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

September 15, 2016

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551

Re: Docket No. R-1539 and RIN No. 7100 AE-53 Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities

Dear Mr. Frierson:

On behalf of the National Association of Insurance Commissioners (NAIC)[1], we write today regarding the Board of Governors of the Federal Reserve System's (Board) advance notice of proposed rule on Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities. The NAIC respectfully submits the following comments to the Advance Notice of Proposed Rulemaking and Request for Comment published in the June 14, 2016 issue of the Federal Register.

At the outset, the NAIC is pleased the Board believes the capital framework should be based on U.S. regulatory and accounting standards, and that it should strike a reasonable balance between simplicity and risk sensitivity. It is our view that any framework the Board develops should maximize consistency with the current structure of U.S. solvency regulation and complement the primary mission of state insurance supervisors whose priority focus is on policyholder protection. While we understand that the Board has a specific regulatory mission under the Dodd-Frank Act[2], we view that role and related endeavors as supplementary to ongoing efforts state insurance regulators are undertaking.

We look forward to working with the Board as it develops its capital requirements to achieve its supervisory objective, but we wish to emphasize that any capital requirements put into place by the Board must not contradict state based capital regimes and regulation. We urge the Board to minimize any inconsistencies with existing state based regulatory requirements. Such inconsistencies could put an insurer in the untenable position of having to choose whether to comply with new federal requirements, or longstanding state requirements, and potentially result in the effective preemption of state law. Such a scenario is clearly unworkable for all affected companies and regulators, and ultimately not in the best interest of policyholders or financial stability.

[1] Founded in 1871, the NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

[2] Pub L. 111-203.

Question 1: ***Are the identified considerations appropriate? Are there other considerations the Board should incorporate in its evaluation of capital frameworks for supervised institutions significantly engaged in insurance activities?***

The considerations identified by the Board seem generally appropriate for the Board's regulatory mission, and are many of the same considerations that resulted in the NAIC adopting a Risk Based Capital (RBC) Aggregation methodology for its group capital calculation, which is currently under development.

Some other important considerations the Board should incorporate in its evaluation of capital frameworks include:

(1) the complexity of the group;
(2) the scale of the group's international activity;
(3) the rationale and drivers of any Systemically Important Financial Institution (SIFI) designation; and
(4) the existence of consolidated financial statements for the group.[3]

Question 2: ***Should the same capital framework apply to all supervised insurance institutions?***

The NAIC believes the same basic capital framework should apply to all supervised insurance institutions. We believe a single baseline capital framework can be created to align with the regulatory purpose and, at the same time, satisfy other necessary considerations, such as costs versus benefits, and account for variations in group structures, dynamics, reporting, and legal requirements. The NAIC is constructing its group capital calculation using an RBC Aggregation approach with intended application to all holding company groups containing a U.S. legal entity insurer.

We encourage the Board to focus on its proposed Building Block Approach (BBA) first, to determine if it can be utilized to adequately address the material risks for all supervised insurers including SIFIs before embarking on a potentially complex alternative approach that would treat Insurance Depository Institution Holding Companies and SIFIs differently and risk unintended consequences.

With respect to its application to SIFIs specifically, we believe the BBA directly supports financial stability goals by incorporating the specific regulatory capital expectations for each legal entity in the group, which is important since insurer capital is not available without explicit state regulator's approval in most circumstances. The BBA also prevents any capital deficiencies of legal entities without individual capital requirements from being masked in a consolidated financial statement. Additionally, a BBA would retain statutory accounting provisions that are designed to serve the regulatory needs of insurers, e.g., avoiding the procyclical impacts of marking to market for assets that are not to be sold in the near term and retaining conservatism in reserves and asset recognition.

Furthermore, the BBA should be consistent with the NAIC's RBC Aggregation approach to avoid the difficulties and costs involved in having to navigate two different capital calculations for groups with a mix of banking, insurance and other entities.

[3] We understand that the Board uses GAAP financial statements for its bank holding company regulation. However, not all U.S. insurance groups file GAAP statements, and the law prohibits the Board from requiring these groups to file such statements.

The NAIC believes banking risks in an insurance group should be treated similarly (although not identically) to banking risks in non-insurance groups, and insurance risks in any group should be treated similarly to what occurs in the legal entity regulatory approach (after all, insurance is written by a legal entity, not a group). Since capital requirement frameworks already exist for depository institutions and legal entity insurers for the Board and the NAIC to utilize, similar treatment of non-banking and non-insurance risks becomes critical. The Board and the NAIC should work together to address such risks without creating arbitrage opportunities.

