North American CRO Council

September 16th, 2016

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

Dear Mr. Frierson,

The North American CRO Council ("CRO Council") is a professional association of Chief Risk Officers ("CROs") from leading insurers based in the United States, Canada, and Bermuda. Member CROs currently represent 29 of the largest Life and Property and Casualty ("P&C") insurers in North America. The CRO Council seeks to develop and promote leading practices in risk management throughout the insurance industry, and provide thought leadership and direction on the advancement of risk-based solvency and liquidity assessments.

The CRO Council commends the Federal Reserve Board ("FRB") on the work performed to date, and appreciates the opportunity to comment on the Advanced Notice of Proposed Rulemaking ("ANPR") on approaches to regulatory capital standards for supervised insurers.

Though the CRO Council is supportive of concept of group capital standards, we want to caution that the FRB should continue to take the appropriate time, care, and caution in designing, testing, implementing, and maintaining any group capital standard. This would include, but not be limited to, robust and comprehensive field testing across a wide range of insurers, markets, and scenarios so that there is clear understanding of how these capital constructs would work (both on their own and through any bifurcated approach that would leverage more than one approach). Furthermore, should the Federal Reserve ultimately adopt a bifurcated approach, there would need to be clear understanding as to how the constructs work with each other, and whether or not any initial calibration would hold through a range of Insurance, financial market, and other conditions. Given these considerations, the Council recommends that further development and any implementation be phased in over time to reduce potentially negative impacts.

Below are some of CRO Council's observations that warrant careful consideration prior to moving forward with either the Building Block Approach ("BBA"), the Consolidated Approach ("CA"), or with a bifurcated approach that would utilize both.

Building Block Approach

Conceptually, the CRO Council believes that the BBA is an approach that can plausibly be developed to meet the FRB's objectives, provided due care is taken as the approach is further developed.

As the BBA is based on the aggregation of existing (and generally well-functioning) legal entity capital requirements, it is more immediately extensible to all supervised insurers. However, appropriate adjustments must be made to the aggregation of capital to reduce the risk of inappropriate outcomes. By providing transparency into a group's structures, transactions, and regulatory permitted or prescribed practices, and with limited changes to existing regimes, an appropriate, meaningful, and comparable group solvency measurement can be achieved. Furthermore, while the FRB has expressed concerns (involving complexity and arbitrage) with respect to applying the approach to those deemed by the Financial Stability Oversight Council ("FSOC") as Systemically Important Financial Institutions ("SIFIs"), the CRO Council believes the BBA – given its guiding principles and architecture – can apply to all supervised insurers, regardless of size. The key steps of the BBA, and our observations for each, are as follows:

1) Identification of appropriate regimes. Given that the BBA will calculate a group capital adequacy based on aggregated entity-level capital, it must ensure that all entities are appropriately captured in the framework. Regulated entities should follow existing jurisdictional requirements (with potential adjustment as described below in items 2 and 3). Unregulated entities such as holding companies would require assignment of an appropriate regime. The assignment of regimes should reflect the primary purpose of the unregulated entity, for instance, a holding company of insurance operating entities should utilize the regime of the primary insurance operating subsidiaries. Banking entities and asset management entities should be subject to Basel III, or the relevant capital standards for those entities at any given time.

2) Adjustments for intercompany transactions and prescribed/permitted practices. As the BBA architecture is one of aggregation, not consolidation, it is important that the architecture appropriately adjust entity-level available capital and required capital for intercompany transactions, and prescribed/permitted practices, so that these entity-level amounts may be coherently aggregated. Key adjustments include: eliminating investments in subsidiaries from a holding company to avoid double-counting the capital of the subsidiaries in aggregation; eliminating the impact of intercompany loans and affiliated surplus notes from entity-level capital as such loans do not impact the risk or capital position of the group. The effort of determining how intercompany transactions are handled under the BBA could be considerable, especially for larger, more complex organizations.

3) Scaling of legal entity available and required capital for purposes of aggregation. The BBA must take into account the differences in valuation conservatism across regulatory regimes. Considering the necessity to leverage existing regimes, and the principle of doing so with minimal changes to the fundamental elements of those regimes, scaling can be employed to provide a more comparable expression of capital across regimes. Scalar adjustment of jurisdictional available and required capital must take into account two key inflection points in the comparison of two regimes: first, the point of regulatory intervention; and second, the typical operating level of insurers in the regime. Scaling one regime to another based solely on one of these two points likely would yield inappropriate results. Furthermore, appropriate supplemental stress testing should be applied to understand the relationship between the various regimes. The CRO Council proposes that scalars be carefully developed to avoid inappropriate outcomes in the group-wide capital adequacy measured. We believe that field testing prior to implementation, as well as post-implementation monitoring and recalibration, will also be critical.

4) Consideration of diversification across the group. Diversification is fundamental to the business model of insurance. Risk diversification is typically recognized within a given insurance regulatory regime. For the BBA to appropriately reflect a group-wide view of capital adequacy,

it must also recognize risk diversification across geographies and lines of business which are not captured within the legal entity derived capital requirements. Thus, an explicit diversification adjustment should be considered after the other BBA adjustments and scaling. This can be done through simple correlation matrices applied to broad categories of types of business (life insurance, non-life insurance, non-insurance) and geographies (North America, Asia, etc.).

An aggregation of legal entity capital which follows the above steps can provide a reasonable proxy for consolidation and an appropriate measure of group solvency adequacy. The BBA has advantages of relative ease of implementation and maintenance, relevance for and comparability across insurers, and closer alignment with (and leveraging of) existing regulatory approaches. While the ANPR states that the BBA may not be appropriate for insurers designated by the FSOC as SIFIs, the CRO Council believes that the BBA can be developed to meet the FRB's objectives with respect to all supervised insurers. Rather than distinguishing between classes of insurers through the capital methodology applied, more appropriate differentiation can be achieved through capital and liquidity stress testing requirements which have been appropriately tailored to the insurance business model.

