TRANSAMERICA

January 22, 2020

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

via email to regs.comments@federalreserve.gov

Re: Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities

Docket No. R-1673 and RIN 7100-AF 56

Dear Ms. Misback:

The Transamerica Companies ("Transamerica")[1] are pleased to provide comments in response to the Board of Governors of the Federal Reserve's Notice of Proposed Rulemaking (NPR) for Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities.

Transamerica's interest in the NPR is indirect but significant. Transamerica is not federally supervised and would not be subject directly to the Board's proposed capital requirements. However, our interest in the NPR is much greater than it was in 2016 when the Board's Advance Notice of Proposed Rulemaking was issued. Two developments, both of which are noted in the NPR, have increased our interest: (1) the Board's collaboration with the NAIC and resulting apparent influence on the NAIC's Group Capital Calculation, and (2) the Board's involvement in efforts of "Team USA" to champion a global standard-like Aggregation Method at the IAIS. Accordingly, the Board should consider the impacts of its proposals on a broader set of stakeholders than in 2016.

Most notably, we have significant concerns about proposed adjustments to available and required capital within the BBA. The NPR indicates that the Board is proposing a variety of adjustments to available and

[1] Operating under the Transamerica brand primarily, the U.S. is the largest market for Netherlands-based Aegon N.V. ("Aegon"). Transamerica products and services help people protect against financial risk, build financial security and create successful retirements. Transamerica markets life insurance, annuities, long-term care insurance, and voluntary benefits (including supplemental health insurance), retirement plans, recordkeeping and advisory services, mutual funds and other long-term savings and investment products. Transamerica provides services and products through life insurance agents, broker-dealers, banks, wholesalers, and direct marketing channels as well as through the workplace. Transamerica services more than 9 million policyholders, with more than 256,000 licensed producers in the United States. In 2018, Transamerica paid more than $6 billion in benefits to policyholders, and employs over 7,500 people.

required capital, primarily involving U.S. insurance operations. While we support adjustments to eliminate double-gearing, several of the Board's proposed adjustments effectively suggest that certain facets of the state-based insurance solvency system are inappropriate. As a foreign-owned insurer that must routinely explain and defend the U.S. framework to non-U.S. supervisors, it is highly troubling and problematic for us when U.S. authorities effectively discredit the state-based legal entity solvency framework. Adjustments also undermine one of the main benefits of an aggregation approach by creating a new "adjustment-based" regime. We believe that, if the Board is unable to rely fully on existing capital regimes, it should develop its own regime in a manner consistent with its mandate under Dodd-Frank.

In our response, we have focused on these adjustments and other elements of the proposed Building Blocks Approach (BBA) that are of greatest interest and importance to Transamerica.

Question 1: The IAIS is currently considering a MAV approach for the ICS; in contrast, the BBA aggregates existing company-level capital requirements throughout an organization to assess capital adequacy at various levels of the organization, including at the enterprise level. What are the comparative strengths and weaknesses of the proposed approaches? How might an aggregation-based approach better reflect the risks and economics of the insurance business in the U.S.?

We assume that the question is focusing on consolidation-based vs. aggregation-based group capital approaches rather than accounting bases such as MAV.

The import of group capital is largely optical, as such measures provide an easily understandable assessment of financial strength and soundness. Both consolidation and aggregation approaches have limitations in that neither directly provides information on amounts that can be returned to company owners.

Consolidation-based approaches such as the ICS view the insurer as a single economic entity. In general, a strength of a consolidation-based approach is that it places risks on a level playing field by applying jurisdiction-agnostic accounting and capital rules. This is why insurers typically employ consolidation-based approaches when creating economic capital models. A weakness of a consolidated approach such as the ICS is that its accounting and capital rules may create incentives and disincentives that conflict with the incentives created by jurisdictional rules at the legal entity level. Such conflicts could even have the effect of undermining policyholder protection, for example by reducing the willingness of insurers to employ risk mitigation strategies.

