MEMORANDUM

TO: Group Capital Calculation (E) Working Group

FROM: Dan Daveline, NAIC Staff

DATE: June 26, 2018

RE: Scope of Group/Non-Insurance Testing

This memorandum represents a combined modified version of the June 11 Scope of Group memorandum and June 11 Non-Regulated Entities memorandum. The revised memorandum is intended to 1) clarify the original intent of the two memorandums; and 2) simplify the presentation since the updated document is intended to be used more specifically for the testing process and less as an explanatory document.

**Scope of the Group**

In determining the companies for which the group capital calculation should be applied, the group is expected to use the following process:

1) A non-U.S. based group may be exempt from completing a group capital calculation if:
   i) The non-U.S. based group is in a (Reciprocal) Jurisdiction that recognizes the U.S. regulatory regime and accepts the group capital calculation from a U.S. based group to satisfy any group capital requirement;
   ii) The group capital calculation is applied by the Group-Wide Supervisor (GWS) at a level that includes the same (or substantially similar) scope of the group as determined by the lead state in step 7; and
   iii) The lead state can obtain information from the foreign group’s GWS either through a Supervisory College or otherwise, that allows the lead state to understand the financial condition of the group and complete the expectations of other states in its Group Profile Summary (GPS).

2) When developing the universe of all potential entities included in the group capital calculation, the starting point is the insurer’s most recent Schedule Y and the ultimate controlling party, along with other relevant Holding Company Filings pertaining to entities directly or indirectly owned by the ultimate controlling party.

3) Deduct from the universe all entities that are neither a material source NOR a material user of capital. Two principles should be used for determining if an entity meets such a criteria for exclusion: 1) exclusion of a material source of capital will prevent the user from understanding the true financial condition of the group, which is one of the intended purposes of the group capital calculation; 2) exclusion of an entity that is consistently profitable is reasonable on the basis that such an entity is unlikely to be a material user of capital in the future.
In implementing these two principles, the preparer should consider the following more specific circumstances that inform the intent of the criteria:

- Any non-financial entity, that is not directly or indirectly owned by an insurance entity, and has capital/stockholder’s equity of less than 5% (on either a stand-alone basis or in combination with other entities) of the universe’s prior year-end, shall be considered an entity that IS NOT a material source of capital. (Note, all financial entities must be included in the calculation as well as all entities that are directly or indirectly owned by an insurance entity)
- Any non-financial entity that is not directly or indirectly owned by an insurance entity, and that has reported net income in each and all of the most recent five consecutive years shall be considered an entity that IS NOT a material user of capital.

4) Deduct from the universe, all entities that are considered negligible when aggregated. Three principles should be used for determining if an entity meets such criteria for exclusion: 1) excluding a combination of entities that do not exceed the material source of capital criteria will not prevent the user from understanding the true financial condition of the group; 2) excluding a combination of entities that have not produced net losses in excess of a material portion of the group’s income capacity for a specified period of time is unlikely to be a material user of capital in the future; 3) in excluding a combination of entities, consideration must be given to the fact that combining positives with negatives may understate the potential losses an individual company or combination of companies can create.

In implementing these three principles, the preparer should consider the following more specific circumstances that inform the intent of the criteria:

- Any non-financial entity, that is not owned directly or indirectly by an insurance entity and that is below the capital/stockholder’s equity threshold in paragraph 3 above AND that has combined net income/net losses (for the five most recent consecutive years) that is less than 5% of the net income/loss of the universe as of the prior year-end can be accumulated with other entities that meet such criteria, provided that the aggregation of such entities results in a combined capital/stockholder’s equity of less than 5% as of prior year-end of the universe AND the individual net losses from each of the entities for the most recent five consecutive when combined (cannot be offset with net income during the same periods) of all net losses are less than 5% of the universe’s net income/loss, shall be considered negligible.

5) The group should submit the listing of all excluded entities to the lead state regulator (in a predefined format included in the group capital calculation inventory) to determine if there are entities excluded by the group that create a material risk to the group’s capital. As the regulator reviews the listing, two principles should be used for determining if an entity either should be added back, or subtracted from the list produced by the group; 1) while historical gains can suggest a reduced likelihood for future losses, there may be other indicators of material dependency or material risk that may suggest to the regulator that a potential future loss of 5% of a group’s prior year capital may be possible, in which case the regulator should have the ability to add an entity back that may otherwise be excluded; 2) while historical losses may suggest that a higher likelihood of future losses are likely, there may be other indicators that suggest to the regulator that a potential future loss of 5% of a group’s capital is unlikely, in which case the regulator should have the ability to subtract an entity that may otherwise be included in the scope of the calculation.

