MEMORANDUM

TO: Group Capital Calculation (E) Working Group

FROM: NAIC Staff

DATE: October 30 2017

RE: Non-Regulated Entities and Related Inventory Method Suggestions

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I. Background Information

In 2016, the Working Group discussed the factor to be used for non-regulated entities on numerous occasions. This included posing various questions for consideration during an exposure. The questions were raised due to various pros and cons of using a flat charge on the book/adjusted carrying value (BACV) of the non-regulated entity. This includes that the use of such a flat charge on the BACV is how non-insurance subsidiaries are charged today within the risk-based capital (RBC) formula. It was noted that such an approach is simple and minimizes the amount of additional data that may be necessary to be collected. Most importantly, it supports the position that all non-insurance entities should be treated the same no matter where they are owned in the holding company structure, which was something important to the Working Group. However, the largest con is that it is widely recognized that such an approach is not particularly risk-sensitive.

As a result of the exposure, the Working Group received some preliminary feedback that included the following:

1) Flat charge is not risk sensitive and could understate risk adjusted capital or may penalize well capitalized entities (discourage robust capitalization);
2) Many suggested they were willing to avoid over complication and can be supportive of the 22.5% against BACV to prevent from being overly burdensome to companies;
3) For those that support the flat charge approach, it appears that they all support utilizing the charge of 22.5% for consistency with the RBC formula;
4) If hybrid approach used, consider optionality so companies that prefer simplicity just use the 22.5% of BACV;

Due primarily to some agreement among members of the Working Group that a flat pre-covariance charge on BACV could understate risk adjusted capital or may penalize well capitalized entities and create incentives for arbitrage, the Working Group agreed to consider an alternative approach from the American Council of Life Insurers (ACLI) and the American Insurance Association (AIA). The following provides a summary of such an alternative.

1) Calculation should exclude all non-financial entities and all immaterial entities that do not present demonstrable recourse to the group;
2) Offered three approaches, two of which propose applying the Basel III operational risk charge to material, non-insurance entities;
    a. First approach
        i. Excludes non-material companies (as defined) and non-financial service entities that have no demonstrable recourse to the group and applies the Basel (Banking) Framework's operational risk change to non-financial services entities with demonstrable recourse;
        ii. Treats insurance related entities under their parent solvency regime;
        iii. Applies sectoral regimes to such entities (e.g., U.S. Basel III for banks);

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   iv. Applies U.S. Basel III to material financial entities, except asset managers (operational risk charge).
b. Second approach
   i. Excludes non-financial service entities (except subsidiaries of insurers or those performing activities for an insurer) that has no demonstrable recourse and applies operational risk change to non-financial services entities with demonstrable recourse;
   ii. Excludes non-material financial services entities;
   iii. Applies sectoral regimes to such entities (e.g. U.S. Basel III for banks);
   iv. Applies 22.5% US RBC charge to material financial services entity and any non-financial services entity with demonstrable recourse to the group.
c. Third approach
   i. Similar to Approach 1 except it does not differentiate between non-insurance entities covered/not covered by a parent regime (e.g., it applies a single materiality threshold regardless of whether the non-insurance entity is covered by a parent regime).

II. Threshold Issue for ACLI/AIA Alternative Approaches

While a number of regulators recognize that approaches 1 and 3 from the ACLI/AIA address a key disadvantage to the use of a flat (e.g., 22.5%) factor applied to BACV, it raises at least one threshold question for regulators which appears to be problematic. Specifically, each of the approaches from the ACLI/AIA proposes excluding entities from the group capital calculation if they are immaterial and do not create demonstrable recourse to the group. A number of regulators have questioned the exclusion of any entities from the calculation and have pointed to the purpose of the calculation as an analytical tool as reasons. Moreover, several regulators have suggested that such an approach would be inconsistent with the scope of the group under the *Insurance Holding Company System Regulatory Act* (Model #440) where the scope of state insurance regulation begins with the ultimate controlling party and includes all insurer and non-insurer affiliates of a registered domestic insurance company. Regulators with concerns about this specific issue have noted that they are more interested in having a mechanism that does not exclude entities than with the ultimate capital calculation that will result from this work stream. Many regulators suggest this is because they believe the greatest value of the group capital calculation will be the data it provides regulators on the risks and capital needs of all entities within the group that could drive attempts to utilize the insurers within the group as a source of strength, or that may expose the group as a whole to material financial distress such as what occurred with AIG during the financial crisis particularly if those risks and capital needs can be trended over a period of time. Additionally, several regulators note that a specific group capital number produced by the calculation has somewhat limited utility due to regulatory constraints on capital fungibility within an insurance group. Several regulators also recognize that for large groups the value of including thousands of entities in the calculation would not outweigh the complexity, and that there is a place in the calculation for determinations of materiality to be made. However, there are concerns about ACLI/AIA's approaches to materiality that focuses on "demonstrable recourse to the group." This concept appeared to require a formal contractual obligation for capital support and therefore would not achieve the intended purpose of the group capital calculation as a tool seeking to obtain data on the risks and capital needs of all material group entities. For these reasons, NAIC has developed the following revised NAIC approach that attempts to consider these views of regulators, as well as the approaches proposed by the ACLI/AIA, as a way to find some common ground.