If after testing and analyzing the issues addressed throughout this letter, the Board determines that the BBA does not adequately capture particular concerns for financial stability posed by particular SIFI firms, a hybrid BBA/Consolidated Approach (CA) could be a workable solution whereby in addition to the capital requirement under the BBA, additional risks that have been deemed most associated with financial stability/systemic risk could be consolidated on an enterprise-wide basis and uplifts/scalars can be applied to the required enterprise-wide capital requirement to address those concerns. This could be a long-term solution that will employ the best attributes of both the BBA and the CA, which will develop over time.

Question 3: ***What criteria should the Board use to determine whether a supervised insurance institution should be subject to regulatory capital rules tailored to the business of insurance?***

The NAIC will be using the RBC Aggregation approach for any group containing a U.S. legal entity insurer. To promote consistency and ensure a level playing field, it would be appropriate for the Board to utilize the BBA for each supervised group containing a U.S. legal entity insurer. However, understanding the Board will have similar consistency concerns with groups with significant depository business relative to minor insurance business, and the relatively small number of firms involved, a qualitative judgment should be reserved. This qualitative judgment would consider the importance and size of U.S. insurance operations within the group and any potential impact on those operations and policyholders, along with similar considerations for the depository institutions. Determinations should also include an assessment of the regulatory value of, and transparency achieved by maintaining relative consistency with entity-based capital requirements.

Question 4: ***If multiple capital frameworks are used, what criteria should be used to determine whether a supervised insurance institution should be subject to each framework?***

Multiple capital frameworks are not preferable and we believe the BBA should be used as a baseline for all Federal Reserve supervised institutions significantly engaged in insurance activities. As previously noted, we are concerned about the complexity and potential for unintended consequences of a novel CA.

For Savings and Loan Holding Companies (SLHC) or Bank Holding Companies (BHC) that are predominantly engaged in insurance operations, we note that the 'source of strength' doctrine is not compatible with insurance legal entities in the same group as a depository institution for policyholder protection. State insurance regulators control whether any assets of a legal entity insurer could be used as a source of strength for a depository institution. Using the BBA capital requirement for groups with insurance legal entities would reflect this fact. The Board and the legal entity banking regulator can still ensure the depository institution maintains an appropriate level of financial condition through active financial monitoring, including additional legal entity minimum capital requirements if deemed appropriate.

With respect to SIFIs, after there has been sufficient time to assess the performance of the BBA for all supervised institutions, an add-on to the BBA would be appropriate to address financial stability concerns that gave rise to an institution's designation.

Question 5: ***In addition to insurance underwriting activities, what other activities, if any, should be used to determine whether a supervised institution is significantly engaged in insurance activities and should be subject to regulatory capital requirements tailored to the business mix and risk profile of insurance?***

As described above, considerations in determining whether a supervised institution should be subject to regulatory capital rules tailored to the business of insurance should focus on the importance and size of U.S. insurance operations within the group, any potential impact on those operations and policyholders, and all activities undertaken to support products regulated as insurance issued by firms within the group.

Building Block Approach (BBA)

As noted above, the Board's proposed BBA is similar to the NAIC's RBC Aggregation approach, and it would be beneficial for these two approaches to be as consistent as possible.

Question 6: ***What are the advantages and disadvantages of applying the BBA to the businesses and risks of supervised institutions significantly engaged in insurance activities?***

Much like the NAIC's RBC Aggregation approach, the BBA's advantages include:

(1) more compatibility with existing legal entity capital requirements and comparability across groups since it uses existing RBC, creating transparency in application of the federal and state regulatory roles;
(2) it does not require consolidated financial statements;
(3) it respects other jurisdictions' regulatory systems;
(4) it is comparatively quicker to develop;
(5) it should have the least impact and cost to industry and regulators;
(6) it reflects the reality of jurisdictional restraints on fungibility; and
(7) it does not mask capital inadequacies that may exist in legal entities.

Potential disadvantages of applying the BBA include the:

(1) inclusion of amounts from different accounting systems, requiring various consolidating adjustments;
(2) need to establish an accounting basis and/or capital standard for entities not currently subject to the same;
(3) potential for some jurisdictions to ignore particular risks in their establishment of capital requirements (requiring the scalar concept or other adjustments); and
(4) difficulty in calibrating to a single target level.

Additionally, the use of scalars to level-set the differing insurance capital standards adds difficulty and maintenance work to the development and application of a BBA.

