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

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

Dear Secretary Misback,

American International Group, Inc. (AIG) appreciates the opportunity to offer comments on the Notice of proposed rulemaking (NPR): "Regulatory Capital Rules: Risk-based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities."

AIG recognizes the efforts by the Board of Governors of the Federal Reserve System (Board) in developing the building blocks approach (BBA) for depository institution holding companies significantly engaged in insurance activities. The BBA proposal, like the group capital calculation (GCC) being developed by the National Association of Insurance Supervisors (NAIC), demonstrates the conceptual viability of an "aggregation" approach for assessing insurance group capital.

We also appreciate the Board's acknowledgement that the design of the BBA is subject to the statutory limitations imposed by the Dodd Frank Act (DFA) and that the BBA, in turn, was developed to generate a risk-based capital requirement that "is no less stringent than the results derived from the Board's banking capital rule." Thus, while the BBA is constructed based on the respective capital requirements applicable to the underlying insurance operating entities, the BBA's design, methodology, calibration, and implementation are intended to satisfy banking-oriented prudential objectives under DFA. We note, accordingly, that there are nearly 200 references to some form of the term "bank" within the NPR.

AIG is not a depository institution holding company, and we are therefore not subject to the BBA. However, we have some concern that the BBA, which was designed for specific statutory objectives related to certain US depository institution holding companies, could inadvertently influence both the NAIC's GCC and the related Aggregation Method (AM) being developed at the International Association of Insurance Supervisors (IAIS) as a potential alternative to the insurance capital standard (ICS). It is worth noting that the NAIC's GCC is intended as a capital construct tailored to the risk profile of US insurance groups and is not subject to banking-oriented statutory constraints. Likewise, we understand that none of the current US holding companies subject to BBA would meet the IAIS definition of an internationally-active insurance group (IAIG). The BBA is therefore not pertinent to the development of the AM, which would cover IAIGs.

Our comments below focus on several of the technical methodology and calibration elements of the BBA proposal, with a view to both the resulting metrics and operational considerations. Our critiques are provided in the spirit of how we believe an insurance-oriented aggregation approach ought to be designed to achieve the NAIC and IAIS prudential goals for policyholder protection and financial stability. We do not mean to question or challenge what may well be legitimate design choices for satisfying the Board's statutory obligations and role as a regulator of depository institutions.

Methodology / calibration issues

As a general matter, the BBA imposes significant adjustments in aggregating the underlying entity-level requirements into a group-wide capital ratio. To be clear, the design of an aggregation approach will ineluctably include certain adjustments, such as to avoid double-counting of down-streamed financial resources or to more closely reconcile differing jurisdictional requirements globally (eg, the application of cross-jurisdictional scalars).

However, the multitude of proposed adjustments within BBA could, in our view, undermine the alignment of the resulting group ratio with the respective entity-level requirements. An aggregation construct should exhibit fidelity with the underlying insurance operating company requirements, which are a primary focal point for insurance group capital management. Misalignment between the entity-level requirements and the resulting group ratio could unnecessarily complicate an insurer's capital management strategy and would create confusion among external stakeholders.

We discuss our concerns with the proposed BBA adjustments in further detail as follows:

Treatment of permitted and prescribed practices

The BBA proposes to unwind the group capital impact of permitted and prescribed practices, which in a sense is a pre-emption of state supervisory authority. This unwinding could also give the misperception that permitted and prescribed practices are mechanisms for regulatory arbitrage, when in actuality these practices serve to either elaborate on, or remedy, errors of omission or commission in underlying statutory rules.

Although the BBA will not, apparently, be applicable to IAIGs, we also think it is a "slippery slope" for group-wide supervisors to over-ride jurisdictional rules and judgments. For example, for an aggregation approach applied to a group operating in multiple foreign jurisdictions, the unwinding of US permitted and prescribed practices could create a thorny precedent for group-wide supervisors to unwind any foreign jurisdictional treatments where the same exposure might be subject to differing methodologies.

We also believe that the objective of seeking "consistency" across jurisdictional regimes will be largely fruitless and counterproductive. It should be acknowledged that an Aggregation approach, one of whose virtues is alignment with binding jurisdictional rules, can never (nor should ever) mimic a natively consolidated approach. The application of complex and opaque adjustments in the service of "consistency" both strips away some of the critical benefits of aggregation, without attaining the attributes of a consolidated approach.

Recognition of senior debt within available capital

For an aggregation construct to reflect the typical modalities for insurance group capital management, it is important to recognize the well-established practice of issuing financial instruments at the group level, with the proceeds down-streamed to capitalize individual operating entities. The loss absorbing capacity of the down-streamed equity capital is buttressed by structural subordination, through appropriate regulatory/supervisory controls over distributions from insurance subsidiaries. We also believe it is important for US aggregation approaches to remain consistent with the recognition of senior debt as part of ICS capital resources, since this decision was made in large measure to reflect the US system of capitalizing insurance operations.

We understand that, as a banking regulator, the Board is concerned that any impairment of senior debt could create anxiety among depositors and a potential run on the bank scenario. However, in an insurance context, the recognition of senior debt can help to support rather than undermine financial stability, as the issuance of debt at the holding company can serve as an important mechanism for recapitalizing insurance subsidiaries during stress. That is, the proceeds from debt issuances can protect and assuage policyholders when equity capital markets are distressed or closed off.

