Financial Security...for Life.
Mariana Gomez
Associate General Counsel
(202) 624-2313
Marianagomez-vock@acli.com

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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

[Via e-mail to regs.comments@federalreserve.gov]

Re: Comments on Docket No. R-1673; RIN 7100-AF 56, Regulatory Capital Rules: Risk Based capital Requirements for Depository Institutions

Dear Secretary Misback,

The American Council of Life Insurers ("ACLI")[1] is pleased to offer these comments in response to the Board's notice of proposed rulemaking on risk-based capital requirements for institution holding companies significantly engaged in insurance activities. ACLI commends the Board for pursuing an aggregated Building Blocks Approach ("BBA") for its consolidated capital requirement. We firmly believe an aggregation approach that leverages existing insurer risk-based capital regimes can effectively capture enterprise-wide risk and is superior to a consolidated approach. ACLI's comments are organized in three primary sections: (I) ACLI's views on the section 171 calculation; (II) feedback on the BBA; and (III) a brief discussion comparing the strengths and weaknesses of an aggregation method and the consolidated, market-adjusted valuation Insurance Capital Standard.

INTRODUCTION

While ACLI has a small number of members who are directly regulated by the Board, a wider number of our companies are keenly interested in the Board's proposed group capital rules because of the proposal's intersection with and potential influence on other group capital workstreams at the state and international level. The Board clearly acknowledges the relationship among these deliverables, stating in the Notice of Proposed Rulemaking that the Board is collaborating with the NAIC and the U.S. Treasury, to develop and advocate for an "aggregation method akin to the BBA, and the GCC being developed by the NAIC, that can be deemed an outcome-equivalent approach for implementation of the ICS."[2] Similarly, past NAIC President Eric Cioppa remarked that the NAIC's "coordination with the Federal Reserve" throughout the process of creating the Group Capital

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[1] The ACLI advocates on behalf of 280 member companies dedicated to providing products and services that promote consumers' financial and retirement security. 90 million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums to achieve public policy that supports the marketplace and the families that depend on life insurers' products for peace of mind.

[2] 84 Fed. Reg. 57240, 57245 (Oct. 24, 2019).

Calculation has led to a GCC that "largely aligns" with the Building Block Approach, which will "lead to enhanced regulatory consistency in the U.S."[3]

Given the increasing intersection between the NAIC's Group Capital Calculation ("GCC"), the Aggregation Method, and the Board's Building Blocks Approach ("BBA"), ACLI reviewed the 2019 Notice of Proposed Rulemaking ("NPR") proposal with a different lens than it viewed the 2016 Advanced Notice of Proposed Rulemaking. In 2016, ACLI's focus was limited to how the Board would satisfy their mandate under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Pub. L. No. 111-203 (2010) to create tailored group capital standards for depository institution holding companies significantly engaged in insurance activities and non-bank systemically important financial institutions. In 2019 and beyond, ACLI's vision is necessarily broader, given the increasing intersection of the Board's rule with standards under development at the NAIC and international level. While ACLI's view of the horizon has widened to accommodate these developments, we continue to respond in good faith and want to engage constructively to help the Board achieve a capital standard that satisfies the Board's statutory mandates and avoids introducing competitive disparities and disruption to an established industry that has developed under the well-seasoned, state-based insurance regulatory system.[4]

I. ACLI believes the separate "Section 171" risk-based capital requirement is inappropriate and ignores the intent of Congress

ACLI is disappointed to see that the proposed capital rule includes a consolidated Basel III calculation (the "section 171 calculation"). We do not believe that either the letter or the spirit of section 171 requires that the Board adopt an approach that applies Basel III to insurance savings and loan holding companies.[5] ACLI understands that section 171 requires that the Board's capital requirements must not be less than the generally applicable risk-based capital requirements established by the Federal Deposit Insurance Act.[6] However, there is no language in section 171 requiring that the capital requirements for insurance savings and loan holding companies ("ISLHCs") must be *identical* to the generally applicable minimum capital requirements.

Instead, section 171(b) is a directive to the Board to establish a minimum risk-based capital requirement that meets three specific parameters:

1. The capital requirement "shall be not less than the generally applicable risk-based capital requirements" for bank holding companies;[7]

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[3] NAIC President Opening Remarks at the 2019 Fall NAIC National Meeting Austin, Texas, *available at* https://content.naic.org/article/national_meeting_news_cioppas_opening_remarks.htm (last retrieved on Jan. 8, 2020).

[4] In addition to the recent developments, ACLI's comments were composed with the perspective that the Board's insurance capital rules, like any solvency regime tailored for a specific industry, should be capable of accommodating diverse corporate structures and the range of business models in the target industry.

[5] ACLI's position has always been that section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Pub. L. No. 111-203 (2010), has always enabled the Board to apply insurance-specific capital standards to meet the requirements under that section. Even prior to its amendment in 2014, section 171 states that the risk-based and leverage capital requirements "shall not be less than" nor "quantitatively lower than" the generally applicable minimum capital requirements under Basel III. The language empowers the Board to apply insurance-based standards similar to insurance RBC so long as they are not "less than" nor "quantitatively lower than" the minimum bank risk-based capital and leverage requirements.

[6] 12 U.S.C. § 5371.

[7] Dodd-Frank Act, § 171(b)(2).

2. The capital requirement shall not be "quantitatively lower than the generally applicable risk-based capital requirements that were in effect for insured depository institutions" (IDIs) as of the date Dodd-Frank was enacted;[8] and
3. The risk-based capital requirement is not less than those that "apply to IDIs under the prompt corrective action regulations implementing section 38 of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure."[9]

The BBA complies with the requirements of section 171(b) and section 171(a) (2) (A) by producing a group-wide, risk-based capital requirement that captures material risks across an ISLHC and is at least as stringent - and as our calculations show, is *more* stringent than, the minimum consolidated bank capital requirements.[10] Further, we do not believe section 171 requires the application of bank-centric rules. We strongly believe the differences between banks and insurance groups make the application of bank-centric rules to an ISLHC inappropriate, especially because because the banking rules already apply to depository institutions and bank activities under the Building Blocks Approach.

