American Academy of Actuaries

Issue Brief

Introduction to Insurance Group Capital Requirements

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Key Points

- The updated group capital standards offer a means for companies and regulators to evaluate the adequacy and quality of total capital concerning group-wide risks.
- Both the Aggregation Method and the consolidated ICS exhibit favorable characteristics, contributing value to the comprehension of group-wide capital sufficiency.
- With these measures recently developed and continuously implemented, it is crucial for pertinent stakeholders to grasp the underlying principles of these group capital approaches, preventing misinterpretation or misuse of the results.

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This issue brief provides an overview of insurance group capital requirements, with a focus on U.S. application, including a discussion of the two primary approaches used to determine group capital.

Risk-Based Capital Concept

To protect policyholders, insurance regulators throughout the world have developed requirements for minimum capital adequacy for insurance entities. Over time, risk-based approaches have replaced or supplemented simpler approaches (for example, requiring a fixed amount of capital). The required capital in risk-based approaches reflects risks from an entity's mix of products, assets, and operations, as well as the interactions among those risks. Using underlying assumptions for confidence level and time horizon, capital risk charges are often calculated by applying predetermined factors to an exposure level,[1] by using risk models that simulate a stressed environment, or some combination of the two. An adjustment for diversification among risks is also typically reflected. These risk-based capital requirements are accompanied by criteria for recognizing and measuring capital resources to create a ratio of available capital to required capital (i.e., solvency ratio). Risk-based capital (RBC) is one component of the overall solvency framework.

1 This is called a factor-based approach. As an example, the required capital for the risk of holding $Y of certain invested assets may be the factor X, such that the required capital is Y times X.

The U.S. Insurance Regulatory System

In the U.S., the financial solvency of licensed insurers is regulated by the states. Each state has formal legal responsibility for the solvency of the insurance entities that are domiciled within it. Regulators in non-domiciliary states, however, have an interest in the financial strength of all insurers that are licensed in their state and may coordinate with domiciliary state regulators.

The National Association of Insurance Commissioners (NAIC)[2] has employed risk-based capital formulas for life, health, and property & casualty insurance companies since the 1990s. The NAIC formulas for determining required capital are designed to identify inadequately capitalized (vulnerable) insurance entities, allowing regulators and management to address the possibility that those entities may not be able to cover their obligations to policyholders. The formulas are accompanied by state laws that establish required actions for an entity and its regulator when an entity's RBC ratio falls below a certain level.

Given that an insurance group frequently consists of multiple licensed insurers, U.S. state regulators have created a lead state oversight system that enables a single state regulator to coordinate certain regulatory activities that span multiple legal entities, such as financial examinations. The lead state oversight, however, only encompasses the U.S. insurance entities (and their subsidiaries) in the group.

During the 2007–2008 financial crisis,[3] a perceived gap involving group supervision within the state regulatory system was identified. Capital shortfalls that emerged within AIG's Financial Products division created stress on the entire group, including AIG's insurance entities. In response, both federal and state authorities attempted to remedy this gap.

2 See "What is the NAIC and what does it do?"; National Association of Insurance Commissioners; undated.
3 This period is called the Great Recession in U.S., but the Global Financial Crisis outside the U.S.

Members of the Prudential Regulation Committee, which authored this issue brief, include Tricia Matson MAAA, FSA—*Chairperson*; Ralph Blanchard, MAAA, FCAS; Thomas Botsko, MAAA, ACAS; Seong-min Eom, MAAA, FSA Tim Finnie, MAAA, FSA; Dana Hunt, MAAA, FSA; Gareth Kennedy, MAAA, ACAS; Jeffery Murr, MAAA, ASA; and William Schwegler, MAAA, FSA.

At the federal level, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (2010)[4] granted the Board of Governors of the Federal Reserve (the Federal Reserve) the authority to supervise certain insurers. These insurers are: (1) insurance groups that are organized as insured depository institution holding companies (i.e., they have a federally insured bank within their group structure), and (2) insurers that have been designated as Systemically Important Financial Institutions (SIFIs) by the Financial Stability Oversight Council. Dodd-Frank requires the Federal Reserve to develop and apply group capital requirements as part of the supervisory framework applicable to these groups.

At the state level, regulators have developed new tools to improve visibility into group activities and risks. An important addition to the regulatory toolbox is the Group Capital Calculation (GCC). The GCC "assists regulators in holistically understanding the financial condition of non-insurance entities, how capital is distributed across an entire group, and whether and to what degree insurance companies may be supporting the operations of non-insurance entities, potentially adversely impacting the insurance company's financial condition or policyholders."[5]

To fulfill their mandates and to address the shortcomings that emerged during the financial crisis, both the NAIC and the Federal Reserve have continued to develop group capital adequacy standards to supplement existing state-based legal entity capital adequacy requirements.

Group Capital Adequacy Requirements

Globally, the International Association of Insurance Supervisors (IAIS) has been working since October 2013 on a group capital requirement, called the Insurance Capital Standard (ICS). The objective of the ICS is to "create a common language for supervisory discussions of group solvency to enhance global convergence among group capital standards."[6] The ICS uses a group-wide consolidated basis, which views the group as a single economic unit.