Question 7: ***What challenges and benefits do you foresee to the development, implementation, or application of the BBA? To what extent would the BBA utilize existing records, data requirements, and systems, and to what extent would the BBA require additional records, data, or systems? How readily could the BBA's calculations be performed across a supervised institution's subsidiaries and affiliates within and outside of the United States?***

In terms of benefits, while there will likely need to be additional data to allow appropriate assessment and allocation of risks within the group, particularly for entities with no pre-existing capital requirement, the BBA will be much less burdensome than an insurer having to adopt an entirely new consolidated accounting system. As indicated, the BBA identifies the capital required for each legal entity in the group, facilitating a more realistic view of fungibility. Also, compared to the CA, the BBA minimizes the opportunities for unintended consequences in insurance group risk management or conflicts with existing legal entity regulation.

As is noted in the ANPR, the current cohort of insurance depository institution holding companies that would be subject to the requirements under consideration has few foreign activities. Some already have the insurer as the ultimate holding company. This should simplify the process for these groups, leaving the focus on: (1) how to treat entities with no pre-existing capital requirements; and (2) how to avoid the double counting of capital when an insurer is not the ultimate holding company.

Challenges to the development, implementation, and application of the BBA will depend on the complexity of the calculation and its use of available data. Key areas to address will include affiliated transactions, different accounting and capital requirements with adjustments and/or scalars, and the need to establish accounting and/or capital standards for entities with no specified industry standards. Another consideration that must be addressed in developing the BBA is the extent of capital fungibility of a legal entity insurer, which also has implications for the potential resolution of an insurance legal entity and policyholder protection. We note that when addressing fungibility of capital concerns, the CA does not readily identify the capital requirement compared to the capital available on a legal entity basis, whereas the BBA does provide this view. This is inherent in the nature of aggregating each legal entity's existing capital requirement and in establishing a capital requirement for those entities without pre-existing capital requirements.

Question 8: ***What scalars and adjustments are appropriate to implement the BBA, and make the BBA effective in helping to ensure resiliency of the firm and comparability among firms, while minimizing regulatory burden and incentives and opportunity to evade the requirements?***

The NAIC recently held initial discussions on scalars and some preliminary views from industry and regulators suggest that scalars would be appropriate in addressing differences for non-U.S. insurers. One concept the Board should consider is the use of sensitivity tests to implement scalars for the BBA as applied to non-U.S. insurers. Once a comfort level is reached with a particular scalar, then the sensitivity test result could be identified by the regulator as the official requirement or calculation result.

As to adjustments, the impact of permitted and prescribed accounting practices will need to be addressed if the Board wishes to reach a truly consistent statutory accounting base. Given the small number of U.S. legal entity insurers involved, it should not be too burdensome to obtain additional data to allow these amounts to be backed out of the detail data if such an approach is necessary. [4] Using a scalar for this purpose would unnecessarily establish generalization issues when the data is mostly already in

[4] Note that current statutory disclosures only detail impacts to capital/surplus and net income / (loss).

existence. For purposes of comparability among firms, we believe that few, if any, other valuation adjustments will be required, given the primarily U.S. nature of the entities. Some adjustments will be needed in capital requirements and capital resources to avoid double counting.

Additional discussion of scalars can be found in our response to ANPR question 19, below.

Question 9: ***To what extent is the BBA prone to regulatory arbitrage?***

In the first instance, consistency in the BBA capital requirement and the NAIC group capital calculation will help minimize regulatory arbitrage opportunities. As indicated previously, the NAIC has just held initial discussions on scalars and we welcome further discussion with the Board.

In addition, we note that regulatory arbitrage may occur when business is transferred or reinsured with companies domiciled in jurisdictions, particularly foreign jurisdictions, where reserving requirements are lower, or where capital requirements are inadequate to capture the legal entity's material risks. As a general matter, these differences can be easily adjusted for by on-top adjustments for U.S. state permitted and prescribed accounting practices. We are cognizant that concerns have been raised with regard to the use of captive reinsurance by life insurance companies, but remediation efforts undertaken by the states through work at the NAIC has already resulted in regulatory changes to address these concerns. Additional accreditation requirements should drive consistency and, in the short term, appropriate and necessary adjustments can be constructed. With respect to foreign jurisdictions, it may be more difficult to account for such differences where, in some cases, the regulatory regime may be dramatically different, thus scalars applied to non U.S. insurers may be appropriate.

