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January 22, 2020

By electronic submission to regs.comments@federalreserve.gov

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities (Docket No. R–1673)

Dear Ms. Misback:

United Services Automobile Association ("**USAA**") welcomes the opportunity to comment on the notice issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") entitled Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities, published in the Federal Register on October 24, 2019 (the "**Capital Proposal**").[1]

USAA is a membership-based association, which together with its family of companies, serves present and former commissioned and noncommissioned officers, enlisted personnel, retired military, and their families. Since USAA's inception in 1922 by a group of U.S. Army officers, we have pursued a mission of facilitating the financial security of our members and their families by providing a full range of highly competitive financial products and services, including personal lines of insurance and retail banking. Our core values of service, honesty, loyalty, and integrity have enabled us to perform consistently and be a source of stability for our members. USAA Federal Savings Bank, an indirect wholly-owned subsidiary of USAA, is a Federally-chartered savings association organized to offer personal retail banking services, including home mortgages and automobile loans.

We support the Federal Reserve's Capital Proposal and its general principles and core themes, particularly the aggregated approach to consolidated capital. The Federal Reserve clearly continues to thoughtfully approach its mandates and authority over insurance savings and loan holding companies ("**I-SLHCs**"), like USAA. We commend the Federal Reserve for undertaking a collaborative and deliberative approach to developing an enterprise-wide capital framework for I-SLHCs that accounts for the differences between the business of insurance and banking. USAA appreciates that the building block approach ("**BBA**") uses, as a starting point,

[1] Federal Reserve, Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities, 84 Fed. Reg. 57240 (Oct. 24, 2019) [hereinafter, Capital Proposal].

existing state risk-based capital requirements for insurance company subsidiaries and bank regulatory capital standards for banking and certain other subsidiaries. The BBA's compatibility with existing legal entity capital requirements provides efficiencies, which will minimize implementation challenges. The BBA is also reflective of the Federal Reserve's commitment to tailored supervision and regulation. Nevertheless, we believe that certain refinements and amendments should be made to the Capital Proposal, consistent with the Federal Reserve's tailored approach.

Part I of this letter includes our comments on the general principles of the Capital Proposal. The remainder of this letter focuses on specific aspects of the Capital Proposal and is organized as follows: Part II provides comment on the elimination of transitional measures and recommends an approach that would introduce optionality for supervised institutions while maintaining comparability; Part III provides comment on the BBA scaling methodology and proposes refinement that would avoid imposing a more conservative capital requirement for I-SLHCs than for bank holding companies and other savings and loan holding companies; and Part IV provides comment on the building block company inventory and recommends the introduction of a threshold for the inclusion of certain subsidiaries. Wherever possible, we have provided responses to and identified specific questions posed by the Federal Reserve in the Capital Proposal.

I. General Principles

As noted above, USAA supports the Federal Reserve's Capital Proposal and its general principles and core themes. We support the BBA as proposed, except as further discussed in Parts II – IV below. If adopted as proposed, and with our suggested refinements and amendments, USAA would expect the effort to comply with the BBA to be minimally burdensome.[2] In addition, should the capital conservation buffer be adopted as proposed, USAA expects minimal burden associated with compliance.[3] Finally, USAA appreciates that the Federal Reserve crafted a solution that permits I-SLHCs to exclude certain state- and foreign-regulated insurance operations and to exempt top-tier insurance underwriting companies from the proposed Section 171 Calculation. As USAA's top-tier insurance underwriting company is exempt, the Section 171 Calculation would instead apply to USAA's farthest upstream non-insurer savings and loan holding company. Should the Section 171 Calculation be adopted as proposed, USAA expects compliance to be straightforward.

II. Comments on the Elimination of Transitional Measures

The Capital Proposal includes an adjustment to remove the effects of "transitional measures under an applicable capital framework in determining capital requirements" in order

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[2] Response to Question 32: "The Board invites comment on the proposed minimum capital requirement. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?"
[3] Response to Question 33: "What are the advantages and the disadvantages of the buffer? What is the burden associated with the buffer?"

"to help increase the comparability of results among supervised firms."[4] The Capital Proposal notes that "one prominent impact of this proposed adjustment would be to accelerate the application of principles-based reserving."[5]

The broad language of the transitional measures adjustment appears to capture transitional measures in addition to the restatement of XXX and AXXX life insurance reserves.