The ICS specifies approaches for valuing assets and liabilities, for recognizing and valuing capital resources, and for calculating risk capital requirements.[7] The risk charges are calibrated at a 99.5% confidence level over a one-year time horizon, such

4 PUBL203.PS (congress.gov)
5 *Group Capital Calculations—2022 Instructions*; National Association of Insurance Commissioners; 2022.
6 Insurance Capital Standard; International Association of Insurance Supervisors; as of January 5, 2023.
7 The IAIS has proposed an alternative internal model approach for capital requirements within its Candidate ICS as a Prescribed Capital Requirement

that they represent the capital needed to withstand a 1-in-200-year stress. Risk capital requirements are calculated for the major risk categories of insurance risk (life, non-life, and catastrophe), market risk, credit risk, and operational risk. To arrive at total required capital, aggregated risk charges are adjusted for diversification effects, both within and across risk categories.[8]

Both domestically and within the IAIS, U.S. regulators have pursued a different approach, whereby the group capital assessment is based on an aggregation of existing legal entity requirements and calculations. This approach, as proposed by U.S. regulators within the IAIS, is called the Aggregation Method (AM). Within the U.S. the NAIC has adopted the previously mentioned Group Capital Calculation (GCC),[9] which is a version of the AM, while the Federal Reserve has adopted a version of the AM called the Building Block Approach (BBA).

Group Capital Approaches: Aggregation vs. Consolidation

As a result of their different conceptual foundations, the aggregation and consolidation approaches to group capital each have distinctive attributes and advantages when applied in practice.

In an aggregation approach, such as the AM, GCC, or BBA, the insurance group is viewed as a set of interdependent legal entities. An aggregation approach is anchored to local regulatory solvency rules for valuation, capital requirements, and capital resources, creating the potential for different sets of rules to apply to different entities within the insurance group. Aggregation implicitly acknowledges the reality and validity of local market differences, including products and risk management practices, as well as different solvency requirements and authority.

In a consolidation approach, such as the ICS, the insurance group is viewed as a single integrated economic unit, subject to a single set of accounting and capital requirements for group supervision purposes. A consolidation approach provides a unified view of risks and capital resources, as the effects of all internal transactions, such as affiliated reinsurance, are effectively eliminated.

Key advantages of each approach are summarized below. Advantages of one method could be seen as disadvantages of another method.

8 Diversification benefits reflect the fact that not all adverse events happen at the same time, so the total risk an entity faces is less than the sum of all the individual risks. For example, in trying to measure the risk in a portfolio of fire insurance policies, it is unreasonable to assume that all insured buildings would burn at the same time.

9 Many of the groups based in the U.S. were required to file a GCC result starting in 2023 and more may be required to file in 2024. See here for a list of states that have adopted the GCC as a requirement for groups domiciled in their state.

Aggregation	Consolidation
• Respects the expertise of local regulators in quantifying risks within their markets • Provides regulatory visibility into both the group's dividend-paying capacity and potential capital weaknesses within the group • Reduces the likelihood of needing to recalculate financials under an alternative accounting basis • Simplifies risk and capital management by avoiding group vs. legal entity differences • Avoids assumptions of cross-entity capital fungibility and frictionless transfer that may not materialize in practice • Prospective changes leverage the work of local regulators	• Produces the same capital ratio regardless of where risk-taking legal entity is domiciled, avoiding ratio impacts from intra-group transactions • Reflects a perspective typically taken by a group's executive management, its owners, and potential investors • Assesses enterprise risks independent of entity's domiciliary requirements, an aspect of group enterprise risk management • Avoids complexities of adjustments for group impacts such as double gearing of capital • Reflects group synergies via inter-entity diversification benefits • Prospective changes not dependent on the work of local regulators

Benefits of Implementation

Whether a U.S. insurer is subject to an aggregation or a consolidation approach, the additional view provided by group capital should provide new insights. Possible high-level impacts from group capital assessments include:

- Identification of risk concentrations within an insurance group.
- Understanding the contribution of non-insurance entities to group capital.
- Early detection of potential threats involving non-insurance entities to insurance policyholders.
- Possible impact of transactions on group solvency.
- Improved communication about capital sufficiency within an insurance group's college of supervisors.
- Support for decisions to distribute excess capital or to source new capital.
- Information about the group's financial strength for non-regulator stakeholders, such as financial counterparties and rating agencies. Depending on legal provisions around public disclosure, these stakeholders may also include investors and policyholders.

Summary

The new standards for group capital can help companies and regulators better assess the quality and sufficiency of the total capital held relative to group-wide risks. Both the Aggregation Method and the consolidated ICS have positive attributes, providing value in terms of understanding group-wide capital adequacy. Given the recent development and ongoing implementation of these measures, it is important for relevant stakeholders to understand the foundations of these group capital approaches in order to avoid misinterpreting or misusing the results. While no method is without certain limitations, understanding the benefits and limitations of any method used is important.

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