Question 10: ***Which jurisdictions or capital regimes would pose the greatest challenges to inclusion in the BBA?***

At this time, it is unclear which jurisdictions or capital regimes could pose the greatest challenges to inclusion in the BBA. As the NAIC discussion regarding the use of scalars in the group capital calculation progresses, we expect to develop a better understanding of the data necessary to assess which regimes would pose the greatest challenges and would be happy to share our findings with the Board. We hope the Board will do the same as it works through its deliberations.

Question 11: ***How should the BBA apply to a supervised institution significantly engaged in insurance activity where the ultimate parent company is an insurer that is also regulated by a state insurance regulator? Are there other organizational structures that could present challenges?***

Regardless of the approach, any group-wide capital standard must not conflict with legal entity capital requirements. The issue is not whether an insurer – rather than a holding company – is present as the head of the insurance group. A conflict under either scenario presents difficulties.

Ideally, the BBA capital requirement and the NAIC group capital calculation using an RBC aggregation method will establish consistent results. However, in the event there are material differences between the two approaches and an insurer is the ultimate legal parent, an appropriate regulator may have to apply additional requirements to offset any perceived capital deficiencies in the non-insurance entities. Because the assets of an insurance legal entity are not fungible, it is absolutely critical that any supervisory concerns or expectations be coordinated with the state of domicile, the primary regulator of the insurance group (lead state regulator), or with the state group-wide supervisor, if applicable.

Question 12: ***Is the BBA an appropriate framework for insurance depository institution holding companies? How effective is the BBA at achieving the goal of ensuring the safety and soundness of an insurance depository institution holding company?***

The BBA appears to be a workable solution to maintain the Board's requirements for the depository institution while incorporating the existing legal entity RBC requirement for a U.S. insurer. Determining an appropriate treatment for all other entities is critical to address in a coordinated manner to ensure consistency between the Board and NAIC approaches. As long as consistency is achieved, concerns regarding which approach is applied should be minimal.

Question 13: ***Would the BBA be appropriate for larger or more complex insurance companies that might in the future acquire a depository institution?***

The NAIC currently intends to apply the RBC Aggregation approach to all U.S. insurance groups; if future testing and use suggest the approach does not work well for certain types of groups, a more appropriate regulatory response will be considered at that time. We suggest that making such determinations prior to testing the BBA capital requirement on the existing identified groups would be premature and unproductive.

Question 14: ***In applying the BBA, what baseline capital requirement should the Board use for insurance entities, banking entities, and unregulated entities?***

The NAIC is currently focused on the treatment of entities without their own industry capital requirement. However, from the initial concept discussions, one suggested baseline capital requirement would be the full amount required to avoid regulatory reaction and/or company responses for insurance and banking entities. For RBC, this would be the Trend Test RBC Level. Current discussions for unregulated entities include a flat factor approach with the potential for some further evolution for identified industries if data supports a more complex approach. Also, there appears to be convergence toward using the same treatment for these entities regardless of whether they are held by an insurer or the holding company. We will look to the BBA with regard to the treatment of banking entities.

Question 15: ***How should the BBA account for international or state regulator approved variances to accounting rules?***

The BBA should not apply scalars to U.S. legal entity insurers using statutory accounting. State permitted and prescribed accounting practices should be adjusted to achieve the baseline statutory accounting. If additional data is needed for specific detail data elements, it should not be too burdensome for companies to provide and the Board to collect. Considering scalars would only make sense if the data was not already mostly available. Since international regulator approved variances are not currently disclosed for non U.S. entities, a scalar might be appropriate for the BBA to address these differences.

Question 16: ***What are the challenges in using financial data under different accounting frameworks? What adjustments and/or eliminations should be made to ensure comparability when aggregating to an institution-wide level?***

Challenges posed by using financial data under different accounting frameworks include whether to require adjusting entries to align the results with statutory accounting or to use scalars to approximate the impact of the accounting differences. Solutions to these challenges will mostly depend upon the effort and costs involved in obtaining reliable data for the adjustments.

Regarding the actual adjustments, a key challenge will be to identify relevant adjustments to material financial data while taking into account the important objectives of simplicity and relevance. Key adjustments would include:

(1) investments (e.g., volatile values under International Financial Reporting Standards [IFRS] or U.S. GAAP vs. less volatile U.S. statutory accounting [SAP] with more amortized cost values and existence of the Asset Valuation Reserve [AVR]);
(2) insurance liabilities (e.g., IFRS or U.S. GAAP measurement principles vs. U.S. SAP's conservative actuarial assumptions, discounting, etc.); and
(3) intercompany transactions.