III. Revised NAIC Approach-Grouping and Scope

Based upon input received from regulators, the NAIC recommends that the Working Group require the group capital calculation to identify all legal entities within the group but include the following individually identified legal entities in the capital calculation inventory:

1) All insurers;
2) All banks and other depository institutions;
3) All asset managers and registered investment advisors;
4) All other financially regulated entities;
5) Other entities material to the group from a risk perspective, where this is further defined by the Working Group in the future based on input from the ACLI/AIA but is designed to address the following: i) contagion risk; ii) embedded risk such as net worth maintenance agreements, indemnities and/or other guarantees; iii) any entity that could reasonably produce an economic loss of greater than X% (Suggest 5%) of unencumbered group

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capital under reasonably forecasted economic conditions taking into account the risks and capital needs of the entity; or iv) any entity required to be individually identified as a legal entity in the calculation by the lead state/group-wide supervisor.

All other entities not specifically included above would be inventoried, but would be allowed to be grouped into similar entities and reported in total for the calculation. The base information included in the calculation for these grouped entities would be the same as for other entities (available and required capital) but would also include other information described in the following. This other information is used to provide assurances that the grouped entities do not need to be individually included in the capital calculation The entities are allowed to be grouped provided 1) the entities are of similar types; 2) the total of the available and required capital of such grouped entities represents less than 5% of the holding company's prior statement (PY or PQ) group GAAP equity, total assets, total debt, and total revenues; 3) the total of these entities' GAAP equity, total assets, total debt, total revenues, net income be reported in the calculation; and 4) the group can produce records if requested by the lead state/group-wide supervisor that demonstrate the accuracy of the figures grouped together and the satisfaction of the criteria being met for grouping.

The above approach attempts to address the need for regulators for a full inventory of companies, but gives some flexibility for how entities are included in the calculation – whether on an individual basis or as part of a grouping. It does this by focusing on the materiality of the entities within a group from a risk perspective so that the lead-state regulator can obtain details on such companies, and separately can still obtain some basic information on the rest of the entities in the group so they have some assurances that other entities are not material using multiple lenses. The intent is to allow the non-risky entities to be grouped, but force the company to consider more carefully other entities that are more risky. This creates a baseline standard that must be followed by all groups, but gives the lead state the ability to require detail on more companies if they feel such information would be helpful.

IV. Revised NAIC Approach-Factors

Based upon input received from regulators, the NAIC recommends that the Working Group utilize the following approaches/factors for each of the above categories for purposes of initial field testing of a beta version group capital calculation:

1) All insurers - **Minimum required by their regulator, or as modified for captives, scalars, etc.;**
2) All banks and other depository institutions - **Minimum required by their regulator (not scaled);**
3) All asset managers and registered investment advisors - 1**2% of three year average revenue based upon ACLI suggestion (BASEL op risk) or another basis such as AUM may be tested. Scalars may be considered after initial field test;**
4) All other financially regulated entities - **Minimum required by their regulator (not scaled);**
5) Other entities material to the group from a risk perspective, where this is further defined in the future by the ACLI/AIA but is designed to address the following: i) contagion risk; ii) embedded risk such as net worth maintenance agreements, indemnities and/or other guarantees; ii) any entity that could reasonably produce an economic loss of greater than 5% of unencumbered group capital under reasonably forecasted economic conditions taking into account the risks and capital needs of the entity; or iv) any entity required to be individually identified as a legal entity in the calculation such by the lead state/group-wide supervisor. This is to be further discussed and determined. (Consider 22.5% BACV or a similar or higher revenue based percentage than what is recommended for asset managers of revenue to consider credit risk also. A risk assessed charge should be layered into the calculation and/or be compared to the BACV charge (e.g., higher of) for non-regulated entities to consider a different approach where necessary such as the notional value of a guaranty multiplied by a probability factor; and
6) All Other entities (as grouped or reported individually) - 1**2% of revenue scaled based upon ACLI/AIA suggestion to roughly 2% (Scaled BASEL op risk charge).or 22.5% of BACV.**

V. Impact on Legal Entity RBC

If adopted for the Group Capital Calculation after field testing, NAIC staff would suggest consideration be given to recommending changes to the legal-entity RBC formulas to align with the above suggestions to address the concern raised regarding the use of BACV for RBC. In particular, there seems to be consensus building within the Working

Group around the above treatment for the first four categories of RBC as these seem to be more appropriate measures of risk given most represent the actual requirement for that regulated entity. With regard to the factor used for “other entities material to the group” and “all other entities,” NAIC staff would recommend these be tested in as large of a scale as possible before recommending, such as what is expected to be done with the first beta release of the calculation.

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