In implementing these two principles, the regulator should consider the following more specific circumstances that inform the intent of the criteria:
• Adding any entity that the regulator believes creates a material dependency, where material is defined as 5% of the group’s prior year capital.
• Adding any entity that provides intra-group financial support or has a structural or contractual relationship which the regulator believes could create a material risk to the group’s capital, where material risk is defined as 5% of the group’s prior year-end capital.
• Adding/subtracting any entity that the regulator believes, despite any measures of materiality risk, based upon the activities of the entity, could have a material (adding)/immaterial (subtracting) impact on the group or markets (including counterparties). This includes but is not limited to pass-through entities that provide services to the group or face counterparties that are not adequately captured by a financial evaluation.

6) In the unlikely event that the lead state regulator has determined through the previous steps that the ultimate controlling party is not part of the scope of the group for the group capital calculation, the reasons therefore should be explained and clearly communicated to the other domestic states/other relevant regulators in step 7.

7) The lead state regulator uses the above steps, which implicitly includes considering the lead state’s understanding of the group, including inputs such as the Form F, ORSA, and other information including considering input from other domestic states or other regulators that have an entity in the group, to determine the ultimate scope of the group. It’s important that this type of information be used by the lead state in cooperation with the domestic states and other impacted regulators when developing the scope of the group for purposes of the group capital calculation.

**Ongoing Determination (Completed at least Annually)**

The scope of the group used in the group capital calculation should be considered for update on an ongoing basis, but at least annually. To assist the regulator in determining the scope of the group, the group capital calculation will include an area where basic financial information on all the entities in the group are included to allow the regulator to gain comfort in determining if the entities excluded from the scope of the group are appropriate. Once the regulator has a full understanding of all the entities in the group, the regulator should work with the group in determining whether this inventory of all companies should be grouped in a specified way in the future. For example, while this inventory must include the full combined financial results/key financial information (net premiums for insurers, total revenues, total net income, total assets, total debt, total capital or equity) for all entities of the ultimate controlling party and all of its subsidiaries, it may be best that this inventory is presented in this area based upon major groupings of entities to maximize the usefulness of this data. The reason being, these grouped figures are intended to be data captured year-in and year-out to allow the regulator to use the figures in a manner that allows the regulator to understand the trends of these figures. Said differently, having the combined information presenting in groupings of a lower number (e.g. 5, 10, 15, 20, 25 entities) would be far more analytically helpful to the regulator than the actual number of entities (e.g. upwards of 1,000 or more entities). In particular, the groupings of the non-financial entities should be considered, since they can be grouped in manner that allows the regulator to understand the group and how they are managed, but understanding that it may be best to separate those entities that may cause some amount of strain since that would allow a more risk sensitive approach to be included in the calculation, and allow the regulator to better understand the group.
To reiterate, this inventory is intended to require legal entity data (or combined legal entities after the lead state regulator has worked with the group to determine the best groupings) as part of the calculation to be certain that such scope is appropriate, given other holding company filings today do not include legal entity/combined legal entity data such as what is being contemplated. (Note also the lead state regulator retains the ability to require further breakout in order to assist in annually evaluating the scope of group)

Non-Insurance Testing
As previously concluded by the Working Group, all insurers must be individually listed in the calculation along with their minimum required capital from their regulator, or as modified for captives or scalars. For other financially entities, they also must be individually listed in the calculation, and will be tested based upon the following (Please note, non-regulated entities where such entities are currently subject to a risk charge in RBC, or subject to a risk charge imposed by a financial regulator, do not need to be individually listed/de-stacked):

1) Financial Entities

A) Regulated Financial Entities
   i. All banks and other depository institutions - Minimum required by their regulator. Test both a) unscaled; and b) scaled to an RBC equal to 300% ACL.

   ii. All asset managers and registered investment advisors – Test both a) 22.5% of BACV; and b) 12% of three-year average revenue based upon ACLI suggestion (BASEL operational risk). In addition to an unscaled calculation, test the BASEL operational risk methodology scaled to an RBC equal to 300% ACL.

   iii. All other financially regulated entities - Minimum required by their regulator (not scaled)

B) Unregulated Financial Entities

   i. Other entities that provide financial activities that support the insurer(s) – Because these entities can cause more strain on an insurer than other non-regulated entities, these entities should receive a 22.5% charge on the BACV. These entities are not subject to a minimum capital requirement.