Question 17: ***What approaches or strategies could the Board use to calibrate the various capital regimes without needing to make adjustments to the underlying accounting?***

Utilizing scalars in some sensitivity analysis and stress testing capital capacity would both seem to be viable options. While the NAIC has only had a brief discussion regarding these options as they relate to its group capital calculation, the members have previously expressed support for the use of stress tests to achieve a common calibration for different global capital requirements. However, it would be important to have appropriate reliable data upon which to base the scalar adjustments, and this may take time to achieve workable results. Implementing this function in a sensitivity/stress testing structure would offer flexibility to the regulators. However, it may be necessary to make some key adjustments to the data even if a scalar is to be used.

Question 18: ***How should the BBA address inter-company transactions?***

It should be noted that state insurance regulators receive information on intercompany transactions with legal entity insurers, including regulatory review and approval authority for material transactions. While the NAIC has not fully studied or debated the issue, deciding upon any capital requirement for non-equity transactions should be based upon an assessment of the risks present and the extent those risks have already been assessed in the legal entity capital requirement. In some cases, a flat factor for equity ownership in entities without their own industry capital requirement may be adequate. Additionally, certain capital financial instruments such as surplus notes and senior debt that provide loss absorption capacity could be more appropriately viewed through an assessment of capital resources. As described above, we also recognize that, at least in the short term, adjustments may be necessary to address captive reinsurance transactions.

Question 19: ***What criteria should be used to develop scalars for jurisdictions? What benefits or challenges are created through the use of scalars?***

If the scalar is used to approximate adjusting entries for non-U.S. insurers and non-insurers, the scalar(s) should be based upon appropriate and reliable data over a period of time. Using a sensitivity test framework would allow flexibility in the implementation of these scalars, allowing the regulator to decide when a sensitivity test is required to be met.

A challenge is whether enough data can be accumulated for each jurisdiction to support statistically sound scalars. The scalars will need to be reviewed regularly and adjusted, which may present additional challenges.

Reliable scalars would create benefits both by saving time and money by not requiring restatement into a consistent accounting framework, and by removing some complexity from the framework.

Question 20: ***What are the costs and benefits of a uniform, consolidated definition of qualifying capital in the BBA?***

A "uniform, consolidated definition of qualifying capital" would potentially reduce the benefits of the BBA and could even cause unintended consequences at the legal entity level. By definition, a BBA is an aggregation approach that utilizes entity based capital requirements and qualifying capital. Statutory accounting, for example, nonadmits various assets, and precludes establishment of deferred acquisition costs (DAC). Imposing additional capital limitations for a group-wide qualifying capital definition would likely cause issues. At some point, the group capital work might dictate changes that would need to occur at the legal entity level, and the appropriate regulator would make those. However, impacting the business model of the legal entity insurer should be carefully assessed for unintended consequences and should only occur with the coordination and approval of the state insurance regulators. We believe these concerns outweigh the consistency benefits of a consolidated definition of qualifying capital.

Question 21: ***If the Board were to adopt a version of the BBA that employs a uniform, consolidated definition of qualifying capital, what criteria should the Board consider? What elements should be treated as qualifying capital under the BBA?***

One of the key criteria the Board should consider is the impact of different accounting frameworks. For example, given that the SAP accounting framework differentiates between admitted and non-admitted assets, SAP capital is far more likely to be composed of "qualified capital" than GAAP capital.

For purposes of the NAIC's Group Capital Calculation, the NAIC has yet to discuss the process of aggregating capital from each entity and making appropriate adjustments. It has been noted that we will need to address the issue of subordinated debt.

However, for the BBA to be consistent with the RBC Aggregation approach, similar processes for calculating the group's capital should be considered and any restrictions on capital types should remain at the legal entity requirements level. Qualifying capital should be assets that are lawful and qualified for the legal entity.

Question 22: ***Should the Board categorize qualifying capital into multiple tiers, such as the approach used in the Board's Regulation Q? If so, what factors should the Board consider in determining tiers of qualifying capital for supervised institutions significantly engaged in insurance activities under the BBA?***

Restrictions and requirements on capital types should be left to the legal entity requirement level. Tiering of capital is not appropriate for U.S. insurance entities in a BBA due to the long-term nature of insurance business. Under statutory accounting principles adjustments are made to not admit assets with questionable value or limited liquidity.

Further, limits placed on lower-tiered capital could fail to take into consideration the nature of the insurer. For example, limits on lower-tiered capital should not penalize mutual insurers that are limited in the type of capital that can be raised during times of stress.

Consolidated Approach

Question 23: ***What are the advantages and disadvantages of applying the CA to the businesses and risks of supervised institutions significantly engaged in insurance activities?***

On balance, we believe the disadvantages to the CA and the benefits of the BBA (as set forth above) outweigh any potential advantages to the CA.