Through the elimination of transitional measures, it appears that the Federal Reserve intends to apply principles-based reserving ("**PBR**") to all in-force term and universal life with secondary guarantees products retroactively to the year 2000, when the XXX reserving regime became effective. However, the broad language included in the Capital Proposal (i.e., "any" transitional measures) appears to capture transitional measures the Federal Reserve may not intend to be included in the adjustment. One example is the transition periods permitted by the Current Expected Credit Losses ("**CECL**") framework. Although the CECL framework is effective for SEC filers beginning January 1, 2020, the effective date is delayed for private and certain small public companies until January 1, 2023. After the effective date, companies may elect a three-year transitional period whereby the regulatory capital effects of the update to the accounting standard are phased in over a three-year period. Moreover, insurance regulators will often provide transition periods with respect to new mortality tables, as those mortality tables impact reserving and financial reporting, in addition to product design and pricing.

Transitional periods, such as those provided above, are necessary because considerable effort is required for insurers to prepare and implement such changes. USAA requests that the Federal Reserve clarify in the final rule that the adjustment for transitional measures applies only to XXX and AXXX reserving.

PBR was designed to apply prospectively and not to in-force business.

For term and universal life insurance policies issued between the years 2000 and 2016, the XXX and AXXX regimes for calculating life insurance reserves used a one-size-fits-all approach to determine those reserves. In order to keep pace with new product designs and differences between companies and products, the National Association of Insurance

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[4] Capital Proposal at 57256. Specifically, Sections 217.607(b)(3) and 217.608(c)(4) of the Capital Proposal provide: "A supervised institution must deduct from the building block parent's company [capital requirement][available capital] any difference between: (i) the building block parent's company [capital requirement][available capital]; and (ii) the building block parent's company [capital requirement][available capital] recalculated under the assumption that neither the building block parent, nor any company that is a member of the building block parent's building block, had prepared its financial statements with the application of any grandfathering or transitional measures under the building block parent's applicable capital framework, unless the application of these measures has been approved by the Board." Id. at 57283-84.
Response to 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?"
Response to 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?"
[5] Capital Proposal at 57256, n.65.

Commissioners ("**NAIC**") and the states adopted PBR to allow the tailoring of reserves to match a company's unique risk profile. When created, PBR was not designed with in-force business in mind, but instead designed to apply prospectively. PBR became effective January 1, 2017, after the NAIC's Valuation Manual was enacted by the requisite number of states. Although the law was effective and companies were permitted to reserve under PBR for new business as of January 1, 2017, the law contained a three-year transition period, and implementation of PBR became mandatory as of January 1, 2020. Under NAIC and state rules, PBR does not apply to business issued before January 1, 2017.

USAA supported the introduction of PBR, believing it better reflects the appropriate reserves for impacted products. As such, USAA began using PBR for one of its products beginning January 1, 2017. USAA's two remaining actively sold life insurance products began using PBR as of January 1, 2020.

Although the Capital Proposal does not directly address the issue, USAA understands that the Federal Reserve intends to eliminate more than just the three-year transition period from 2017 to 2020 that is built into the NAIC's Valuation Manual. The Capital Proposal's elimination of transitional measures appears to require a life insurance subsidiary of an I-SLHC to restate all XXX reserves to PBR, including for policies issued prior to January 1, 2017, in order to address concerns regarding the use of captives by some I-SLHCs under the XXX framework and to create comparability among I-SLHCs. For the reasons discussed below, USAA respectfully submits that such a restatement would be unduly burdensome for companies, like USAA, that did not utilize life insurance captives and instead requests that the final rule provide options for the transitional measures adjustment as an alternative to the restatement of reserves.

Retroactive application of PBR would create a significant burden with little, if any, corresponding benefit to stated policy goals.

Retroactive application of PBR would create a significant burden to I-SLHCs. In addition, application of PBR to pre-2017 policies would be inconsistent with several policy goals reflected in the Capital Proposal, including a tailored approach to insurance group supervision and streamlining and minimizing implementation burdens.

The Capital Proposal provides that the "initial implementation costs of administering these [transitional] adjustments are anticipated to be comparable to such ongoing costs since reviewing and making these adjustments would generally be done on an annual basis when performing the BBA's calculations"[6] and, further, that the costs associated with these adjustments "are expected to be modest within the context of the organizations."[7] However, full implementation of PBR to pre-2017 historical reserves would entail considerable effort and cost, creating significant burden, as discussed further below.

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[6] Capital Proposal at 57271.
[7] Id. at 57272.