Section 171 does not expressly require holding companies to conduct multiple capital calculations, or even any particular calculation. Because the minimum capital requirements for depository institutions that apply to bank holding companies are themselves no less stringent than the requirements that apply to insured depository institutions under the prompt corrective action regulations, regardless of asset size or foreign exposure, the parameter of section 171(a)(2)(A) is also satisfied by the BBA given its stringency, and as demonstrated through the Board's proposed scaling methodology.

For these reasons, ACLI believes that additional section 171 calculation should not be included in the final version of the Board's risk-based capital requirements for ISLHCs. The legislative history of section 171, as amended, provides additional support for our views on why the section 171 calculation is unnecessary and inconsistent with Congressional intent.[11]

II. Feedback on the proposed Building Blocks Approach

1. The calibration of the BBA minimum capital requirement appears more stringent than the minimum bank capital requirement.

ACLI supports the use of the NAIC Risk Based Capital ("RBC") system as the "common capital framework" for the BBA. However, ACLI believes the minimum capital requirement for the BBA needs further work to avoid creating a BBA that is more conservative than the bank capital requirements.

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[8] *Id.*

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Pub. L. No. 111-203, § 171(a)(2)(A).

[10] *See* Table 1.0, *infra*, comparing the BBA calibration to the bank capital requirements.

[11] After the Dodd-Frank Act passed, Congress, repeatedly directed the Fed to develop capital rules tailored for the business of insurance. *See* 160 Cong. Record S. 6530 (daily ed.) (March 11, 2014). The Board declined to do so because they believed section 171 required the application of a consolidated bank capital standard to Board-supervised insurance groups. Congress attempted to resolve the impasse by unanimously passing the Insurance Capital Standards Clarification Act of 2014 (S. 2270), Pub. L. No. 113-279 (2014) and directed the Board to create tailored rules for insurance operations and activities. The amendment included an expansive definition of insurance activities. The amendment defined the "business of insurance" in a way designed to include subsidiaries and affiliates who are conducting acts necessary to writing or reinsuring insurance, such as supporting insurance company general and separate accounts. *See* 160 Cong. Rec. S6531 (daily ed.) (Dec. 10, 2014) (statement of Mr. Johanns).

ACLI recommends the BBA adopt a minimum capital requirement of 160% Authorized Control Level ("ACL") RBC.

The Board created the minimum threshold of 250% ACL RBC by translating the minimum total capital requirement of 8 percent of risk-weighted assets ("RWA") under the Board's banking capital rule to its equivalent under NAIC RBC. Using the scalars developed by the Board, 8% RWA equals 160% ACL RBC. During a call with ACLI members, Board staff described 160% ACL RBC as the Board's best estimate of achieving a BBA requirement that aligns with its minimum banking rule, but to account for any uncertainty in scaling parameters, a "margin of safety" was added on top of the best-estimate.

The table below (Table 1.0) demonstrates how the BBA's proposed minimum capital requirement of 250% ACL RBC scales to 8.95% RWA. This means that groups operating under the BBA will be subject to a minimum capital requirement that is approximately **12% higher** than the generally applicable bank minimum capital requirement of 8% RWA. The discrepancy stems from the margin of safety added to the best estimate of a scaled bank capital requirement. The margin of safety leads to a minimum BBA capital requirement that is **56% higher** than the 160% "best estimate." In a hypothetical company with $7.5 billion in Tier 1 capital, $1 billion in Tier 2/surplus notes, and $35 billion risk-weighted assets, the impact of the additional 56% "safety surcharge" is $333 million.

Table 1.0. Comparing the calibration of the bank capital requirement to the BBA capital requirement

Capital Elements	Insurance Requirement		Bank Capital Requirement	Example of Impact ($MM)[12]
	BBA	*Calibration*		
Initial Min. Assessment	160%	8%[13]		
(A) Minimum Requirement	250%	8.95%	8%	$333
(B) Buffer Requirement	235%	2.5%	2.5%	
(C) Total Requirement	485%	11.4%	10.5%	
Qualifying Capital Limits				
(D) Tier 2 Limit/ Risk Weighted Assets (RWA)	0.66%[14]		2.0%	
(E) Additional Tier 1 (AT1) Limit/ RWA			1.5%	
(F) Tier 2 (D) / Min. Req (A)	7.4%		25.0%	$468
(G) AT1 (E) / Min. Req (A)			18.75%	<u>$525</u>

It is unclear how the Board determined that increasing the minimum requirement to 250% ACL RBC would achieve an "adequate degree of confidence in the stringency of the requirement"[15] but it seems like it may have been selected arbitrarily, based on the resulting 250% being the midpoint

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[12] Assumes a hypothetical company with Tier 1 Capital = $7.5B; Tier 2/Surplus Notes Capital = $1B; Risk-Weighted Assets = $35B.

[13] $BBA = \frac{T1+T2-0.063*RWA}{0.0106*RWA}$

[14] $T2_{Maximum} = 0.625 * 0.0106 \text{ RWA}$

[15] 84 Fed. Reg. at 57261.

between two prominent, existing state insurance supervisory intervention points, the Company Action Level ("CAL"), which is 200% ACL RBC, and the NAIC RBC trend test level, which is 300% ACL RBC. Stronger quantitative support should be provided to rationalize the proposed uplift, which ACLI believes exceeds the level of prudence required by the Board's statutory mandate.

More broadly, we are concerned that the proposed BBA calibration does not take into account all of the elements of the BBA methodology that introduce additional conservatism into the BBA, such as the treatment of qualifying capital, including surplus notes and senior debt, the application of Basel III for unregulated entities, the omission of explicit diversification benefits across groups risks/entities, and the potential effect of unwinding of permitted and prescribed practices and transitional measures. These elements result in a BBA that reflects a modified version of the NAIC's RBC framework and their impact should be considered when the Board establishes the proposed minimum capital requirement for the BBA, especially given the Board's apparent interest in using "prominent, existing state insurance supervisory intervention points" to anchor its decision.