The primary advantage of applying the CA to the business and risks of supervised institutions significantly engaged in insurance activities is that one can get a consolidated view of all entities within a group through the use of GAAP. SAP has historically not been a consolidated accounting regime though as cited above state regulators are in the process of developing a group-wide capital calculation, which will tend to create a more consolidated view. Another advantage some might see is that the GAAP consolidated financial statement is audited. While legal entity insurers' statutory financial statements are audited, some of the separate non-insurance or foreign insurance entities within a U.S. insurance group may not have audited financial statements.

The primary disadvantage of applying the CA to the business and risks of supervised institutions significantly engaged in insurance activities is the possibility that the CA's risk weighting and capital charges will be inconsistent with existing capital requirements for the legal entity insurers in the group, potentially resulting in direct conflict with state requirements, and ultimately could result in effective preemption of state law. Such regulatory conflicts could be highly problematic for the entities and regulators. The Board should carefully consider whether to pursue a CA, particularly given the time and effort involved in creating a new approach from scratch with the necessary level of complexity, and adequately testing it. Although the ANPR indicates the approach would initially have broad risk segmentation and would be refined as experience builds, the complexity may be an issue even in the initial stages, making it difficult to prevent unintended consequences for the insurance business and regulatory conflicts.

Another disadvantage relates to the ability of consolidated financial statements to disguise issues at the legal entity level (for example, an over-leveraged or poorly-capitalized legal entity). As described above, capital in the insurer material legal entities is not fungible or available as a source of strength without obtaining state regulator approval for most dividends/contributions. The BBA would incorporate the established capital requirements for each legal entity, which would at least allow consideration of distributing the capital in a similar manner. Given that legal entities can fail while the group continues to exist, this seems to be an important benefit for financial stability and better reflects reality when insurance groups experience financial distress.

Question 24: ***What are the likely challenges and benefits to the development, implementation, and application of the CA? To what extent could the CA efficiently use existing records, data requirements, and systems, and to what extent would the CA require additional records, data, or systems?***

As the Board has noted, the designated SIFIs already prepare consolidated financial statements under GAAP. Depending upon the amount of regulatory adjustments, the additional data demand on companies could be minimal. However, GAAP financial statements may not capture requisite exposure amounts or in the appropriate detail, so additional data may be needed. With respect to the SLHCs, some of them do not use GAAP reporting and under the law are not required to do so. Constructing an entirely new consolidated accounting regime and the implementation of such a regime could be quite burdensome.

Further, constructing a brand new capital requirement based upon adjusted figures will be challenging, particularly in light of possible conflicts with existing legal entity capital requirements. These existing legal entity requirements should be considered, as should incentives for specific behavior by insurers that might be detrimental to policyholder protection goals.

Question 25: ***To what extent would the CA be prone to regulatory arbitrage?***

Although the risk of legal entity redomestication involved in the BBA may not be as prevalent in the CA, considerations regarding diversification could still leave some room for legal entity arbitrage. However, the primary risks regarding arbitrage for the CA relate to products and activities. If the risk charge fails to accurately capture the risks, then arbitrage will be possible.

Question 26: ***Is the CA an appropriate framework to be applied to systemically important insurance companies? What are the key challenges to applying the CA to systemically important insurance companies? How effective would the CA be at achieving the goals of ensuring the safety and soundness of a systemically important insurance company as well as minimizing the risk of a systemically important insurance company's failure or financial distress on financial stability?***

As discussed in the questions on the BBA, the NAIC believes that the BBA can be an effective enterprise-wide capital regime for SIFIs either alone or, if demonstrated after testing, as a hybrid approach with CA as discussed above. Thus, we urge the Board to first determine whether the BBA, in conjunction with various augmentation approaches (e.g. scalars, CA consolidation of risks particularly associated with systemic risk/financial stability), stress testing and other tools, can meet the needs for SIFIs. If the Board determines, after testing, that the BBA cannot be adjusted and/or combined as recommended above to address financial stability/systemic risk concerns, it could then consider development and application of a CA approach to SIFIs.

In terms of challenges, a key challenge is that a consolidated approach implicitly assumes fungibility as a source of strength between entities, and this is not materially available without state regulator approval and therefore is not appropriate for legal entity insurers.

