmodified IFRS (such as Aegon/Transamerica) are exempt. Accordingly, for many companies, the use of U.S. GAAP offers no inherent operational advantages over any other reporting basis.

- **U.S. GAAP is a piecemeal, dated standard.** Because it has been developed over time, U.S. GAAP applies different accounting models to different types of insurance contracts. For example, the accounting model for whole life is different than the model for universal life. U.S. GAAP also has noteworthy shortcomings, such as that it does not reflect the time value of guarantees in certain contracts.

- **U.S. GAAP presents a fundamental accounting mismatch.** Under current U.S. GAAP rules, assets are held at fair value, and liabilities are valued at a basis closer to cost accounting. Balance sheet noise that results from accounting mismatch is contrary to the interests of all stakeholders, particularly in a regulatory context. We recognize that various proposals exist to address this issue, but each would present its own challenges.

In short, the U.S. GAAP approach offers no inherent operational advantages for many companies, nor is it "exportable" to other jurisdictions. While it is understandable why some stakeholders support U.S. GAAP as an accounting basis, we are persuaded that it would promote unwelcome regulatory divergence rather than regulatory convergence.

5. **The "accounting agnostic" Cash Flow approach offers some promise of global appeal, but ultimately the same considerations apply under an approach that uses a specified accounting basis**

We do not inherently oppose the use of a market-based approach, but we believe that significant and potentially complicated adjustments must be made to appropriately accommodate long-duration insurance liabilities. As a result, we welcome the Cash Flow approach as an alternative worthy of consideration.

We highlight certain strengths of this approach:

- **It illustrates the manifestation of risks over time.** In practice, long term life insurers are rarely compelled to take drastic, immediate action to address a potential solvency issue. The timing of a potential concerns is important information that is captured by the Cash Flow approach.

- **It uses infrastructure that is already in place.** A significant majority of life companies around the globe have cash flow models in place. Although non-life companies might need to devote resources to the development of models, such investments would be required under any approach.

- **It reflects asset-liability management (ALM) practices.** The approach would accommodate interactions between assets and liabilities. It also provides for appropriate ALM incentives.

In our view, the main drawback of this approach involves the challenge of translating the entire balance sheet into cash flows. Today, for purposes of asset adequacy testing (where assets cover reserves only), U.S. companies typically assign difficult-to-model assets such as owner-occupied real estate to the surplus account, where they are effectively ignored for purposes of the analysis. Under the Cash Flow approach, however, it would be necessary to translate such assets into cash flows, which might involve extensive challenges.

Moreover, careful consideration the Cash Flow approach brings to light the fact that this approach is not novel. On the contrary, it embeds core elements that are part of any solvency framework:

- **A valuation basis.** A liability calculation is the present value of future benefits and expenses less the present value of future premiums. Under the cash flow approach, future benefits, expenses, and premiums would be based on model inputs, and the accumulation/discount rate would be an expected book yield less expected defaults and investment expenses.

- **An assumed future economic environment.** In a market-based valuation approach, the baseline assumed future economic environment is determined by current market prices (e.g. forward rates). Under the proposed Cash Flow concept, the future economic environment would be determined, in part, by a regulator-prescribed economic scenario generator.

- **Contract boundaries.** Under the IAIS's current proposals, future anticipated premium payments are disregarded unless they can be compelled as a condition of future coverage. (We have found that this produces bizarre and unrealistic effects.) It appears that the proposed Cash Flow concept would include such premium payments in the analysis.

- **Identification of risks.** The NAIC's RBC framework includes specific risk taxonomies for life, health, and property-casualty companies. The Cash Flow approach proposes to align the risk taxonomy with the group's ORSA.

- **Capital charges based stressed environments.** In order to create the BCR, the effects of balance sheet stresses were translated into factor-based risk charges. Under the Cash Flow concept as proposed in the Discussion Paper, a stressed environment would be used to determine Total Assets Required, the denominator of the solvency ratio.

- **Diversification effects.** Under U.S. Risk-Based Capital, the benefits of risk diversification are determined by a square root covariance formula. The proposed treatment of diversification under the Cash Flow approach is somewhat unclear, although there is mention that diversification "would be a function of the stresses of the cash flows."

While the Cash Flow approach may be perceived as too big of a leap from an international standpoint, we recommend that proposals that are conceptually consistent with the Cash Flow approach be proposed to the IAIS for further exploration, such as:

- An adjusted book value approach for valuation;
- An assumed future economic environment that is less directly linked to current market prices; and
- Contract boundaries that reflect economic realities rather than subjective regulatory prudence.

6. We recommend the development of a vision regarding the quantitative dimension of the state-based solvency system

While not part of the C-DAWG exposure, we would be remiss not to mention the Stress Testing proposal currently exposed by a subgroup of the Life Risk Based Capital Working Group. The Stress Testing proposal would apply to insurance legal entities and would involve an alternative calculation of the "Total Asset Requirement" (TAR) which amounts to the sum of statutory reserves and Company Action Level Risk Based Capital, along with other technical adjustments. Requirements for "field testing" are exposed within the instructions for Life Risk-Based Capital.

The TAR Stress Testing proposal is conceptually linked to the two C-DAWG proposals in that *all three proposals represent potential add-on regulatory solvency frameworks*. Each would involve a new valuation method (implicit in the Cash Flow and TAR Stress Testing approaches) and new capital requirements. Each would require both industry and regulators to make large-scale resource investments. From a company standpoint, each framework would create a new set of disincentives (and incentives) that would significantly complicate management decision-making.

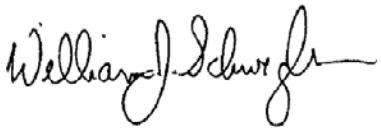
While we are skeptical of the merits of a U.S. group solvency framework that is fundamentally different than the existing legal entity framework, we find the proposed creation of a parallel

solvency framework *for legal entities* to be misguided. We are troubled by the fact that the proposal has been developed by a small subgroup with no opportunities for stakeholder input prior to the current exposure draft. There has not been a discussion of concepts or, more fundamentally, debate about whether such an exercise is worthy of undertaking at all. Nor was such a proposal contemplated as part of the NAIC's Solvency Modernization Initiative.

In light of the wide array of solvency frameworks being developed and proposed at the state, federal, and international levels, we encourage the NAIC to develop a high-level, commissioner-led vision regarding its overall solvency system for both legal entities and groups, taking into account the need for such a system to be created and administered with finite resources. We support a group-level capital requirement that is applied to all insurers that is either consistent with existing local regimes or with a universally applied global standard. Such an approach will foster sound and cost-effective policyholder protection, promote financial stability, and preserve robust competition within the U.S. insurance marketplace.

We appreciate the opportunity to provide input on the Discussion Paper and look forward to working with the NAIC on these important issues.

Kind regards,



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