2. ACLI views on the capital conservation buffer and total BBA requirement

In addition to the 250% minimum capital requirement, the Board is proposing an additional 235% ACL RBC capital conservation buffer. The 235% ACL RBC buffer calibrates to 2.5% RWA, the same capital buffer that applies to bank holding companies.[16] An insurance group needs to maintain a total BBA ratio of 485% ACL RBC to avoid Board-imposed restrictions on bonuses and discretionary payments. The 485% total BBA ratio calibrates to 11.4% RWA, which is higher than the 10.5% RWA required for bank holding companies to avoid restrictions on bonuses and distributions.

In addition to being more onerous than bank capital requirements, the BBA's 485% calibration may exceed market-conventions. Depending on the insurance group's mix of business, it may also give rise to unintended consequences such as creating unlevel playing fields or establishing unwarranted new expectations for sector-wide capitalization levels, etc. For example, there are insurance companies, especially property and casualty insurers that are highly rated but operate at capital levels below 485% ACL RBC.[17] ACLI encourages the Board to consider the potential for unintended consequences and how to avoid such dynamics in its framework, especially with respect to the addition of conservatism or capital buffers that cause the BBA to exceed the mandated prudence levels.

Consequently, we recommend that the total of minimum BBA ratio and capital conservation buffer (should one be deemed necessary) be set at 395% ACL RBC, which is equivalent to 10.5% RWA. The 395 percent is based on a 160% minimum capital requirement, plus a 235% capital conservation buffer. We do not believe the aggregate requirement (i.e., 395%) needs to be allocated between the

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[16] The application of a capital cushion makes more sense in banking than it does in insurance, because the concept of a capital buffer in bank capital rules recognizes that a bank's capital position is subject to great volatility due to a bank's susceptibility to runs that is embedded in the banking business model (i.e., demand liabilities backed by less liquid assets), which creates the risk of a fire-sale of assets in the wake of a run. Insurance liabilities are much longer-term than banking liabilities, and thus much less liquid than banking ideas, and insurers match their assets and liabilities in duration. As a result, some have suggested that the capital conservation buffer should apply only to the insured depository institution.

[17] Average RBC ratios for the life and property-casualty insurance industry are available for 2007-2018. Life RBC is available at https://content.naic.org/sites/default/files/inline-files/research_stats_rbc_results_life_0.pdf; property-casualty RBC data is available at https://content.naic.org/sites/default/files/inline-files/research_stats_rbc_results_pc_0.pdf (last retrieved Jan. 7, 2020).

minimum and buffer in precisely that way, but the total requirement should not exceed 395% ACL RBC.

We further recommend that any capital requirements, including minimum ratios and limitations on qualifying capital, be phased-in over a two-year transition period beginning on January 1, 2021. Moreover, to the extent the Board requires any total amount above 395% ACL RBC, amounts that exceed 395% ACL RBC should be phased-in over a longer timeframe, with each increase or decrease subject to an approval measure similar to the countercyclical capital buffer.

3. Qualifying capital restrictions need additional refinement (capital composition limits, surplus notes, elimination of additional tier 1 capital)

The BBA's proposed restrictions on qualifying capital restrictions are significantly more severe for ISLHCs than for bank holding companies. ACLI requests that the Board reconsider the restrictions on qualifying capital to bring the limits for ISLHCs in line with the limits for bank holding companies. We also recommend that any limitation on additional tier 1 capital ("AT1") or tier 2 capital requirements be phased-in over at least a two-year transition period beginning on January 1, 2021.[18]

A. Capital composition limits – total tier 2 limitation

The rule proposes a capital composition limit that restricts the amount of tier 2 capital that qualifies as available capital in the BBA. An ISLHC may not use tier 2 capital instruments to meet more than 62.5% of its minimum BBA capital requirement. When the BBA requirements are scaled to the bank capital rules, an insurance group can only use tier 2 assets to satisfy 0.66% of their 11.4% RWA ratio.[19] In contrast, bank holding companies can use tier 2 assets to satisfy 2.0% of their 10.5% RWA ratio. We believe The BBA limit on tier 2 capital should be increased to avoid introducing further conservatism into the BBA and to bring the ISLHC restrictions in line with the banking rules.

ACLI calculated the combined effects of the NPR's standards of 250% minimum capital requirement and the 235% additional capital conservation buffer, and the 62.5% tier 2 limit. Using a hypothetical ISLHC with tier 1 capital of $7.5 billion, tier 2/surplus notes capital of $1 billion, and total consolidated risk-weighted assets of $35 billion, the ACLI determined that a firm with those characteristics would have to hold more than $800 million more in tier 1 regulatory capital under the BBA than it would under the banking capital rules – an outcome that we believe is not appropriate and may not have been intended.

This disparity is not justifiable on policy grounds and should be addressed by permitting Board-supervised insurance groups to hold the same amount of tier 2 capital as banking organizations. If the minimum BBA ratio is 250%, then the tier 2 limit should be 211% of the BBA capital requirement.[20]

B. Additional Tier 1 Capital

The NPR does not provide a separate category of capital that corresponds to additional tier 1 instruments. The limitation derives from the Board's supervisory experience that insurers do not commonly use capital instruments that meet AT1 criteria, and that when such instruments are used

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[18] A transition period is consistent with past Board approaches to limitations on available capital for bank holding companies. When implementing the Basel III framework, the FRB provided a three-year transition period for trust preferred securities. *See* 78 Fed. Reg. 62018, 62025 (Oct. 11, 2013).

[19] *Id.*

[20] A minimum BBA ratio of 250%, which equates to 8.95% of RWA. The Tier 2 banking limit is 25%. Thus, a BBA Tier 2 limit of 25% of RWA would equal 2.238% RWA. Scaling 2.238% RWA back to BBA (2.238% RWA * 0.0106 = 211%) results in 211%.

they do not represent a material proportion of the insurer's capital.[21] In contrast, AT1 capital instruments can count for up to 1.5% of a banking organization's capital requirement. While such instruments have not been commonly used by insurers, the BBA should be built in a manner that would accommodate the use of such instruments in the future.

