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September 20, 2018

Commissioner David Altmaier
Chair, Group Capital Calculation (E) Working Group
National Association of Insurance Commissioners (NAIC)
Via email: jgarber@naic.org

RE: *Group Capital Calculation Scope and Non-Insurance Testing* (August 7, 2018)

Dear Commissioner Altmaier,

On behalf of the Solvency Committee of the American Academy of Actuaries,[1] I appreciate the opportunity to offer the following comments on the document, *08-07-18 Scope and Non-Insurance Testing Exposed with Questions* (the exposure draft).

At the outset, we would like to reiterate our agreement with the objective stated in the fourth paragraph on page 1 of the exposure draft that the Group Capital Calculation (GCC) "should consider risks that originate within the Insurance Group along with risks that emanate from outside the Insurance Group but within the Broader Group."

To better implement this objective, the Solvency Committee believes that there could be fewer exemptions for field testing purposes. While the final scope for GCC is still being decided, it would be beneficial to cast a wide net for the purposes of field testing. Analyzing results across a wide variety of groups can provide a basis for making informed decisions on the many policy questions under consideration by the working group. In order to provide an informative measure for insolvency risk and help avoid future financial crises, GCC field testing should consider risks across all groups and entities within a group—even if a specific entity itself may not appear to present significant solvency risk. In addition, to adequately test a range of groups and entities, broad participation from companies that wish to be a part of field testing should be encouraged, recognizing that doing so may require states to provide more resources to support the field testing exercise.

The following lists the Solvency Committee's comments on questions 1, 2, 6, and 7 in the exposed document, in addition to recommended edits:

[1] The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

1) Questions 1 and 2: Groups exempted from the GCC—Exemptions for both groups and entities within non-U.S.-based groups should be limited and determined through field testing data. The NAIC might wish to seek a broad field testing audience to gather sufficient data that could sustain any of the suggested exemptions. To accomplish this:

   - *Recommendation: Remove Paragraphs 13 and 14, in relation to scope for GCC field testing.*

   In addition, for purposes of field testing, we believe that Paragraphs 15., 16., 17., 18., and 19. should be interpreted so as to encourage a broad scope of entities included in the field testing exercise.

2) Questions 6 and 7: Expedited approaches for companies that are subject to federal requirements and underwriting company-owned groups—Paragraph 20. provides expedited approaches to the GCC in certain circumstances. In subparagraph (i), U.S. groups subject to the Federal Reserve Board's group capital requirements may use such federal requirements for the purposes of GCC. While federal and NAIC frameworks may have similar objectives, the Federal Reserve Board has yet to release a formal Notice of Proposed Rulemaking relating to its proposed group capital standards. The NAIC has a unique opportunity to compare the results of its GCC with the results of federal capital standards for applicable groups.

   Paragraph 20.(ii) allows for Annual Risk-Based Capital (RBC) reports to be provided for U.S. groups where the Ultimate Controlling Party is an underwriting company that owns all other entities. We believe there are likely to be differences in the results of the GCC and RBC, which will be driven in part by differences in the purposes for each calculation. The purpose of RBC is to provide an early warning sign for weakly capitalized companies, whereas GCC may provide further insights into groupwide solvency risk. Additionally, RBC may not capture all of the entities which will be in scope for the GCC. A notable example might be a life insurance company that may own a foreign insurance entity that does not report RBC and, therefore, would not be accounted for in the NAIC Life RBC formula. We understand that foreign insurance entities would be in scope for the GCC. Given the potential for differences in purpose and scope, the NAIC might use the field testing exercise to validate the appropriateness of the proposed expedited approaches. To that end:

   - *Recommendation: Remove Paragraph 20., in relation to scope for GCC field testing.*

In addition, the exposure includes certain carve outs and guidance that can be simplified and made more consistent:

RBC Ratio Inconsistencies—Paragraph 27.A. (i) and (ii) require scaling to an RBC level equal to 300% of the Authorized Control Level (ACL). In comparison, Paragraph 27.C., Test 2a provides non-financial entities the option to scale to a factor based on 486% of ACL for life insurers and

332% for P&C insurers. In addition, Paragraph 27.C., Test 2a mentions life and property/casualty average RBC Company Action Level ratios, but does not address health business.

- *Recommendation: Make Paragraph 27.A. and Paragraph 27.C. reflect a consistent level of RBC and add the health average RBC Company Action Level ratio to Paragraph 27.C., Test 2a.*

Historical Look-Back Period—With respect to Paragraph 27.C., Test 1a, material changes to the entity over the past five years could significantly distort the ratio being applied to the current-year gross revenue. A five-year look-back at the greatest loss may not reflect volatility and risk over the economic cycle. In addition, a five-year look-back period is inconsistent with other risk measures that try to capture adverse economic conditions, such as economic capital and stress testing. Therefore, a longer historical look-back period would be preferable and would better reflect tail risk to the group. Therefore:

- *Recommendation: Modify Paragraph 27.C., Test 1a to be based on a longer historical time period. In setting the time period, there should be consideration for whether companies generally have net cash flow data available for the proposed historical length.*

Expenses as Basis for Risk of Net Loss—Tests 1a and 1b in Paragraph 27.C. base the factor applied on gross revenue. However, the risk of lost income is based on whether revenue is greater than the expenses being incurred, including fixed costs and overhead. For example, risk of loss for a service organization is largely driven by the level of operating expenses, and is not necessarily based on revenue alone. It therefore would be more appropriate to measure risk of future losses based on expenses instead of revenue for non-insurance, non-financial entities.

- *Recommendation: Modify the ratio in Paragraph 27.C., Test 1a and Test 2a to be based on operating expenses (both fixed and variable) rather than revenue.*

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We are grateful for your time and attention to our comments. If you have any questions or would like to further discuss this topic, please contact Nikhail Nigam, the Academy's policy analyst for risk management and financial reporting issues, at 202-223-8196 or nigam@actuary.org.

Sincerely,

Elizabeth K. Brill, MAAA, FSA
Chairperson, Solvency Committee
American Academy of Actuaries