As to whether the CA will be effective in achieving the dual purpose of ensuring safety and soundness of a SIFI and minimizing the impact upon its material distress, the answer to this question depends in large part on the design of the CA or the BBA for that matter. However, the NAIC considers capital requirements to be an important part of solvency oversight, but it is not necessarily the most important tool. This is partly why we believe a BBA or the BBA with augmentation can work for SIFIs, along with appropriate stress testing to address liquidity and other concerns not addressed by capital. So a key challenge the NAIC would highlight is ensuring that the capital requirement is not expected to remedy risks it actually cannot remedy.

Additionally, the Board should be careful about conflating:

(1) safety and soundness of a SIFI;

(2) minimizing an insurer's risk of failure; and
(3) minimizing the risk of a company's distress causing material impacts on financial stability.

While SIFIs have been designated due to concerns about systemic risk, it should not be ignored that insurance operations can and have played a significant buffer role in times of financial crisis. As discussed earlier, care must be taken to avoid unintended consequences that diminish those benefits.

Question 27: ***What should the Board consider in determining more stringent capital requirements to address systemic risk? Should these requirements be reflected through qualifying capital, required capital, or both?***

The Board should remember that capital adequacy is only one element in the regulatory toolkit. There is often a delay in regulators noting capital issues since financial statements are not produced daily; specific issues can be masked for a time if other oversight activities are not robust. As the Board recognizes, appropriate corporate governance, risk management and liquidity monitoring and governance processes are particularly important for insurance groups. Stress tests, liquidity buffers and other assessments may be more effective in addressing certain regulatory concerns than specific stringent capital requirements.

Question 28: ***What should the Board consider in developing a definition of qualifying capital under the CA? What elements should be treated as qualifying capital under the CA?***

The NAIC believes qualifying capital should be determined by reference to the legal entity requirements (insurance and non-insurance). However, if the Board develops additional requirements, they should consider:

(1) loss absorbency;
(2) subordination; and
(3) the robustness of the regulatory regime behind the capital instrument.

Question 29: ***For purposes of the CA, should the Board categorize qualifying capital into multiple tiers? What criteria should the Board consider in determining tiers of qualifying capital for supervised institutions significantly engaged in insurance activities under the CA?***

Restrictions and requirements on capital types should be determined by reference to the legal entity requirement level. Tiering of capital is not appropriate for U.S. insurance entities in the CA approach due to the long-term nature of insurance business. Under statutory accounting principles adjustments are made to not admit assets with questionable value or limited liquidity.

Further, any limits placed on lower-tiered capital could fail to take into consideration the nature of the insurer. For example, limits on lower-tiered capital should not penalize mutual insurers that are limited in the type of capital that can be raised during times of stress.

Question 30. ***What risk segmentation should be used in the CA? What criteria should the Board consider in determining the risk segments? What criteria should the Board consider in determining how granular or risk sensitive the segmentation should be?***

For insurance risks, segmentation in the CA should be by product type and geographic region. The Board should bear in mind that the appropriate exposure(s) could vary by product. Due to the very small number of SIFIs, risks that are immaterial to those few SIFIs can involve less granular treatment.

Question 32: ***What are the pros and cons of using the risk segmentation framework in the proposed Consolidated Financial Statements for Insurance Systemically Important Financial Institutions as the basis of risk segmentation for the CA?***

Pros of using the risk segmentation framework include: (1) simplicity, and (2) consistency and comparability of capital charges for similar risks within an insurance group or in comparison to other insurance groups.

Cons include: (1) the term "similar risks" defined in FR2085 for grouping products will need careful explanation and may still create an incentive to take on additional risks or offset non-performing or riskier product categories; and (2) for property/casualty lines of business, the grouping should, at a minimum, tie with the revenue level grouping on Schedule IRI-C and Schedule IRC-I for consistency.

Question 33. ***How should the CA reflect off-balance-sheet exposures?***

As a general matter, the CA could utilize a number of different methods to address off-balance sheet risk including capital add-ons, factor based approaches, stress testing of off-balance sheet risks, or balance sheet consolidation of such risks. In terms of areas of specific consideration, if derivatives are used off-balance sheet, the focus should be on properly reflecting credit risk with due consideration for hedging.

For property/casualty insurers, catastrophe risk should be reflected in a manner similar to the NAIC's method under review: establishing a risk charge for modeled loss amounts at a specific safety level.

Question 34: ***Under what circumstances should US GAAP be used or adjusted to determine the exposure amount of insurance liabilities under the CA?***

Should the Board proceed with a CA for SIFIs, U.S. GAAP is an appropriate starting point for determining the exposure amounts of insurance liabilities under the CA because it is well established, audited and well understood by all stakeholders. However, without additional information, it will not accurately determine the exposure amount under the CA.