The lack of AT1 capital means that approximately 93% of the remaining minimum BBA capital requirement needs to be funded by common equity or retained surplus for ISLHCs, versus approximately 56% for bank holding companies.[22] In addition, 100% of the insurance capital conservation buffer must be funded by common equity or retained surplus. [23] ACLI does not believe such degrees of difference between bank holding companies and ISLHCs are warranted.

Insurance groups should receive the same credit for AT1 instruments as banking organizations. We recommend an AT1 capital limit of 158% of the "building block capital requirement" (as defined in § 217.607 of the NPR).

C. Surplus notes

The rule proposes to "grandfather" non-affiliate surplus notes issued prior to November 1, 2019. Surprisingly, the rule does not discuss how the limitations on tier 2 capital, including surplus notes, may impact mutual insurance companies who are unable to issue common equity. ACLI is concerned that the proposed restrictions on tier 2 capital, especially surplus notes, will penalize mutual insurers because of their corporate structure and could make it more challenging to recapitalize a mutual insurer during times of stress.

The restrictions effectively eliminate a key lever in times of stress for mutual insurers. Unlike retention of earnings, which grows slowly over time as profits emerge, surplus notes can be issued relatively quickly to provide a more immediate capital infusion.[24] From a regulatory perspective, this means that surplus notes are the most readily available source of capital to meet the near-term capital needs of a mutual insurer. If the BBA imposes too severe a limit on the use of surplus notes, it could jeopardize a mutual insurer's ability to raise capital in times of stress.

With that in mind, ACLI recommends that non-affiliate surplus notes should be permitted to count towards the conservation buffer and we respectfully request that the final rule consider the effect of the restrictions on a mutual ISLHC's ability to recapitalize in times of stress.

4. **Applicable capital regime – the final rule should avoid the asymmetric treatment of assets-under-management in the BBA**

The BBA exempts registered investment advisors, and broker-dealers who are subsidiaries of a depository institution, from classification as a Material Financial Entity ("MFE"). ACLI supports this

[21] 84 Fed. Reg. at 57260, note 76.

[22] This recommendation is based on assuming minimum BBA ratio of 250%, which equates to 8.95% of risk-weighted assets under the banking capital rules.

[23] ACLI is also concerned that the BBA's proposed restrictions on the amount of tier 2 capital, including surplus notes, that can count towards minimum capital requirement and capital conservation buffer could be problematic for mutual insurers during times of stress.

[24] Surplus notes are a common source of loss-absorbing capital among insurers, especially mutual insurers, with equity like features and supervisory guardrails. Surplus notes are usually long-term obligations, with average maturity periods of 25 to 30 years. Surplus notes have unique, equity-like features: they are deeply subordinated to all policyholders and non-regulatory capital creditors and require regulatory approval prior to issuance. Supervisory approval is also required before a note is redeemed (payment of principal) or a distribution (payment of interest) is made.

exemption and appreciates the Board's acknowledgement that Basel III, which was created for bank risks, is not designed to capture the risks associated with assets under management.

However, the proposal classifies the same type of companies (broker-dealers) as MFEs if they are subsidiaries of insurance companies, which means they would be subject to Basel III. ACLI believes the same rationale – that Basel III is not designed to capture the risks associated with assets under management, is equally applicable regardless of the corporate structure of the insurance group and asks the Board to correct this inconsistency. Below, we offer a proposed amendment to address the inconsistency.

* * * Suggested amendment:[25]

> *Material financial entity* means a financial entity that, together with its subsidiaries, but excluding any subsidiary capital-regulated company (or subsidiary thereof), is material, provided that an inventory company is not eligible to be a material financial entity if:
>
> (1) The supervised insurance organization has elected pursuant to § 217.605(c) to not treat the company as a material financial entity;
>
> (2) The inventory company is a financial subsidiary, as defined in section 121 of the Gramm-Leach-Bliley Act <u>or the inventory company would qualify as a financial subsidiary if it was a subsidiary of a depository institution</u>; and
>
> (3) The inventory company is properly registered as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 *et seq.*), or with any state.

Although the NPR did not address the appropriateness of applying Basel III to holding companies, ACLI believes that Basel III regulations are also inappropriately designed for unregulated holding companies – both at the parent and intermediate holding company level.

5. Regulatory adjustments to building block capital requirements and available capital

A. Permitted and prescribed practices ("PPS")

The Board is proposing to reverse all state permitted and prescribed practices ("PPS"). ACLI believes this is unduly broad and unnecessary to achieve the Board's objective and could cause unintended consequences. Instead, we recommend that the Board collect a robust inventory that includes a description and the impact of the permitted or prescribed practice, along with an *ad hoc* review of permitted and prescribed practices to determine if the practice should be adjusted or not.

Insurers typically seek variations from traditional state standards either due to unique company circumstances or because the application of existing standards would create inaccurate or unintended impacts. Resolving these issues through formal changes to the statutory accounting or RBC framework may require years of work to develop. As a result, insurers and state regulators employ PPS as an appropriate and timely solution, especially for niche issues encountered by an individual firm or transaction. Therefore, ACLI believes the Board should not view PPS as efforts by companies to evade requirements or weaken resiliency. PPS' are approved by state regulators and reported publicly. Companies also file confidential reports with their domiciliary regulators describing the impact of all permitted and prescribed practices, which the regulator must in turn share with other state regulators.[26]

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[25] Suggested text of amendment is underlined.

[26] A domiciliary state insurance regulator can only approve a permitted accounting practice after providing notice to each of the states or U.S. territories where the insurer is licensed. The notice must include a clear description of the practice, as well as the projected impact of the permitted accounting practice on each affected financial statement account. *See also* https://isiteplus.naic.org/help/html/help_permitted_accounting_practices.htm (describing the process for

We are aware that the Board desires to achieve "consistent representation of financial information across all companies" in a jurisdiction. However, we do not believe it is necessary or appropriate for the Board to include a blanket reversal of all PPS in the BBA given their bespoke nature which requires state regulatory approval.[27] Rather, ACLI believes the Board should collect an inventory of PPS utilized by supervised firms that outlines their respective basis and impact on available and required capital (if any). The Board can use this information to determine if it is necessary to proceed with executing an adjustment for the purposes of the BBA.

