

**Meeting Between Staff of the Federal Reserve Board and the
Federal Reserve Bank of Boston
and Representatives of Prudential Financial, Inc. (Prudential)
October 15, 2013**

Participants: Mark Van Der Weide, Anna Lee Hewko, Constance Horsley, Mona Elliot, Anthony Sampson (Federal Reserve Board), and Bart Simon (Federal Reserve Bank of Boston)

Mark Grier, Robert Falzon, Ann Kappler, Richard Lambert, Nicholas Silitch (Prudential)

Summary: Staff of the Federal Reserve Board and the Federal Reserve Bank of Boston met with representatives of Prudential to discuss the company's views on an alternative regulatory framework for assessing the capital adequacy of insurance companies in the context of insurers. Additionally, Prudential's proposed adjustments to capital and leverage ratios were discussed. The attached document was distributed.

Insurance Company Regulatory Regime

Prudential Financial, Inc.
October 2013

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Considerations in the Construct of an Insurance Company Regulatory Regime

- The existing insurance regulatory regime is relevant, but not defining
 - Solves for a different problem: paying claims vs. systemic risk
 - Focuses on many things that do not exist in banks
 - Emerging focus on group level and special activities
 - Standardized locally, but not uniformly across all jurisdictions
 - Not a consolidated view
- Insurance companies have unique risks, accounting and business models
 - Insurance liabilities: valuation, recognition, reserving and cash flows
 - Modeled liabilities
 - Risks emerge over decades
 - Liquidity profile changes nature of risks vis-à-vis banks
 - Product design uses legal and economic structures that do not exist in banking
 - GAAP accounting deficiencies in risk, solvency and capital
 - Assets with no “line of sight” to capital
 - Liabilities established to protect capital from stresses
 - Mark to market of assets backing cost basis insurance liabilities – creates non-economic volatility

“Convergence” Concepts

- Clarify the character of capital on the balance sheet
- Clarify the exposures of capital
- Define reasonable and economic leverage and risk-based capital ratios
- Consider the application of Collins Amendment standards to the properly defined metrics