In general, a strength of an aggregation-based approach is that it more naturally provides insights on capital sufficiency at more granular levels of an organization. (Some proposed adjustments within the BBA negate this advantage.) A weakness of an aggregation-based approach is the absence of a uniform single standard for measuring risk within a group. This may lead to hidden risk concentrations or encourage regulatory arbitrage.

Question 2: In what ways would an aggregation-based approach be a viable alternative to the ICS? What criteria should be used to assess comparability to determine whether an aggregation-based approach is outcome-equivalent to the ICS?

It is not clear from the question whether the Board is differentiating between a general "aggregation-based approach" and the Aggregation Method at the IAIS. The board's BBA, an "aggregation-based approach," appears to vary significantly from the Aggregation Method at the IAIS, based on what information is known about the latter.

An aggregation-based group capital approach is based on a different construct than a consolidation-based approach. The former relies on divergent jurisdictional standards, while the latter relies on a uniform, prescribed set of standards. We view the two approaches as "outcome-equivalent" only in the broadest possible sense, or perhaps by unusual coincidence.

Given the decentralized and legal entity-based supervisory system that has traditionally existed within the U.S., we believe that aggregation-based group capital approaches have merit in a U.S. context. Several years ago we recommended that the NAIC pursue such an approach. While we are less persuaded that such an approach is optimal for the Board given its mandate, we do not oppose the Board's consideration of such an approach. However, as explained below, the proposed BBA deviates from a "true" aggregation approach through various adjustments, which lead us not to support the BBA as proposed.

Indeed, the Board's proposed adjustments create a gulf between the proposed BBA and what has commonly been understood as an aggregation approach to group capital (such as the Deduction and Aggregation alternative method within the European Solvency II framework. We believe the proposed adjustments within the BBA may negatively impact the viability of the Aggregation Method internationally.

Finally, we have some misgivings about the pursuit of outcome equivalence. Outcome-equivalence would propagate the myth that a unified global capital standard is in the offing, while in reality the political will to enact such a standard does not currently exist. Moreover, the Aggregation Method is being developed in a non-transparent manner that conflicts with the IAIS's own governance. Nothing in the IAIS bylaws appears to allow a handful of "interested jurisdictions" to develop a "general international standard" for insurance capital, but this is what is happening with the Aggregation Method. The Aggregation Method should be either an official IAIS project and subject to full IAIS governance, procedure, and stakeholder participation, or it should be outside of the IAIS entirely.

Question 13: The Board invites comment on the proposed approach to determine applicable capital frameworks. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?

In general, we support the use of "stacking" within insurance-centered aggregation-based group capital approaches. In general, we believe that an approach should rely on "top-tier regulated" insurance entities within the group structure, and the available and required capital of this "top-tier regulated" entity should be assumed to adequately reflect all subsidiary entities. Such an approach maximizes the use of the U.S. insurance-based capital requirements. To its credit, the proposed BBA appears to rely on a significant degree of "stacking" but makes exceptions for depository institutions and certain insurance entities. While we acknowledge the Board's desire to align with its capital standards for depository institutions, we do not to see the rationale for failing to rely on subsidiary capital rules for insurance entities.

We observe that the Board's approach varies significantly from the "unstacked" or "de-stacked" approach suggested by some stakeholders and apparently promoted via the Aggregation Method as a part of this quasi-international standard. The de-stacked approach discards the legal entity structure and invites rewriting the capital rules for subsidiaries. We believe this creates significant operational burdens, unnecessary complexity, and may create a difficult-to-explain impact on available capital due to varying accounting frameworks. We believe that subsidiaries should be viewed as an asset of the parent entity, with required capital based on that asset. Just as an aggregation approach permits regime-specific treatment of various assets, it should permit a regime-specific treatment of subsidiaries. We therefore believe the Board's approach, while not optimal, is superior to the approach that we understand is being proposed under the banner of the Aggregation Method.

Question 22: The Board invites comment on the proposed approach to scalars and the associated white paper. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?

While the white paper is appreciated, the discussion of scaling between assumed equivalent points has two shortcomings. First, it presumes that there must be interpolation between two of the three equivalence assumptions. It would be possible to develop a scaling approach using just one assumption. Second, the criticism of "industry average capital levels" fails to assess the possibility of using a multi-year analysis to mitigate volatility.