B. Transitional measures and grandfathering

The BBA proposes adjusting available and required capital to remove the effects of any grandfathering or transitional measure. The Board asserts that while transitional or grandfathering measures "are important for application of regulatory capital frameworks, in practice, the framework, without applying the transitional measures, can provide a more accurate reflection of risk as intended by that framework."[28] ACLI disagrees with the latter part of the assessment, as the inclusion of transitional measures or grandfathering is often anchored to cost-benefit analysis and practicality considerations.[29] For example, it may be costly or unworkable for insurers to "unwind" business decisions made in conformity with the historical regulatory framework in place when the business decisions were made. The Board itself has recognized the appropriateness of transitional measures and fathering elsewhere in the rule, including in its treatment of surplus notes.

The ACLI is most concerned with how this element would be applied in practice for term and universal life with secondary guaranty ("ULSG") business. The NPR's description of this adjustment has generated confusion among ACLI members. Notably, the NPR does not distinguish how the BBA will treat term life and ULSG captives subject to Actuarial Guideline 48. These captives are not grandfathered, and if they are issued between 2015 and 2017, they are not subject to any transitional measures.[30]

In 2016, the ACLI proposed that the Board adopt the forward-looking Principles Based Reserving ("PBR") standard for reserving and that consideration could also be given to applying those rules to grandfathered captives, depending on materiality and complexity. As noted above, the increasing intersection between the BBA, the GCC and the Aggregation Method have broadened ACLI member interest in the Board's development of a group capital framework. With respect to the GCC, the ACLI advocates that the GCC should not include adjustments to remove the effects of grandfathering or any transitional measures. ACLI is hopeful that the NAIC's final GCC will respect the existing regulatory regime.[31] ACLI also believes the Board should refrain from making such adjustments in

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submitting permitted practice notification to other states and how insurance regulators can search permitted practices by state and financial statement date).

[27]ACLI is also concerned that "unwinding" permitted and prescribed practices in the BBA will create differences between the group and legal entity treatment of the same risk exposure, which could generate complexity and confusion for Board-regulated groups.

[28] 84 Fed. Reg. at 57256.

[29] ACLI respectfully disagrees with the Board's analysis of potential costs related to the application of adjustments to remove transitional measures. The regulatory impact assessment conflates the confidential regulatory filings describing the impact of permitted and prescribed practices with application of PBR, retroactively. Applying PBR retroactively will be a costly and time-intensive process.

[30] *See* Appendix 1 for a brief overview of the background and technical details surrounding the development of captive financing arrangements and principles-based reserving ("PBR").

[31] The NAIC field tested five potential on-top adjustments to term and universal life with secondary guaranty products. Simple options, such as the application of a single factor to reduce the excess conservatism in the reserves, may not work equally well for all firms or products. This finding tracks with the NAIC's finding in 2012

the BBA. In any case, we believe the Board's approach should align with that employed by the NAIC to ensure regulatory consistency for U.S. insurers.[32]

It would be extremely challenging to apply Valuation Manual 20 ("VM-20") retroactively.[33] The framework was not designed with in-force business in mind when it was created. It is also unclear how accurate a retroactive application of VM-20 will be.[34] The cost and burden of applying VM-20 retroactively does not justify whatever marginal benefits (if any) the adjustment will yield. Therefore, ACLI believes the Board should refrain from making such adjustments in the BBA regarding term life and ULSG assets and reserves and rely on the existing regulatory treatment for these assets and reserves. If the Board disregards the existing insurance regulatory regime for term life and ULSG assets and liabilities, then at a minimum, the application of VM-20 should be optional for in-force business and should permit reasonable simplifying estimations.

6. Scalars for international insurance regimes

ACLI encourages the Board to continue to explore methodologies for scaling foreign insurance regimes to the level of conservatism within the RBC framework in close collaboration with the NAIC. While the domestic focus of the firms currently subject to Board supervision may permit deferring resolution of this topic, it remains important for a variety of reasons. First, ambiguity on this item, as well as other facets of the BBA, will inhibit the ability for Board-supervised firms (or those who might be in the future) to make strategic business decisions such as expanding internationally. Second, ACLI believes the Board's current position has the potential to undermine achieving Team USA's shared objective of securing global recognition of an aggregation method.

7. The treatment of senior debt

ACLI is concerned that the BBA's treatment of senior debt disregards the loss-absorbing capacity that senior debt provides to an insurance subsidiary of a non-operating holding company. We encourage the Board to consider adopting an approach to long-term senior debt that is similar to what is under consideration at the IAIS. The BBA's treatment of surplus notes indicates that the Board accepts there are some circumstances when debt can have sufficiently loss absorbing capacity to meet the Board's definition of qualifying capital.[35] This recognition should extend to structurally subordinated debt issued by non-operating holding companies to insurance companies.

Structural subordination has robust case law in the United States, which is enhanced in an insurance regulatory landscape with strong regulatory controls over capital and up-streaming of dividends. Some of the controls that exist for surplus notes have functional equivalents for senior debt, like regulatory mechanisms that restrict an insurance subsidiary's ability to repay a surplus notes without regulatory approval. Regulators achieve a similar restraint on senior debt by requiring regulatory

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that variations in ULSG product design and interpretation of reserve calculations made it difficult to calculate a single factor to "right size" all ULSG firms at every company. *See PBR Educational Brief*, *available at* https://www.naic.org/documents/committees_ex_pbr_implementation_tf_130621_educational_brief.pdf (last retrieved Jan. 17, 2020).

[32] The NAIC is expected to finalize the Group Capital Calculation by August 2020.

[33] VM-20 contains the NAIC Principles Based Reserving methodology for term life and ULSG insurance.

[34] Because the NAIC is applying VM-20 prospectively, the existing VM-20 guidance does not address how to apply VM-20 retroactively, which could lead to a lack of uniformity in assumptions as companies try to apply the framework retroactively in the absence of guidance.