   ii. Other financial entities-For purpose of this calculation, unregulated financial entities include those which create financial risks through products or transactions such as a mortgage, other credit offering, a derivative, corporate guarantees, intercompany indebtedness, operational interdependence, including the existence of shared resources such as IT platforms or treasury or other material operations; materiality to the application of credit rating methodologies to the overall group rating and other financial links. Because these entities can cause more strain on an insurer than other non-regulated entities, apply the greater of the following factors:
      • 22.5% of the BACV
      • Notional value of the contract (e.g. a net worth guaranty/indemnification/guaranty multiplied by a probability factor as determined by the company based upon past historical experience)
      • Other proposed factors suggested by testing participants
NAIC staff is open to allowing grouping of like entities in type 1Aii and 1Bi, above assuming that the members of the group all use the same accounting rules (e.g., all GAAP), and are at least consistent with the way the group manages their business.

2) Consistently Profitable Non-Financial Entities

Any non-financial entity that has reported positive net income each of the past five years can be subject to a minimal charge based upon the principle that consistently profitable companies are unlikely to cause a material loss in the future, and any risk of this changing is likely only minimal operational risk. For these entities, they may be combined and subject to a ½% charge on the most recently reported amount of revenues.

3) Other Non-Financial Entities

Some of the comment letters, including those related to scope of the group, make the argument that non-financial entities are not as risky as regulated entities and other financial entities. NAIC staff believe that while this is not always the case, in many cases it is true. NAIC staff is open to allow the regulator and the group to decide together how best to group and be subject to the following charges that we propose to be tested. Unlimited grouping of non-financial entities is allowed.

Test 1-Principle-Past Income/Loss is a sound predictor of risk

Test a factor that considers the specific net losses/ﬂuctuation in profitability over an economic cycle, where five years is used as a proxy for an economic cycle. This factor will be risk-based not only to the industry, but to the individual company since it considers past performance. The calculation would be determined based upon the following (for each entity or group of entities):

Test 1a-Factor to Apply = (Absolute value of the greatest net loss in the past five years/Gross revenue in that year for that entity or grouped entities) Multiplied by the current year gross revenue for the same entity or grouped entities

Test 1b-Factor to Apply = (Absolute value of the greatest net loss in the past five years/Gross revenue in that year for that entity or grouped entities) Multiplied by the current year gross revenue for the same entity or grouped entities*

*Subject to a minimum charge that assumes a net loss equal to 2% of total gross revenues. The minimum is expected to cover the fact that the group is not consistently profitable or that the losses are not material, but it covers this risk in this way as opposed to requiring a calculation that considers this dependence through the use of a more complex standard deviation of profits over a period of time.

Test 2- Principle-Potential Capital Needs of Non-Financial Entities is Equivalent to an Operational Risk Charge

Test a factor that considers non-financial entities an operational risk

Test 2a-The American Council of Life Insurers (ACLI)/American Insurance Association (AIA) have long suggested that non-regulated entities be subject to either an operational risk charge used in International Basel III or a 22.5% charge on the BACV. The ACLI has further suggested that the 12% Basel Charge be scaled to convert to U.S. RBC. The ACLI notes that when this is done, the scaled factor becomes 2.47% for life insurers (based upon an average RBC operating ratio of 486%) and a factor of 3.64% for property/casualty (P/C) insurers (based on an average RBC operating ratio of 332%). A life factor of 3.7% should also be tested, which corresponds to
a 300% RBC calibration, and P/C of 5.4% based upon an average industry life RBC of 332%. This should be applied on the absolute value of the entities revenues.

**Test 2B** - Use the NAIC recently adopted Operational Risk Charge of 3%, but apply to revenues consistent with test 2a.

**Test 3- Principle-Simplicity and Consistency with RBC Requirements**
Test a more simple method as suggested by America’s Health Insurance Plans (AHIP). Specifically, test a factor applied to the Book/Adjusted Carrying Value (BACV) of the entity. This should be applied on the absolute value of the entities BACV. NAIC staff suggest the relevant RBC charge (22.5% for P&C and Health and 19.5% (post tax) for Life) applied to BACV (post-covariance) be tested, but with the understanding that the reason we have proposed other alternatives is to attempt to be sensitive to the argument that such an approach may not align the risks posed by these entities when they are not owned by a U.S or foreign insurer. Even if we find that this is the case, the Working Group may find that it is open to considering giving groups the option of using the relevant RBC charge applied to BACV, provided they do so consistently from one year to the next and across all of their entities.