Question 23: How should the Board develop scalars for international insurance capital frameworks if needed?

We have a somewhat theoretical preference to use industry average capital levels (perhaps assessed on a longer-term basis to mitigate volatility). The NPR acknowledges that the Board's proposed scaling mechanism is unworkable internationally, and the NPR is proposing a provisional approach that amounts to no scaling plus a "jurisdictional adjustment" surcharge. The Board should further explore viable alternatives that can be used to scale non-U.S. capital frameworks to a U.S. basis.

Question 24: The Board invites comments on all aspects of the proposed adjustments to capital requirements. Should any of the adjustments be applied differently? What other adjustments should the Board consider?

We have significant concerns about proposed adjustments to available and required capital and comment on these in our response to Question 25.

Question 25: The Board invites comments on all aspects of the proposed adjustments to available capital. Should any of the adjustments be applied differently? What other adjustments should the Board consider?

We have a number of specific concerns about the Board's proposals to adjust available and required capital, most notably adjustments for permitted practices, prescribed practices, grandfathering, and transitional measures.

At a high level, we consider the NPR's justification for adjustments to be flawed. The NPR justifies adjustments for permitted practices, grandfathering, and transitional measures on the basis that such adjustments will "help to increase the comparability of results" among supervised firms. We believe that such adjustments would lead to false perceptions of solvency and financial soundness because they would diverge from the standards that companies have actually used to manage risk and capital. Although, as explained below, the scope of adjustments is unclear, we believe that any purported "comparability" achieved by adjustments would be illusory.

Although several of the proposed adjustments seem to target captive structures, the NPR gives little evidence that the Board appreciates the underlying purposes and merits of captives. These arrangements have been allowed because of widely acknowledged flaws within the U.S. insurance solvency framework. Such flaws, even once they are recognized, have taken many years to address, and in some cases, a policy decision has been made that a direct remedy is not needed.

Captive arrangements generally produce outcomes that bring the U.S. statutory framework more in line with the economic perspective taken by IAIS's Insurance Core Principles. Term, ULSG, and embedded value captives effectively allow alternative assets (such as letters of credit) to back statutory liabilities in excess of the prudent economic reserve of the business (which is backed by high quality assets). ICP 14.4.1 and 14.5.15 would effectively suggest that no assets should back excessive liabilities (i.e. such liabilities should not exist). Similarly, in light of recognized flaws in the variable annuity framework, captives have been established to provide a more appropriate reflection of the risk, capital needs, and solvency position of the insurer. U.S. state regulators have permitted captive arrangements only because substantial evidence has existed that the statutory framework distorts the risk and solvency position of an insurer and that the captive results in a <u>better</u> measure of risk and solvency. It is unclear whether the Board fully appreciates this.

Ironically, the NPR is silent about a major disconnect where adjustments <u>could</u> be warranted. In Section VII of the NPR, the Board acknowledges that the state-based solvency framework is based on a gone-concern perspective, which differs from the going-concern safety and soundness perspective that the Board is required to take. It does not appear that the Board has explored the implications. For example, under its gone concern perspective, the statutory framework severely restricts the recognition of deferred tax assets. On the flip side, the statutory framework also limits the liability for policyholder dividends. These and potentially other elements of the statutory framework have markedly different impacts on different insurers. Scaling and the Board's proposed capital buffer are likely to be inadequate for translating the statutory framework from a "gone concern to a "going concern" basis. Although we are not advocating adjustments, if any adjustments are made, they should prioritize the going/gone concern disconnect.