Specifically, for property/casualty risks, U.S. GAAP premiums and reserves would provide a good starting place for exposure amounts. While these figures are not likely to have the desired level of granularity, it would be relatively straightforward to reconcile the SIIC's own more granular reporting to such aggregated figures.

Question 35: ***What considerations should the Board apply in determining the various factors to be applied to the amounts in the risk segments in the CA?***

As the Board determines factors to be applied to the amounts in the risk segments of the CA, it should be mindful of the:

(1) granularity of the exposure measure to which the factor would apply;
(2) margins inherent in GAAP;
(3) time horizon of the CA (we believe for long-term business, e.g., most of life insurance, the outlook should be long-term, and an argument for this is below);
(4) risk sensitivity of the exposure; and
(5) uncertainty around the estimates underlying the exposure.

Additionally, the Board should give significant consideration to the long-term time horizon associated with insurance risks in determining amounts in the risk segments in the CA. For insurance risks, the factors used should reflect the full risk as runoff-to-ultimate. While a shorter time horizon – e.g. one year – may make sense for market risks that can be hedged or sold, this is generally not possible (and, even if so, very expensive) for insurance risks. A short time horizon does not fully capture the risk to a firm of long-term insurance obligations. On a going concern basis, the firm takes on the full risk of an insurance policy at the time it is written – not just the first year of that risk. Any methods that attempt to fully capture this total risk in a one-year framework (e.g. through margins) can be arbitrary and unnecessarily complex. The NAIC believes a more appropriate – and practical – approach is to use a single factor to capture the full risk.

Question 36: ***What challenges are there in determining risk factors for global risks?***

Determining risk factors for global risks gives rise to many challenges, including but not limited to:

(1) nomenclature difficulties – to use one example, differing definitions of variable annuities exist across the globe, which have exaggerated the perceived riskiness of such products;
(2) identification of risk factors – jurisdictions differ widely on how risk factors are identified, and more importantly how they are combined for purposes of applying any capital risk charge;
(3) lack of resources – many jurisdictions suffer from a paucity of professionals appropriately trained to identify risks;
(4) rating differences, particularly with respect to differences in sovereign debt treatment; and
(5) "soft" factors – wide variations in supervisory direction and discretion.

As currently designed the proposed CA will not consider diversification between risks. This means that the impact of an individual factor on the total required capital could potentially be much larger than under the capital regimes from which the factors may be taken.

Question 37: ***What criteria should the Board consider in developing the minimum capital ratio under the CA and a definition of a "well-capitalized" or "adequately capitalized" insurance institution?***

As the Board develops any minimum capital ratio and seeks to define "well-capitalized" or "adequately capitalized" under the CA: (1) the ratio should not be a zero-failure standard; (2) the construct of minimum capital ratios should be commensurate with the level of regulatory intervention and intensity, including plans for remediation; and (3) the ratio must not be inconsistent with capital regimes already applicable to the legal entities within the group.

Question 38: ***Should the Board reevaluate any of these approaches? What additional consideration, if any, should the Board give to any of the regulatory capital approaches discussed above?***

Yes. The NAIC believes the same basic capital framework should apply to all supervised insurance institutions, as long as the framework aligns with the regulatory purpose and satisfies other necessary considerations, such as costs versus benefits, and accounts for variations in group structures, dynamics, reporting, and legal requirements. The NAIC is constructing its group capital calculation using an RBC Aggregation approach with the intent to utilize it to analyze all holding company groups containing a U.S. legal entity insurer.

The NAIC does not believe the Board should consider regulatory capital approaches for insurers based on Regulation Q, Solvency II, or internal stress testing. We encourage the Board to focus on the proposed BBA first, to determine if it can be applied in a manner used to adequately address the material risks for all supervised insurers, including SIFIs, before embarking on an alternative baseline approach that would treat Insurance Depository Institution Holding Companies and SIFIs differently.

Conclusion

We look forward to continuing our constructive engagement with the Board as it moves forward with the development of capital requirements for the insurance institutions for which it has supervisory responsibilities. As the roles of the Board and state insurance regulators should be complimentary, we believe avoiding – or at least minimizing – inconsistencies with existing state based capital regimes and our ongoing group capital work will yield the best results for all affected policyholders, insurance institutions, regulators, and ultimately, financial stability. Should you wish to discuss this comment or any other matter relating to the NAIC's views on this ANPR, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980 or Mark Sagat, Counsel and Manager, Financial Policy and Legislation, at (202) 471-3987.

Sincerely,

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