[35] ACLI believes that senior debt offers advantages that makes their issuance attractive to insurance groups. One advantage is that the investor base for senior debt is considerably deeper and more liquid than the surplus note market, which is predominantly composed of insurance investors.

approval before an insurance subsidiary can issue an extraordinary dividend, which effectively curbs the parent company's ability to obtain funding for senior debt repayment without regulatory approval.

The BBA's proposed disparate treatment of senior debt and surplus creates a "fairness" issue that penalizes companies depending on their corporate structure. Insurance groups that are led by a non-operating holding company may prefer to use senior debt in lieu of surplus notes to fund insurance subsidiaries capital requirements because they consider senior debt a more liquid form of qualifying capital than surplus notes.

Insurance regulatory bodies, including the NAIC in their efforts to develop a GCC and the aggregation method, and the IAIS in the Insurance Capital Standard, have also recognized that structural subordination can achieve comparable outcomes in terms of loss absorbency. We encourage the Board to consider adopting an approach to senior debt that aligns with the NAIC's approach in the Group Capital Calculation. We have also proposed an alternative approach that we believe is consistent with the Board's mandate to develop standards that are tailored to the business of insurance and at least as stringent as the bank minimum capital requirements,

Rather than disallowing senior debt entirely, the Board could consider a tailored approach that will satisfy the rigors of section 171. We propose a deduction or offset for a top-tier building block parent's investment in the capital instruments of a subsidiary building block holding company whose applicable capital framework is NAIC RBC. The top-tier building block parent's investment could be reduced by the lesser of (1) the amount of senior debt issued by the top-tier building block parent that meets the criteria for qualifying capital instruments other than prong (ii) of the definition (regarding subordination); and (2) the "building block capital requirement" for the ISLHC attributable to insurance building blocks, including the capital conservation buffer.

For example, if an ISLHC holds $1 billion of long-term senior debt, and has a "building block capital requirement" of $3 billion ($2 billion of which was attributable to insurance building blocks), the ISLHC would be able to recognize $1 billion of that senior debt to satisfy its $2 billion "building block capital requirement" attributable to insurance building blocks. This insurance building block deduction approach limits the offset to insurance-driven BBA capital requirements, which prevents arbitrage of senior debt. To ensure structural subordination and provide further guards against arbitrage, the deduction is limited to top-tier ISLHC with more than 25% of assets (on a standalone basis) that are in the form of capital instruments in subsidiaries.

8. The Final Rule should align common stock repurchases for insurance savings and loan holding companies with the repurchase process for traditional bank holding companies

We recommend that the Board harmonize the BBA's stance on common stock repurchases with the July 2019 revisions to Regulation Q. The final rule should clarify that prior Board approval of common stock repurchases is not required for common stock to qualify as "qualifying capital" absent a separate prior approval requirement.[36] This change would provide regulatory efficiency, eliminating the burden and cost of application to the Board and reposing oversight with the Board's supervision function, which would in any case be more familiar with a firm's particular business and financial condition. This change is consistent with the Board's objective of achieving a more aligned approach

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[36] Notably, Regulation Q's definition of common equity tier 1 capital was amended to provide in relevant part that. "(iii) The instrument ,. . . can only be redeemed via discretionary repurchases with the prior approval of the Board *to the extent otherwise required by law or regulation* . . ." 12 CFR. 217.20(b) (iii). (emphasis added).

This clarification from July 2019, embodied by the italicized words cited above, appears to have been inadvertently omitted from the equivalent reference in the NPR: proposed Section 217.608(a)(vi). Thus, we would propose clarification to revise proposed Section 217.608(a)(vi) to read in its entirety as follows:

"(vi) Redemption of the instrument prior to maturity or repurchase requires the prior approval of the Board to the extent otherwise required by law or regulation."

with traditional bank holding company rules and eliminating restraints on future business or capital development because of distinctions in organizational structure.

9. The Final Rule should clarify that audited financial statements for an inventory company are not required where no audit requirement currently applies.

Section 605(b)(5) of the NPR, titled "Financial Statements" would require a supervised insurance organization to prepare financial statements in accordance with SAP with respect to any inventory company whose applicable capital framework is NAIC RBC. Section 605(b) is not clear, however, on the nature of the financial statements required for building block parents whose applicable capital framework is the banking capital rules or any other inventory company, including whether those financial statements need to be prepared in accordance with GAAP and whether they would need to be audited.

If interpreted broadly, this section could be read to require audited financial statements from all inventory companies in an ISLHC's corporate structure. Such a requirement would be extremely burdensome, without offering a commensurate supervisory benefit. ACLI requests that the Board confirm that section 605 does not impose a standalone requirement for audited financial statements, where none previously existed.

III. ACLI's views on an Aggregation Approach and the market-adjusted valuation Insurance Capital Standard

ACLI strongly supports the Board's decision to utilize an aggregation method instead of a consolidated market-adjusted valuation approach, like the Insurance Capital Standard ("ICS"). The NPR solicited feedback on the comparative strengths and weaknesses of the proposed approaches, as well as how an aggregation-based approach better reflects the risk and economics of the insurance business in the U.S.

1. Comparative strengths and weaknesses of the Insurance Capital Standard and an Aggregation Approach

A major strength of an approach that aggregates existing company-level capital requirements is that it gives the supervisor an enterprise-wide group capital ratio, but an aggregation process gives the regulator the ability to identify the exact location of any capital weakness in the enterprise. In contrast, a consolidated balance sheet approach, like the ICS, could produce an alarming result, but it might be time-consuming and challenging for the regulator to identify which entity was causing the firm to experience insufficient capital levels. The ability to quickly identify weakly capitalized entities that pose material risk to firms is a significant benefit provided by an aggregation method. Similarly, a consolidated balance sheet is easy to stress test, but the results may include false negatives because a consolidated balance sheet test can mask substantial weakness in a single entity when its combined with others.

ACLI believes that an aggregation approach that leverages an insurance capital regime that was intentionally designed to avoid the application of fair value accounting rules to most life-insurance company assets, thereby avoiding unwarranted volatility in regulatory capital, is beneficial for U.S. consumers and the U.S. insurance market. We also believe that avoiding volatility through an aggregation approach based on the NAIC RBC framework will contribute to financial stability by avoiding the introduction of unnecessary pro-cyclicality that can occur in market-consistent capital regimes.