Finally, the scope of proposed adjustments is unclear, potentially extensive, and potentially highly disruptive. The NPR proposes to reverse the effects of permitted accounting practices, prescribed accounting practices, "grandfathering or transitional measures," or other practices that "depart from a solvency framework as promulgated for application in a jurisdiction." The NPR, however, does not adequately consider a host of circumstances that include the following:

- **Jurisdictional discretion.** In multi-jurisdictional regimes, it is common for solvency standards to include a degree of jurisdictional discretion, reflecting a balance between the desirability of consistency, jurisdictional sovereignty, and supervisor discretion. In the U.S., for example, states have the option to increase legal reserve requirements over NAIC minimums, which are generally established by model laws and regulations and enforced through the accreditation system. Prescribed practices are also a type of jurisdictional discretion. In Europe, Member States also have certain options under Solvency II, such as whether to include duration-based equity risk charges. Although footnote 32 (Section IV.A) references "NAIC RBC <u>as adopted by the insurer's domiciliary state</u>," the NPR lacks a clear and consistent principle to determine which, if any, jurisdictional discretions would be deemed to merit adjustment. It is our view that jurisdictional discretion should be fully respected within the BBA.

- **Supervisor-approved variations.** Although supervisor-approved variations are part of virtually every modern insurance solvency framework, the Board seems to view them negatively, as the NPR proposes to reverse effects of permitted practices. The NPR, however, lacks a fulsome discussion of supervisor-approved variations under various regimes, leading to unclear implications. For example, the European Solvency II framework requires supervisory approval for certain liability discounting approaches. Moreover, in Solvency II, an insurer may, after a specified application and rigorous review process, use a bespoke internal capital model to calculate its regulatory requirement, either in part or in whole, thus aligning insurer and supervisor perspectives of risk and capital. The NPR is unclear as to whether the Board would effectively proscribe Solvency II valuation adjustments and internal model-based capital requirements. Our view is that the rationale for allowing such measures is the same as for permitted practices, i.e. they result in a better reflection of risk and capital, and that all such variations should be included.

- **Transitional measures: phase-ins.** In light of the fact that many insurance business lines are long term, supervisors often allow phase-ins of new requirements in order to avoid excessive and unintended market impacts. In the U.S., for example, state regulators are permitting a phase-in of the new variable annuity framework that can be as long as three years (without regulatory approval) or seven years (with regulatory approval). In Europe, Solvency II includes a phase-in of technical provisions that can be as long as sixteen years. The NPR, however, seems to view phase-ins negatively, noting that the adjustment for transitional measures could "encompass transitional measures in Europe, such as the long-term grandfathering of disparate accounting of insurance liabilities." (Note that the European approach is technically a phase-in, not grandfathering.) Overall it is not clear that the Board has fully considered the extent, scope, and consequences of disallowing phase-ins, and we see no compelling rationale for the Board to unwind these measures.

- **Insurer optionality, including as a transitional measure.** Insurance solvency regimes often include the ability for insurers to choose among multiple approaches. For example, the NAIC's updated variable annuity framework includes two different ways to determine the floor reserve and two different ways for hedging to be reflected in actuarial modeling. At times, optionality is a type of transitional measure. For example, state regulators have traditionally allowed a three-year optional application for new life insurance mortality tables. During the transition period, companies can choose to calculate reserves and nonforfeiture amounts using either the "old" table or the "new" table. This optionality was expanded to the principle-based reserving regime, which is being incorporated simultaneously with a new mortality table. PBR is prohibited for individual life insurance policies issued prior to 2017, <u>optional</u> for 2017-19 issues, and required for policies issued in 2020 and beyond.

  The NPR signals that the Board is not inherently averse to all insurer optionality, proposing options for insurers in at least three different areas. However, the NPR is unclear as to the extent to which the Board views insurer optionality as meriting adjustments to available and required capital. For example, footnote 66 notes that the proposed adjustment for "grandfathering or transitional measures" would "accelerate the application of principles-based [sic] reserving." "Accelerate" might imply that the Board is proposing that insurers apply PBR to individual life insurance policies issued from 2017-19, because state regulators, at present, never intend to apply PBR to business issued prior to 2017.

Regardless of the Board's intended approach, we fail to see the supervisory benefits of second-guessing the decisions of local supervisors to allow for optionality.