We nevertheless believe it is important to have supervisory safeguards in place to ensure that an insurance group does not become overly leveraged and does, in fact, use the debt proceeds to fund subsidiaries rather than for general corporate purposes (eg, share buybacks). These safeguards should give comfort for the recognition of at least a portion of senior debt within group capital.

Application of scalars

The proposed scalars within BBA are largely intended to reconcile insurance capital requirements with the banking rules. While this may be appropriate for BBA given the Board's statutory obligations under DFA, it is not a pertinent exercise for the GCC and AM. The GCC and AM will likely entail scalars to provide a more comparable basis of jurisdictional insurance regimes across countries, but there is no need for alignment with banking requirements. We therefore would caution against applying the BBA scalar methodologies to the development of the GCC and AM international scalars, since the calibration objectives are fundamentally different.

Application of Basel III to unregulated entities

The BBA proposes to apply Basel capital rules to non-insurance, unregulated entities, irrespective of whether these entities are engaged in banking-like activities. While the application of Basel helps the Board to satisfy their DFA objectives of alignment with banking requirements, this treatment could have unintended and inappropriate consequences in practice.

If Basel capital rules were applied to an insurance group holding company on a standalone basis, then the rules governing capital resources would be imposed on a non-banking entity for which these restrictions were not designed to apply. As an example, the Basel limitations for recognition of deferred tax assets (DTA) within bank capital resources is designed and calibrated based on a banking group's consolidated financial resources, not on a discrete insurance holding company entity. As a result, the application of Basel to an insurance holding company would be inconsistent with that entity's tax position and would, in turn, underestimate an insurance group's economic loss absorbing capacity.

Overall BBA calibration

The overall BBA calibration of a minimum 485% NAIC risk-based capital (RBC) authorized control level (ACL) ratio (250% ACL minimum plus 235% ACL capital buffer) is untested, unsubstantiated, and – while perhaps reasonable for the cohort of insurance depository holding companies to which BBA would apply – is not tailored to the capital profile of the much broader and diverse population of insurers that would be subject to GCC and AM. For example, certain well-rated property and casualty companies operate with statutory capital ratios below 485% RBC ACL.

A related issue is that the 485% threshold should be viewed in the context of all of the underlying synthetic adjustments within BBA (non-recognition of senior debt, Basel treatment of unregulated entities, unwinding of permitted and prescribed practices). The many design elements of the BBA that create breakage between the group ratio and the underlying entity insurance requirements make it challenging to assess the relevance of the BBA's "top-down" calibration target of 485%. Accordingly, the 485% BBA target is not readily comparable to typical standalone statutory requirements for operating entities.

Another complicating factor in assessing the proposed BBA calibration is that there is no explicit or even implicit recognition of cross-entity diversification. In particular, the demonstrable risk mitigation inherent in a composite model, comprising financial risk-intensive life entities and insurance risk-intensive property and casualty businesses, is not in any manner reflected within the BBA. The lack of diversification recognition is another reason why the 485% BBA calibration could well overstate the true economic risk of a diversified global insurance group.

Operational issues

Another important value proposition of an aggregation construct is its facility for implementation. Given that the component inputs to the calculation are, primarily, the readily-available entity-level statutory requirements, it should be a relatively straightforward process to assemble those components into a group-wide measure. Of course, certain adjustments to eliminate double-counting will be necessary within any form of aggregation.

The BBA, however, would entail a relatively high degree of implementation complexity, due in large part to the significant adjustments that are applied. This exercise requires the creation of a new system of regulatory reporting – which is distinct from both statutory and GAAP currently – creating operational challenges and potential confusion for stakeholders. For example, the application of Basel banking requirements to unregulated entities would entail that insurers must build out specialized risk-weighted asset (RWA) calculators – for the sole purpose of generating capital estimates that are inconsistent with how insurers generally manage the risk exposure of these entities.

Overall, the multitude of adjustments within BBA also makes it more challenging to reconcile the resulting group ratio with an existing consolidated group balance sheet (eg, US GAAP). Reconciliation likely poses less of a challenge for a largely domestic US group with a handful of operating entities. However, it becomes a more complicated exercise for global groups operating across multiple jurisdictions, with differing local statutory accounting requirements and holding companies that are not managed on a statutory basis. Other aspects of BBA that create operational challenges are (i) the requirement to recalculate in-force policies under principles-based reserving, as well as (ii) insufficient specification of international scalars across foreign jurisdictions.

The application of complicated adjustments also creates another operational challenge – a misalignment between the underlying entity requirements and the resulting BBA ratio for the group as a whole. This misalignment could lead to a ratio that is opaque and difficult to interpret, which, in turn, diminishes its potential utility both as an internal management tool and as a metric for supervisors (and other external stakeholders, should an aggregation ratio be publicly reported).

In closing, we look forward to continued engagement with the Federal Reserve and the broader US delegation at the IAIS to promote an implementable AM that both achieves comparability with the ICS and accommodates a range of insurance business models, activities, and practices.

Sincerely,

Thomas Leonardi
Executive Vice President
Government Affairs and Public Policy

cc: Thomas Sullivan
Associate Director, Federal Reserve Board

Linda Duzick
Manager, Federal Reserve Board