We appreciate that the Board, along with other members of Team USA, are committed to the acceptance of an aggregation method internationally and we look forward to supporting the U.S. in their ongoing efforts to secure recognition.[37]

ACLI believes strongly that an aggregation method is a viable alternative to the market-adjusted valuation ICS. Our members are still evaluating the proposed high-level principles for criteria and are not ready yet to opine on specific criteria to assess comparability. However, ACLI members are working diligently to identify a set of criteria we can support, and we are collaborating with other U.S. trade associations. We look forward to sharing our work with you at the soonest possible date.

The table below is an attempt to capture the comparative strengths and weaknesses of the ICS and aggregation method (table 2.0).

Table 2.0 Comparative strengths and weaknesses of the Insurance Capital Standard and an Aggregation Approach

ICS	Strength or weakness?	Aggregation Approach
Results in consolidated capital	A major benefit of aggregated results is that it provides legal-entity level transparency for the supervisor. This allows quick identification of any weakly capitalized entities. An aggregated approach with legal-entity level transparency also offers a more realistic view of a company's capital position because capital in regulated entities is not necessarily fungible. The benefits of a consolidated approach (no double counting, consistent treatment of entities) can be achieved through careful application of an aggregation method, including adjustments to remove double counting, and scaling to achieve consistency between regimes.	Results in aggregated, enterprise wide capital measure (not consolidated capital)
Does not require the development of scalars	While an aggregation approach may need scalars, as long as calibration follows a systematic methodology, it can be applied to most regimes with a risk-based capital system. A greater number of regimes does not increase the difficulty, because the scaling will follow a common methodology for all scalar-compatible regimes. The use of scalars is neither good nor bad, although their existence is tied to a major benefit of an aggregation approach – an aggregation approach leverages the existing regulatory regime. Thus, an aggregation approach incorporates the regulatory framework that is best suited for the jurisdiction and market where the entity operates. That is a significant benefit, because regulators in a specific jurisdiction have the best understanding of their markets and the products sold there. Regulations designed around products sold in a developed economy country may not be ideal in an emerging market, and vice versa. A great strength of an aggregation method is that it recognizes the diversity that exists in different markets.	Requires development of scalars
Consolidated stress test	While an aggregation approach would require stress tests to be performed at the legal entity level, that is a strength of an aggregation approach because it provides transparency into the legal entities during times of stress. It is simpler to perform a single, consolidated stress level, but the results are less useful because consolidated balance sheet stress testing can mask substantial weakness in a single entity when its consolidated with others.	Legal entity level stress test

[37] As discussions with Team USA and the IAIS continue, ACLI believes it is important that an aggregation method ultimately reflects the insurance regulatory system, not a banking system.

ICS	Strength or weakness?	Aggregation Approach
Intended to produce a single, comparable capital measure across jurisdictions	The reality is that, even in the countries that adopt the ICS, it will not be implemented consistently across all jurisdictions. The ICS acknowledges this when it refers to "jurisdictional discretion." Further, it's likely that the IAIS will eventually allow companies to use Solvency II internal models to calculate their ICS capital requirements. While Solvency II internal models are calculated to the same confidence level, the models are bespoke, which tends to decrease uniformity in the ICS if they are adopted.	An aggregation method is a general aggregation approach that leverages existing regimes and may vary, depending on how its adopted
Expected to be volatile	The ICS, which is modeled after Solvency II and uses a market-consistent valuation approach that is more volatile than an aggregation approach that uses NAIC RBC as the common capital framework. The volatility in the ICS capital framework disincentivizes the issuance of long-term guarantees and does not provide appropriate recognition that insurers who hold long-term liabilities match those liabilities with long-term assets.	Less volatile

CONCLUSION

As noted above, ACLI is encouraged and pleased by the Board's demonstration that an aggregation-based approach is a viable way to create an enterprise-wide measurement of risk. We appreciate the Board's consideration of our recommendations and would be pleased to discuss them further with you, at your convenience.

Sincerely,

Mariana Gomez

APPENDIX 1

(1) <u>Background – genesis of captive financing arrangements</u>

Captive financing arrangements for term life, universal life with secondary guarantee products, and variable annuity products began to proliferate in the early 2000's. At the time, it was widely recognized that the formulaic reserve requirements for some products, like term life and universal life with secondary guarantees ("ULSGs") and variable annuities were overly conservative and did not accurately reflect the risk of the products.[38] As a result, many companies, with the approval of their lead-state regulator, entered captive financing arrangements that were designed to reduce the impact of the excess reserve requirements. These arrangements typically allowed the use of "soft assets" (e.g., letters of credit) to back the portion of statutory reserve requirements that exceeded the economic risks associated with the products. The remaining reserve requirements (i.e., the "economic reserves") were backed by high quality assets. Supervisors were the final arbiter of what portion of reserves qualified as economic and non-economic in nature.

The upshot of captive financing arrangements that are undertaken to bring reserve requirements into line with the economic risk associated with a product are consistent with ICP 14.4.1[39] and ICP 14.5.15[40], which states that insurance liabilities should be valued using an economic valuation. An economic valuation is a "valuation such that the resulting assessment of an insurer's financial position is not obscured by hidden or inherent conservatism or optimism in the valuation."[41] Liability valuation should be tested annually for adequacy and "***adjustments should also be made to reduce any significant, undue conservatism identified by the adequacy test."***[42]

Regulators who have permitted captive arrangements did so because there was substantial evidence that the existing statutory framework did not reflect the risk for certain products, and the resulting valuation, if left unadjusted, created misleading results for the solvency and capital position of insurers. Regulators also acted to "right-size" reserves with consumers in mind. "Right-sizing" reserves is important for consumers because holding higher-reserves than necessary (e.g., having reserves that exceed the actual risk associated with the product) results in higher costs for consumers.[43]

(1) <u>Background – genesis of PBR</u>

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[38] NAIC Legislative Brief, *Principles Based Reserving*, June 21, 2013.

