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September 16, 2016

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW.
Washington, DC 20551

Via email to regs.comments@federalreserve.gov

RE: Request for Comment on ANPR for Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities (Docket No. R-1539, RIN 7100 AE 53)

Dear Secretary Frierson,

On behalf of the American Academy of Actuaries'[1] Financial Regulatory Task Force, thank you for the opportunity to provide our feedback on the advanced notice of proposed rulemaking regarding *Capital Requirements for Supervised Institutions Significantly Engaged in Insurance*.

We have focused our comments on issues that are either actuarial in nature or where we believe an actuarial perspective would be useful. To this end we are providing comments on the approaches presented in the proposed standards and are not responding to the specific questions asked.

High Level Comments

The Task force supports having a single approach that applies to all types of entities as it will improve comparability between organizations, provide efficiency versus maintaining multiple systems and reduce the potential for arbitrage between regimes. A single approach can accommodate different levels of capital requirements using a consistent methodology.

Companies that engage in insurance are frequently regulated at the legal entity level. As a result there are often regulatory constraints on the ability to move assets and capital from one legal entity to help satisfy obligations at other entities within a group. We believe it is critical that any capital standard appropriately reflect these legal entity-level constraints.

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[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists 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.

While acknowledging that each method has its drawbacks, we believe the Building Block Approach (BBA) will be more transparent than the other approaches in its reflection of such constraints, in particular regarding the availability of capital across an insurance group.

Application of Approaches

The proposed determination of whether a group engages in significant insurance activity is based on the assets involved in the insurance activity versus the assets for the entire group. This measure may not meaningfully reflect the level of insurance activity, in particular if a group is active in certain types of insurance, such as excess of loss or catastrophe coverage.

Building Block Approach

The BBA could be implemented more quickly than the Consolidated Approach because the regulatory filings at the jurisdiction level are available. The leveraging of jurisdiction-based regulatory financial filings is a practical starting point. The National Association of Insurance Commissioners Risk-Based Capital regime (RBC) is designed to identify potentially weakly capitalized insurance companies, with varying levels of regulatory action triggered based on the RBC ratio. While not the stated intent of the NAIC RBC regime, the capital requirements defined at the Company Action Level are considered to be a de facto minimum capital standard. The vast majority of insurers will hold capital in excess of the Company Action Level requirements in order to avoid any regulatory intervention. The NAIC RBC regime was implemented in 1994; the RBC requirements, along with the overarching framework for regulating solvency, are continually evaluated and refined to better capture risks[2].

A key step in the BBA will be the identification and assignment of appropriate required capital regimes for non-insurance and non-regulated entities, including holding companies. Even some types of insurance entities (e.g., title insurance companies) are not currently subject to a risk-based capital regime.

When calibrating the scalars used in the BBA, it will be important to consider differences in the level of conservatism resident in any given regulatory capital regime. The level of conservatism in each required capital regime will in turn be dependent on the level of sufficiency in the underlying reserve liabilities. These can vary significantly from state to state (e.g., permitted practices, treatment of surplus notes), and country to country. Levels of margins in the reserve liabilities can vary significantly from entity to entity. Another consideration is the treatment of taxes which can vary significantly by jurisdiction. For example, some insurance liabilities reflect after-tax cash flows while others reflect pre-tax cash flows. The tax related adjustments to required capital amounts can also have significant variation.

Consolidated Approach

[2] Work is currently being conducted to enhance risk-based capital for catastrophe risk for P/C companies, investment risk and operational risk, among other areas of risk.

We believe that the most important element of a Consolidated Approach that needs to be defined is how it will reflect entity level constraints regarding the movement of capital and assets. It is possible that elements of a building block approach will be needed to supplement a consolidated group-wide view of available and required capital.

Many adjustments to the published GAAP financials will be necessary to produce capital amounts that are fully reflective of the amounts available to absorb losses. These include, but are not limited to, intangible assets, accumulated other comprehensive income and margins resident in reserves. This may also mean that certain reserve liabilities may be increased relative to reported GAAP liabilities, for instance to reflect the time value of options and guarantees or to the extent that the reported liabilities are required to reflect a company's non-performance risk, which reduces liabilities, all else being equal.

A Consolidated Approach should reflect asset-liability mismatch risk. Current GAAP reporting does not reflect any adjustment for this risk and thus, reflecting asset-liability mismatch risk will need to be done outside of the main accounts. We believe that supplemental stress testing could provide insight into risk sensitivity.

Credit for diversification, in general, needs to be considered in any approach used. We note that most accounting systems do not reflect how diversification might impact financial results and most regulatory systems attempt to reflect lack of correlation of risks with varying degrees of sophistication and approximation.

Maintenance of Approaches

The maintenance required to support either approach should not be underestimated.
With the BBA, the individual components will evolve as the local regulators adjust their regimes in response to the evolving markets. Once the Federal Reserve Board (FRB) has developed the methodology to evaluate the building blocks as a whole, there will be a need to evaluate those changes and adjust the methodology and/or the calibration of the methodology in response to those changes.

Maintenance of a Consolidated Approach will require the same evaluation of the impact of local regulatory regime changes on the methodology and calibration, but will also require the FRB to evaluate changes in the underlying markets to be sure the appropriate information continues to be captured and included in the approach. Additionally, to the extent the underlying accounting is based in GAAP, the FRB will need to monitor GAAP accounting changes and decide how to handle such changes. Requirements for elements of balance sheets of all entities change continuously. While the accounting for insurance activities does not change that frequently, both the US Financial Accounting Standards Board and the International Accounting Standards Board are in the process of updating the accounting for certain insurance products.

Calibration of Approaches

In either approach there will be a need to use scalars to express underlying information (building blocks or GAAP information) in common terms and calibrate them for a specific purpose. There should be clarity as to the connection between the calibration of the scalars and the consequences of a regulated group falling on one side or the other of the resulting capital requirements. The development of such scalars and their calibration needs to be done in a way that fits the purpose and does not lead to group or systemic behavior. Testing will be required to ensure that the resulting calibration scalars do not produce material numbers of false positive or negative results.

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Thank you for the opportunity to comment on the proposed rule *Capital Requirements for Supervised Institutions Significantly Engaged in Insurance*. If you have any questions or would like to discuss our comments in more detail, please contact Nikhail Nigam, the Academy's policy analyst for risk management and financial reporting, at 202.223.8196 or nigam@actuary.org.

Sincerely,

William Hines, MAAA, FSA
Chairperson
Financial Regulatory Task Force
American Academy of Actuaries