Consolidated Approach

The CRO Council also believes that the CA has merit, but warrants similar care in any additional development to prudently address areas of concern. In the event that the FRB pursues the CA anchored in GAAP accounting, there are several points the CRO Council would like to put forward for consideration.

First, while no accounting standard provides a perfect representation of an insurer's loss absorption capacity for solvency measurement, GAAP Equity has some unique limitations. Adjustments would be required to produce a meaningful and appropriate measure of available capital for purposes of regulatory solvency assessment. These adjustments stem from two guiding principles:

1) Available capital should reflect the insurer's full loss absorption capacity. This would require adjustments, including adjustment of GAAP insurance liabilities to best estimate levels to reflect loss absorbing margins in reserves in available capital. Best estimate liabilities are defined within U.S. GAAP's Loss Recognition Testing rules, and based on the insurer's best estimate assumptions and discount rates which reflect the assets supporting liabilities (asset earned rate and future reinvestment yields, adjusted for expected defaults and investment expenses).

2) The measurement of available capital should recognize the asset-liability management that underpins insurance business model. Asymmetry in the valuation of assets and liabilities (for example in a GAAP-based CA) can be problematic in accurately reflecting capital adequacy, potentially leading to artificial volatility and pro-cyclicality. As insurers invest primarily in high quality assets, and hold them to maturity to support insurance liabilities, adjustments to market value may be appropriate in some instances. As such, the CA should consider adjustments to GAAP capital to better reflect asset-liability management dynamics of the insurance business model (e.g., by adjusting treatment of unrealized gains and losses).

Required capital in the CA could be based on factors applied to drivers, and it should be appropriately aligned to the risks borne by the insurer. Accordingly, drivers should reflect appropriate exposure bases (e.g., the face amount of life insurance in-force as the basis for mortality risk exposure); participating policies, which pass risks on to policyholders through the participation mechanism, should be subject to risk charges commensurate with the reduced risk to the insurance company; and separate account assets for which the insurer does not bear any asset risk should not be subject to risk charges (guarantees are captured through the general account risks). Additionally, the calibration of required capital should be reasonably modest given the simple, straightforward nature of a factor-based approach which cannot explicitly take into account the diversity of risk exposures within an insurance group or across the industry. A starting point for calibration could be the U.S. RBC system which is primarily a factor-based capital requirement. Risk sensitivity can be evaluated through Own Risk and Solvency Assessments ("ORSAs") and/or a stress testing regime.

While the CRO Council believes a CA, with the appropriate adjustments, is feasible for supervised insurers that produce GAAP financials, it should be noted that not all supervised insurers currently do so. This limitation could limit applicability beyond those insurers currently required by law to produce GAAP financials. Finally, in the event the CA is implemented a significant amount of time should be allotted to fully develop, refine, and test any new factor-based regime.

Bifurcated Approach

The ANPR contemplates the possibility of a bifurcated approach for group capital standards across the insurance industry, proposing a BBA for insurance depositary institution holding companies, and a CA for insurance companies designated by the FSOC as SIFIs. The CRO Council firmly believes that there are material challenges and risks associated with the use of two different approaches which must be considered, particularly with respect to unintended market consequences, capital disparities, calibration and ongoing maintenance. Subjecting small subsets of supervised insurers to different group-wide regulatory capital regimes without careful and ongoing calibration would create significant potential for arbitrage, resulting in risk and capital disparities, and competitive distortions across the U.S. market which would negatively impact all stakeholders. Therefore, in order to establish and maintain two different capital standards, careful upfront calibration and significant ongoing monitoring, analysis, and recalibration, would be required to ensure that the two regimes remain aligned as intended as markets and environments change. This would create substantial additional maintenance work for the FRB and supervised insurers.

Conclusion

The CRO Council believes that there are important considerations around the potentially significant risks that a bifurcated approach presents with respect to arbitrage and calibration/maintenance of different standards, and the potential unintended consequences on insurance market participants, consumers, and other stakeholders. The CRO Council also puts forth critical design considerations for both the BBA and the CA, and we strongly encourage the FRB to ensure proper time for development, implementation and testing. The time and resources needed to develop, test, and maintain a bifurcated approach is significantly greater than for a single approach.

An appropriately designed group capital standard should be able to be applied to all supervised insurers, regardless of size, complexity, global span, or presence of non-insurance activities, in a manner that meets the FRB's supervisory objectives. In the Council's view, bifurcation of the capital standards is not necessary to address differences in insurers associated with these or other characteristics. To the extent necessary, differentiation for insurance companies capital standards can be achieved, for example, by applying stress testing requirements to those insurers.

In addition to the regulatory capital standard, the CRO Council submits that strong consideration be given to leveraging ORSAs to gain further insights into an insurer's risk profile. ORSAs provide a robust company-specific perspective of capital, solvency, and stress testing to complement the standardized perspective provided by the regulatory capital measure.

While we continue to advise caution and care in developing and implementing any new capital regime, we are supportive of reasonable group capital standards, and commend the FRB for their consultative approach. As a Council that is uniquely qualified to provide risk management perspectives in the North American insurance market, we would welcome the opportunity to serve as a resource to the Federal Reserve as these capital standards are further developed.

Sincerely,

Stephen Gruppo, Chair
North American CRO Council

Nicholas Silitch, Lead
International and Federal Affairs Working Group