[39] Insurance Core Principles 14.4. "The valuation of assets and liabilities is an economic valuation." ICP 14.4.1: "An economic valuation is a valuation such that the resulting assessment of an insurer's financial position is not obscured by hidden or inherent conservatism or optimism in the valuation. Such an approach is appropriate in the context of risk-based solvency requirements which satisfy these ICPs and standards and shares their objectives of transparency and comparability."

[40] Insurance Core Principles 14.5.15: "When an amortised cost method is used, the values produced should be evaluated for adequacy at least annually. For assets, when the asset has been impaired to a significant degree, the carrying value of that asset should be adjusted to reflect that impairment. For liabilities, the value should be tested at least annually. When the liability value is found to be inadequate, it should be strengthened***. Adjustments should also be made to reduce any significant, undue conservatism identified by the adequacy test."*** (emphasis added).

[41] Insurance Core Principles, *supra* note 35.

[42] Insurance Core Principles, *supra* note 36.

[43] NAIC Principles Based Reserving Educational Brief, p. 4, June 21, 2013, *available at* https://www.naic.org/documents/committees_ex_pbr_implementation_tf_130621_educational_brief.pdf.

In the mid-2000's, the NAIC acknowledged that the regulatory reserve system needed to evolve. As products grew more complex, it was no longer sufficient to use simple formula to determine the amount of reserves for a liability.[44] The standard formulas do not always reflect the risks or the true cost of the liability of the insurer. For some products this leads to excessive conservatism in reserve calculations, and for others it could result in adequate reserves.[45] The NAIC's own study showed that the standard formula contained high degrees of excess conservatism in term life (XXX) reserves.[46] The impact study also showed that the reserves for Universal Life with Secondary Guarantees needed to be "right-sized" as well.

In 2009, the NAIC adopted a revised Standard Valuation Law ("SVL") which laid the groundwork for states to apply Principles Based Reserving, a more advanced methodology that better reflects and measures the risks of modern life insurance products. In 2012, the NAIC issued the new Valuation Manual for term life and universal life with secondary guarantees (VM-20), and as of early 2019, all 50 states and the District of Columbia have adopted Valuation Manual 20. Under PBR, insurers will be required to hold the higher of (a) reserves using prescribed factors or (b) reserves which consider a wide range of future economic conditions and is computed using credible insurer experience factors specific to an insurer, such as mortality, policyholder behavior and expenses.[47]

Although the NAIC adopted the valuation manual in 2012, its application, and the application of PBR for term life and ULSG guarantees could not begin until at least 42 states adopted the revisions to the Standard Valuation Law. In the meantime, regulators sought to address the growing use of financing transactions that were proliferating to address the excessive reserve requirements for term life and ULSG (XXX/AXXX reserves). Regulators spent three years compiling data, researching legal issues, studying actuarial models and consulting with outside advisors related to the industry's use of term life and ULSG reserve financing transactions. The result was Actuarial Guideline 48 ("AG 48"), which applies to term life and ULSG reserve financing transactions (i.e., captives) issued after Jan. 1, 2015.[48]

Unlike PBR, which was formally implemented in 2017, and has a mandatory effective date of January 1, 2020, AG 48 immediately established national standards for the use of term life and ULSG (AXXX and AXXX) financing arrangements, and applied to all captive arrangements entered into on or after Jan 1, 2015. AG 48, which was codified into NAIC Model Regulation #787 (XXX/AXXX Framework) establishes greater uniformity among jurisdictions and regulators for the review and approval of such financings, facilitates transparency by requiring comprehensive reporting of such transactions, and enhances policyholder protection by increasing liquidity and solvency margins.

(2) <u>Background: what is the rationale for grandfathering XXX/AXXX captives?</u>

The regulators who drafted the XXX/AXXX Framework and VM-20 spent a large amount of time considering the appropriate treatment of captives that were already in force at the time AG 48 was created. The regulators ultimately concluded that those existing transactions should be grandfathered for two reasons. First, there was a general recognition that it is impossible to "unwind"

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[44] *See* NAIC Principles Based Reserving Legislative Brief, *supra* note 34 at 1.

[45] *See* NAIC Principles Based Reserving Educational Brief, *supra* note 39 at 2.

[46] *See id.* at 2 (noting that the 2012 NAIC PBR Impact Study showed that the application of PBR would result in lower reserves (38-64%) for competitive level premium term products for all surveyed companies).

[47] Center for Insurance Policy and Research, Principles Based Reserving, *available at* https://content.naic.org/cipr_topics/topic_principle_based_reserving_pbr.htm (last retrieved Jan. 17, 2020).

[48] Actuarial Guideline 48, *available at* https://content.naic.org/sites/default/files/inline-files/committees_ex_pbr_implementation_tf_related_actuarial_guideline_ag48.pdf (last retrieved Jan. 17, 2020).

past business decisions made in conformity with the existing regulatory framework. For example, the grandfathered policies were priced, assets and liabilities were duration-matched, and capital was deployed based on the laws and regulations that existed when the policies were written. Secondly, and more practically, because a significant number of grandfathered policies are 20-year term insurance policies, regulators recognized that the block of grandfathered policies and the associated reserves shrinks significantly every year, and within a few years the “grandfathered” issue would resolve itself as the last of the policies mature. Thus, in the next several years, there will be a significant decline in the number of grandfathered policies, which should assuage concerns about uniformity.

Although the reserve requirements in AG 48 applied only to captives issued after January 1, 2015, AG 48 (codified in Model Regulation 787) contains transparency and reporting measures for all XXX/AXXX captives, regardless of when they were issued. Regulators created the Supplemental Term and Universal Life Reinsurance Exhibit that shows the relationship between statutory reserves ceded and the “hard” assets being held for each captive reinsurance treaty. The exhibits show the amount of “economic reserve” for grandfathered policies, which allows regulators to easily evaluate whether the captive is holding the appropriate amount of hard assets (*i.e*. SAP admitted assets) to back the economic risk in the captives. Non-grandfathered captives must show the Required Level of Primary Security, a number which is designed to correspond to the economic risk in the captive.