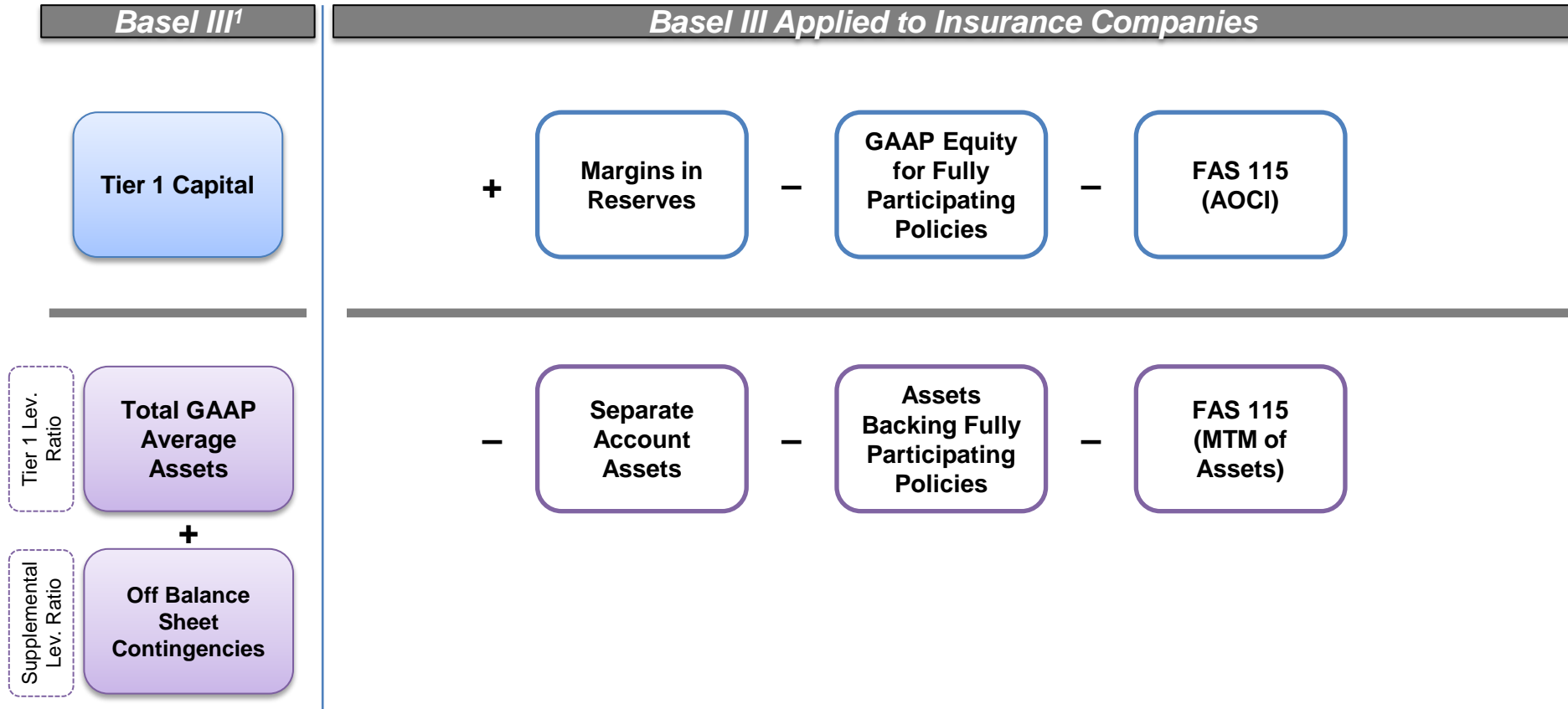
Applied Basel III Framework

- The various Basel III ratios focus on capital as a percentage of assets (i.e., GAAP or risk-weighted assets) because banks are predominantly funded with highly liquid deposits backing relatively illiquid and credit risky assets, creating “bank run” risk.
- Applying Basel III ratios to a financial services company predominately engaged in insurance requires certain adjustments due to the presence of unique insurance risks, insurance specific accounting conventions, and because assets are held to support predominantly long-term liabilities. These risks and considerations should be captured comprehensively rather than ad hoc.

Applied Basel III Framework Key Concepts

- Insurance capital includes GAAP Margins in Reserves that act as a cushion against the impact of shocks to Tier 1 capital.
- Unique insurance risks should be captured using an appropriate stress analysis, net of diversification benefits.
- Separate accounts policyholders carry the risk of assets held in the policies. The risk to the insurance company is the result of guarantees, if any, of such policies. This is captured and evaluated by the adequacy of insurance reserves and capital held for those guarantees.
- Fully Participating Policies do not present material leverage or solvency risk to an insurance company since risk is transmitted to policyholders over time. Such policies can create liquidity risk that needs to be evaluated and monitored.
- The removal of non-economic volatility resulting from FAS 115 AOCI, which can be significant for an insurer due to the long duration of assets used to match similarly long duration liabilities, creates consistency in the treatment of assets and liabilities. Asset/liability mismatch risk should reflect a severe interest rate shock to both an insurance company's assets and liabilities.
- The advanced approach for credit risk is appropriate for the public and private bonds in an insurance company General Account, which are analogous to a bank's loan portfolio.

Applied Tier 1 Leverage Ratio =



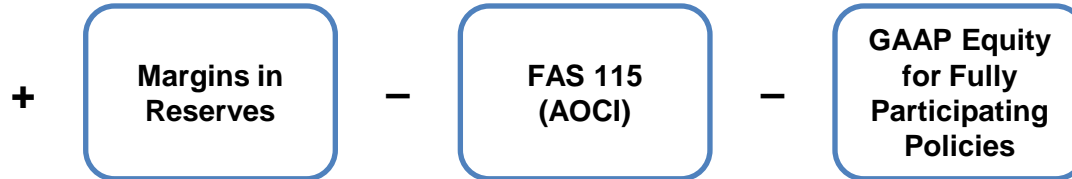
¹ Ignore insurance deduction applicable to banks owning modest insurance subsidiaries

Applied Tier 1 Capital Ratio =

Basel III¹

Basel III Applied to Insurance Companies

Tier 1 Capital



Total Risk-Weighted Assets

+

Risk-Weighted Off Balance Sheet Contingencies

Advanced Approach for Risks

Exclude Separate Account Assets (*Guarantees are captured in next box*)

Asset/Liability Mismatch: Apply severe interest rate shocks

Calculate credit risk per Basel III advanced approach

Apply standard approach for operational risk with insurance definition of net revenues

Other Risk-Weighted Assets
Policyholder loans at 0% risk-weight

+

Separate Account Guarantees
(Risk-Weighted)

+

Insurance Risk
(Risk-Weighted)
Net of Insurance Risk Diversification

-

Assets Backing Fully Participating Policies

¹ Ignore insurance deduction applicable to banks owning modest insurance subsidiaries

Appendix

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Applied Tier 1 Capital Ratio =