Moreover, USAA anticipates that compliance issues may arise due to inconsistencies in reserve calculations. For example, under the proposed rule, USAA must calculate different reserves for the Federal Reserve and state regulators, which may cause confusion. Capital requirements may still be limited by the larger XXX reserves required under state law, and intercompany dividend, capital structure, and investment strategies may still be driven by NAIC requirements that necessitate larger reserves under the XXX regime.

It is also important to note that since no new business will be sold using AXXX and XXX reserves, its impact on insurers' finances will decline with time. For example, XXX reserves were used for term life insurance with level term periods of up to thirty years, but most frequently ten or twenty years. Therefore, the amount of XXX business on an insurer's books, and the impact of XXX reserves on its capital position will decline as that business rolls off. While reserve restatement would be an incredibly burdensome undertaking, over time, those reserves will diminish and have less and less impact on a reported capital position.

USAA recommends an approach to reserve restatement that introduces options, which reduces burden while maintaining comparability between I-SLHCs.

The Capital Proposal provides that the transitional measures adjustment is designed to "provide a more accurate reflection of risk as intended" by the applicable capital framework and "to help increase the comparability of results among supervised firms."[8] USAA respectfully recommends that the final rule provide options for the reserve restatement adjustment that would eliminate the burden of applying PBR retroactively and still achieve comparability between I-SLHCs.

As an initial matter, in order to achieve comparability, the Federal Reserve could require insurers that used life insurance captives to restate those reserves using the XXX and AXXX regimes. To the extent an insurer has no life insurance captives, it would not be required to restate reserves. The burden of restatement for those insurers that did not utilize captives would be eliminated, and the Federal Reserve would attain comparability between I-SLHCs.

If the Federal Reserve determines that reserves must be restated for all in-force XXX and AXXX business, USAA suggests the following options for the transitional measures adjustment:

> Option 1: Apply a factor-based method to statutory reserves, which would estimate PBR reserves on in-force business through applying factors to statutory reserves depending on the prevailing reserving standard (e.g., 40 percent on XXX, 90 percent on AXXX). This method was developed for the 2019 NAIC Group Capital Calculation field test. Such an approach would greatly simplify the restatement to PBR while preserving the Federal Reserve's desire to achieve comparability by significantly reducing the

[8] Id. at 57256.

discrepancy in reserves between those I-SLHCs that used captives and those that did not.

Option 2: Substitute the use of GAAP reserves for XXX and AXXX reserves. GAAP reserves are readily available for those who do GAAP reporting. In terms of reflecting individual insurer risk, one advantage of the use of GAAP reserves is that they reflect an insurer's assumptions for its business, either at issue under current GAAP, or current best estimates when Targeted Improvements is implemented.

Providing I-SLHCs with the options set forth above would greatly simplify the transitional measures adjustment, while preserving the Federal Reserve's desire to achieve comparability of results for I-SLHCs, but with greatly diminished burden to companies. Further, each of the options set forth above provides distinct benefits. Each option uses currently-developed rules (i.e., NAIC or GAAP), and each avoids future burden on the Federal Reserve to create additional reserving rules and guidance with respect to the retroactive application of PBR, as discussed below. Each option is readily available or easily calculated by the I-SLHC, and each option uses calculations that are subject to audit by independent external auditors.

Retroactive application of PBR is not possible without additional guidance.

Applying PBR retroactively is not possible without additional guidance because insurers are not, under the NAIC PBR standard or directly applicable state law, permitted to apply PBR to policies issued prior to January 1, 2017. The NAIC does not apply PBR retroactively, and as such, two issues may arise with retrospective application. First, the NAIC's Valuation Manual has undergone significant change in recent years as implementation of PBR uncovered issues necessitating revision. The NAIC designed PBR to apply prospectively in order to allow for such revisions. Since only a small subsection of a company's policies was impacted by those changes, the financial and operational impact of those changes would be muted. For example, the modeling of yearly-renewable term reinsurance in the deterministic and stochastic reserves under PBR continues to be a topic of discussion among regulators and the industry.

Second, because retrospective application is not permitted, the NAIC has not developed guidance for the application of PBR prior to 2017. In order to apply PBR retroactively, I-SLHCs would need additional guidance from the Federal Reserve on the following questions, among others: Which mortality tables are acceptable? Which expense assumptions should be used? Which interest rate calculation should be used? May pre-2017 and post-2017 policies be aggregated, and under what circumstances? Must companies do asset adequacy testing against two reserve bases? Must the new unique calculations be audited?