- **Grandfathering.** "Grandfathering," while not defined in the NPR, generally means that "old rules" apply instead of "new rules." The NPR proposes to include a grandfathering provision for certain surplus notes issued prior to 11/1/2019, apparently using state statutory accounting requirements as the "old rules." However, the NPR also includes adjustments to available and required capital to "remove the effects of any grandfathering…measures" (unless such measures are approved by the Board). The NPR is unclear what is meant by such "grandfathering," as the only example, in footnote 66, reflects an incorrect understanding of the Solvency II transitional measure for technical provisions (this is not grandfathering because the valuation requirements will, after 16 years, fully reflect Solvency II requirements and will not reflect pre-Solvency II valuation requirements).

  Some of the confusion may have arisen because of an NAIC policy decision to "grandfather" captive financing arrangements prior to 2015 (in light of the fact that such arrangements were entered into and approved in good faith) and to approve a new uniform approach only to new financing arrangements. The NPR, however, suggests that the elimination of "transitional measures" leads to a requirement to use principle-based reserving (Section IX.E.1). And Section IX.E.2 indicates that such elimination would impact the treatment of captives, not differentiating when such captives were formed. Therefore one interpretation is that the Board is proposing to overturn the NAIC's policy decision involving the "grandfathering" of captive arrangements.

  The NPR appears to propose that reserve adjustments be made to certain captives, but it is unclear whether those adjustments are limited to captive arrangements that were "grandfathered" by the NAIC. It is possible, but unclear, that the Board is proposing to require adjustments to non-financed business, perhaps based on the implied presumption that requirements for new business are preferable to requirements that are "locked in" or "grandfathered" based on the historical cost accounting approach within statutory accounting. If this is the case, the scope and impacts of "grandfathering" adjustments are potentially immense. One of many challenges involves the fact that statutory solvency rules are often (but not always) intended to apply to new business going forward, and therefore clear rules for "grandfathering" adjustments may not exist. The circumstances under which "grandfathering" adjustments might apply in a non-U.S. context are also unclear.

  Overall, the NPR is unclear about grandfathering, but we fail to see why the Board should systematically disregard "grandfathering" policy decisions made by jurisdictional insurance regulators. Such decisions, like the Board's proposed grandfathering of surplus notes, generally are made because the full, immediate application of "new" rules would be disruptive. The Board should respect these decisions.

- **Early adoption.** In the U.S., early adoption of accounting changes is commonly permitted. Even more notably, the NAIC is permitting early adoption of its revised variable annuity reserve and capital framework for year-end 2019 (officially it applies from 1/1/20). The NPR is silent as to whether the Board is proposing to reverse early adoptions, but it seems unwise to penalize the desire of both supervisors and insurers to apply improved standards as soon as possible.

In summary, while aspiring to achieve "a consistent representation of financial information" through adjustments to available and required capital, the Board's NPR leaves many practical questions unanswered. This creates significant uncertainty both for firms that are currently subject to supervision and for firms that might contemplate future actions that would bring them under the Board's supervision. We believe that the so-called comparability or consistency produced by the proposed adjustments is specious and that it is incongruous for the Board to adopt an aggregation approach for group capital and to overrule material portions of the underlying local regimes. We recommend additional consideration of these issues before finalizing the rule.

Question 36: The Board invites comment on all aspects of the foregoing evaluation of the potential impacts of the proposed rule. Are there additional impacts that the Board should consider? Would the magnitude of any impact be different than as described above?

The proposed BBA is likely to have significant and possibly unintended consequences on strategic decisions. For example, if the scope and impact of proposed adjustments is significantly negative, such adjustments are likely to deter insurers with certain business profiles from acquiring insured depository institutions and thus becoming subject to the Board's requirements.

The proposed BBA could also deter U.S. insurers from expanding internationally. The NPR notes that the insurers that are currently subject to the Board's supervision lack material international operations, and the Board seems to have given little consideration of how proposed adjustments might impact operations outside of the United States. The NPR acknowledges that the Board's proposed scaling mechanism is unworkable internationally, and the NPR seems to be effectively proposing a provisional approach that amounts to no scaling plus a "jurisdictional adjustment" surcharge. Overall, this approach seems to treat international operations more punitively than domestic operations, which may create a disincentive for certain U.S. insurers to expand internationally.

Conclusion

Transamerica appreciates the opportunity to provide comments and we hope our input will help to improve the Board's final rule.

Sincerely,

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