Basel III¹

Basel III Applied to Insurance Companies

Tier 1 Capital¹

Tier 1 Capital^{1,2}

Margins in Reserves³

FAS 115 (AOCI)⁴

GAAP Equity for Fully Participating Policies

Total Risk-Weighted Assets¹

Advanced Approach for Risks

Exclude Separate Accounts
(Guarantees are captured in next box)

Asset/Liability Mismatch: Apply severe interest rate shocks⁵

Calculate credit risk per Basel III advanced approach.⁸

Separate Account Guarantees^{5,6}
(Risk-Weighted)

Insurance Risk^{5,7}
(Risk-Weighted)
Net of Insurance Risk Diversification

Assets Backing Fully Participating Policies

Risk-Weighted Off Balance Sheet Contingencies¹

Apply standard approach for operational risk with insurance definition of net revenues

Other Risk-Weighted Assets
Policyholder loans at 0% risk-weight

Risk-Weighted Off Balance Sheet Contingencies¹

Applied Tier 1 Capital Ratio

Basel Tier 1 Capital (Tier 1 Capital Ratio Numerator)

- Tier 1 Capital should recognize that an insurance company's GAAP equity is protected from insurance and capital markets stresses.
 - Margins in Reserves: Capital is located in two places on an insurance company's balance sheet: GAAP equity (surplus) and reserves. GAAP insurance reserves include margins in assumptions and deferred profits at risk, which are recognized as income as the uncertainty in cash flows decreases and are available to mitigate the impact of stress events on GAAP equity.*
 - FAS 115 (U.S. GAAP Mismatch): An insurer holds in its General Account an investment portfolio of primarily long duration fixed income securities that are purposely selected to match long duration liabilities.
 - U.S. GAAP creates non-economic volatility by requiring MTM of assets under FAS 115 but not of liabilities. While non-economic, such volatility can be material due to the long duration of assets held to match the similarly long duration of an insurer's liabilities. This should be addressed by removing the FAS 115 adjustment in AOCI, resulting in a treatment similar under GAAP to a bank's loan portfolio.**
 - The risk of asset/liability mismatch is captured through the calculation of risk-weighted assets.
 - Fully Participating Policies: The risk and performance of Fully Participating Policies (such as Prudential's Closed Block of participating whole life policies) are passed through to the policyholders over time and should be excluded from consideration of capital.
 - The risk associated with the time lag between the experience of fully participating policies and the adjustment of distributions to policyholders should be addressed by holding sufficient liquidity rather than by holding capital.

* Under the proposed FASB update to insurance contract accounting, an explicit margin would be presented in the financial statement, in contrast to current US GAAP in which the margin is implicitly included as part of the insurance contract liability. The disaggregation of the estimated future net cash flows and the remaining deferred profit is intended to provide further transparency into the liability measurement.

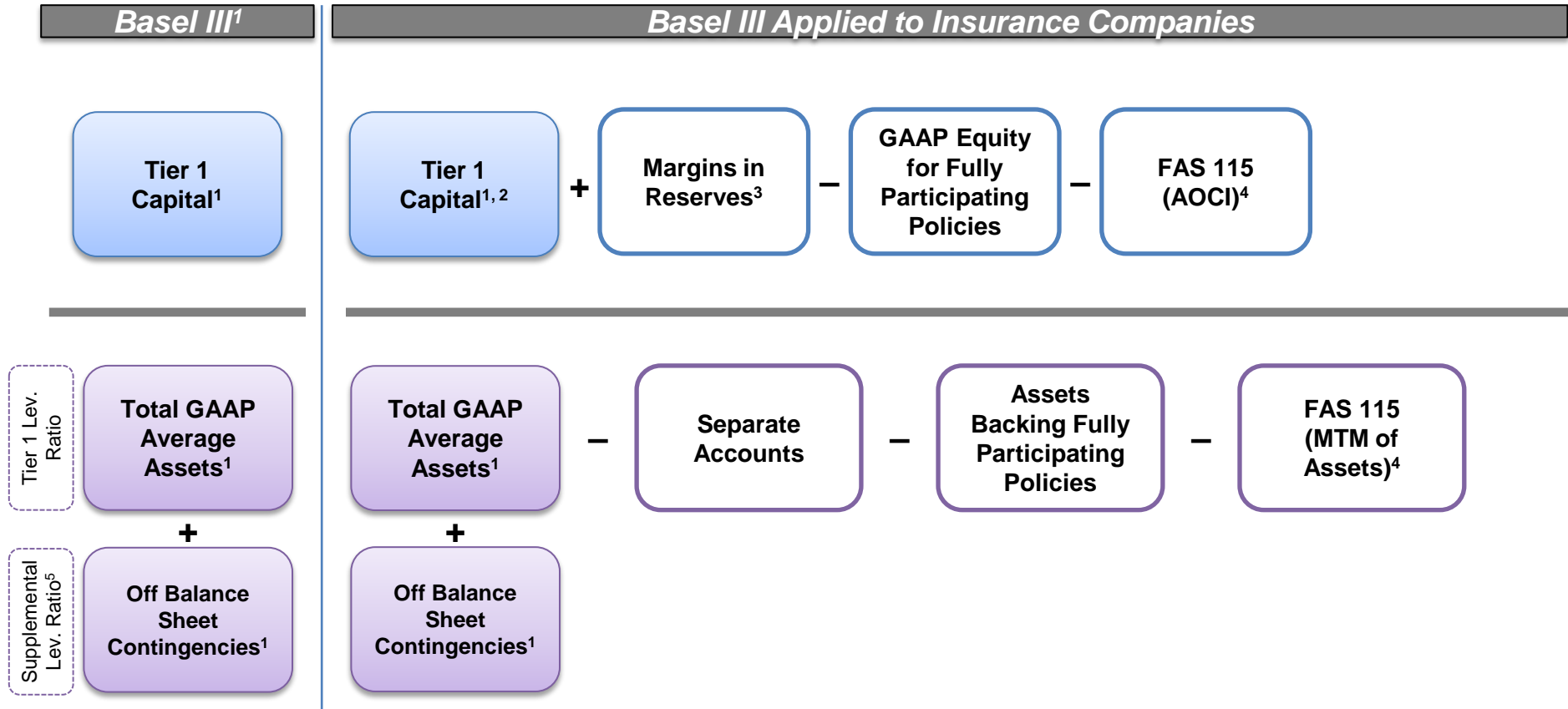
** This can be reevaluated once the FASB finalizes its projects on insurance contracts and financial instruments, as those updated standards might capture a reasonable economic estimate of asset-liability mismatch.