If the Federal Reserve opts not to introduce the optionality discussed above, in order to complete the requisite guidance, we believe it would be appropriate for the Federal Reserve to seek further public comment on how best to retroactively apply PBR.

III. Comments on the Scaling Methodology

USAA generally supports the proposed scaling methodology, and specifically, the use of the NAIC Risk Based Capital ("**RBC**") regime as the common capital framework for the BBA.[9] We appreciate that the Federal Reserve, in its white paper entitled Comparing Capital Requirements in Different Regulatory Frameworks (the "**White Paper**"), identified the following three important considerations in assessing the scaling methods: reasonableness of the assumptions, ease of implementation, and stability of the parameterization.[10] With these three important considerations in mind, the Federal Reserve determined that the derived historical probability of default method produces "the most faithful translation of financial information between the U.S. banking and insurance regimes," while noting that "[h]istorical insolvency rates are currently the most credible economic benchmark to assess regimes against, and the long track record and excellent data on both the insurance and the bank U.S. regimes make this analysis feasible."[11]

While USAA supports the use of the scaling methodology to calibrate banking and insurance capital requirements, we believe that the scaling adjustments set out in the Capital Proposal, as we understand them, require further refinement to avoid imposing a more conservative capital requirement for I-SLHCs than for bank holding companies and other savings and loan holding companies.

The Federal Reserve has proposed a minimum BBA ratio of 250 percent based on the combination of two factors. First, using the proposed scaling methodology, the Federal Reserve translated the minimum total capital requirement of 8 percent of risk-weighted assets ("**RWA**") under the Federal Reserve's banking capital rule to its equivalent under the NAIC RBC regime. Second, the Federal Reserve "added a margin of safety to account for factors including any potential data or model parameter uncertainty in determining scaling parameters and an adequate degree of confidence in the stringency of the requirement."[12]

Using the proposed scalars, our calculations indicate that the minimum banking capital requirement of 8 percent of RWA equates to a minimum BBA ratio of 160 percent. It is unclear from the Capital Proposal how the Federal Reserve determined that an additional 90 percent RBC was an appropriate safety margin, other than noting that the resulting 250 percent minimum requirement "aligns with the midpoint" between the NAIC's "Company Action Level" (200

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[9] Response to 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?"
Response to Question 32: "The Board invites comment on the proposed minimum capital requirement. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?"
[10] Federal Reserve, Comparing Capital Requirements in Different Regulatory Frameworks 6 (September 2019) [hereinafter White Paper].
[11] Id. at 23.
[12] Capital Proposal at 57261.

percent) and "Trend Test Level" (300 percent) RBC requirements.[13]

We believe that the proposed 250 percent minimum BBA ratio equates to a bank capital ratio of 8.9 percent and is, therefore, unnecessarily more conservative than the banking capital requirements (8 percent of RWA). This means that the proposed minimum BBA ratio is approximately 11 percent higher than the required minimum under the banking capital rules.

For the reasons discussed below, USAA recommends that the Federal Reserve set the minimum BBA ratio at 160 percent, as determined by the proposed scaling methodology. This would align the BBA minimum capital requirement for I-SLHCs with the minimum capital requirement for banks under the banking capital rules.

As noted above, the BBA ratio includes a margin of safety to account for potential data or model parameter uncertainty in determining scaling parameters.[14] However, USAA believes that the data and models used in the scaling methodology are sound and relatively free of uncertainty. The data sets used in the scaling formulas are reliable, long-term data sets maintained by federal and state financial regulatory authorities. With respect to potential data uncertainty, the White Paper notes that "[p]lentiful data exists on U.S. markets but not many international markets" and that "because the Board's current population of supervised insurance groups has immaterial international insurance operations, scalars for other jurisdictions were not developed." The White Paper concludes that because the Federal Reserve's supervisory population has immaterial international insurance operations, "[s]calers for non-U.S. regimes are not specified" and "may be set through additional rulemakings as needed."[15] There is no indication that the data for U.S. markets is insufficient or that the current proposed scaling methodology would benefit from international data. Thus, there is no indication that an additional margin of safety should be required due to data uncertainty.

With regard to model parameter uncertainty, the White Paper notes that the "parameter estimates appear stable and robust" and "[b]ecause this method has a relatively robust parameterization, the parameters would not need to be updated on a set schedule and could instead be revisited if new data or conditions suggest a change is warranted."[16] Similar to the data used for the scaling methodology, there is no indication that uncertainty with the model parameter estimates would require an additional margin of safety.

Alternatively, should the Federal Reserve determine that the minimum BBA ratio still requires an additional margin of safety, USAA recommends instead setting the BBA ratio at 200 percent. The 200 percent threshold is well-established within the insurance industry and corresponds to the NAIC's Company Action Level. By our calculations, a BBA ratio of 200

[13] Id. The "Company Action Level" under state insurance RBC requirements is the amount of capital below which an insurer must submit a plan to its state insurance regulator demonstrating how the insurer will restore its capital adequacy. The "Trend Test Level" adds a margin above the company action level, reflecting the company's current and recent preceding years' results. Id. at 57243, n.16.
[14] Capital Proposal at 57261.
[15] White Paper at 23.
[16] Id. at 13.

percent would equate to a bank capital ratio of 8.4 percent under the banking capital rules.

Last, should the Federal Reserve determine that the BBA ratio should remain at 250 percent, we respectfully request that the Federal Reserve provide a credit or adjustment in the BBA calculation for the banking building blocks, such that the capital requirement remains consistent with the Federal Reserve banking capital minimum requirement of 8 percent of RWA.

IV. Comments on the Building Block Inventory

When constructing the building block inventory, the Capital Proposal provides that an I-SLHC is required to include all companies in order to reflect the full enterprise under the BBA's scope.[17] Creation of the company inventory begins with the NAIC's Schedule Y, filed quarterly as part of the SAP financial statements, and because it is possible that certain companies may not appear on the I-SLHC's Schedule Y, the inventory also includes the set of companies appearing on the Federal Reserve's Forms FR Y-6 and FR Y-10. We appreciate the Federal Reserve's thoroughness in capturing all possible inventory companies. However, USAA believes that the proposed inventory requirement is a highly burdensome undertaking without a commensurate benefit to the Federal Reserve's supervisory and policy objectives.

USAA respectfully recommends that the final rule contain a quantitative threshold for inclusion to ensure that the definition of inventory companies does not unnecessarily include entities that support investment activities but do not represent operating companies or significantly affect an I-SLHC's risk profile.

Insurance companies hold certain passive investments as one asset class in a balanced, diversified portfolio. These investments, such as investments in real property, among others, are frequently held through special purpose vehicles such as limited partnerships or limited liability companies. As such, these investments meet the definition of "company" within the meaning of FR Y reporting forms and are captured by reporting requirements that apply to actively-managed operating subsidiaries. However, the investments are passive and are not operating companies.

The Capital Proposal provides that by utilizing reports already prepared by I-SLHCs, including those reported to state insurance regulators, the burden to I-SLHCs in inventorying companies is minimized.[18] However, as currently drafted, once a company has been included in the building block inventory, the financial information required to calculate the BBA ratio exceeds the information required to be provided in the NAIC Schedule Y, FR Y-6, or FR Y-10 forms. More specifically, to calculate the BBA ratio, asset and liability information is required for every company in the company inventory. Conversely, asset and liability information is not required on the NAIC Schedule Y, FR Y-6, or FR Y-10 forms. As a result, the company inventory can include hundreds of investment entities that do not affect the company's risk profile, but whose financial information must be compiled in order to calculate the BBA ratio. USAA estimates that it would take approximately 1300 to 1600 hours to compile this additional

[17] Capital Proposal at 57249.
[18] Id.

financial information.

USAA recommends that the company inventory include only those nonbank subsidiaries that have at least $250 million in assets, a threshold that the Federal Reserve already employs to identify companies required to file the FR Y-11S on an annual basis. Although asset and liability information is not required on the NAIC Schedule Y, FR Y-6, or FR Y-10 forms, in our judgment it would not be unduly burdensome for I-SLHCs to be required to compile such information for those nonbank subsidiaries with $250 million or more in assets. Relying on such a well-established threshold meets the Federal Reserve's objectives of including any company in the company inventory that may materially impact an I-SLHC's risk profile, while minimizing the burden of compiling financial information for entities that will not ultimately change an I-SLHC's capital requirements.

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USAA is appreciative of the opportunity provided by the Federal Reserve and for its consideration of our comments. If you have any questions, please do not hesitate to reach out to Tate Wilson, Assistant Vice President, at 210-722-2312, or Kristin Lee, Senior Attorney, at 210-456-5794.

Yours sincerely,

USAA

By: ______________________

Neil H. Wilcox
Senior Vice President
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