Applied Tier 1 Capital Ratio

Basel Total Risk-Weighted Assets (Tier 1 Capital Ratio Denominator)

- Risk-Weighted Assets for an insurance company should reflect the following:
 - Separate Accounts: The policyholder carries the full risk of the underlying assets held in the separate accounts. The insurance company is exposed to the impact of a severe stress only in the value of the guarantee, if any, of the policy. Only the assets associated with the reserves and capital backing any such guarantee should be captured in the calculation of risk-weighted assets.
 - Market Risk: Basel III VAR and Stressed VAR calculations are applicable to short-term liabilities and assets, but are inappropriate for long-term insurance liabilities and the associated investment portfolios.
 - Asset/Liability Mismatch Risk: A risk-adjusted capital measure should reflect the impact of a severe interest rate shock on both the long-term assets and liabilities of the insurer.
 - Credit Risk: Calculate credit risk per Basel III advanced approach. Do not apply standard approach since it does not differentiate for credit quality (creating incentives for risk taking) and was calibrated for banks, which tend to have lower quality asset portfolios.
 - Operational Risk: Apply the standard approach with an adjustment that recognizes how revenues are defined for an insurance company; apply appropriate risk-weights to revenue categories.
 - Insurance Risk: Insurance risks (i.e., mortality, morbidity, policyholder behavior) should be captured under an appropriate stress analysis, net of any benefit from the lack of correlation between insurance risks and other risks.
 - Fully Participating Policies: Assets backing Fully Participating Policies (such as the Closed Block) should be excluded from Tier 1 Capital Ratio risk-weighted assets since risk is passed to the policyholder over time (consistent with the treatment of such policies in the calculation of Tier 1 capital).
 - Subject to liquidity testing, as previously described, to address the potential time lag between policy experience and adjustments to policyholder distributions.
 - Policyholder Loans: Policyholder loans should receive a risk-weighting of 0% to reflect that the insurance company has direct access to the offsetting liability and thus there is no associated risk to an insurance company's capital.

Applied Tier 1 Leverage Ratio =



Applied Tier 1 Leverage Ratio

Total GAAP Average Assets (Tier 1 Leverage Ratio Denominator)

- GAAP Assets should be adjusted to remove assets where such assets and corresponding liabilities do not present leverage or risk to an insurer's capital.
 - Separate Accounts: The policyholder carries the risk of the underlying assets held in separate accounts (not the insurance company).
 - The insurance company is exposed to the impact of a severe stress only in the value of the guarantee. As such, only the assets supporting reserves and capital backing such guarantee should be captured in Total GAAP Average Assets.
 - Fully Participating Policies: The risk and performance of assets backing Fully Participating Policies are passed through to the policyholders over time and should be entirely excluded from consideration in the Leverage Ratio.
 - The risk associated with the time lag between the experience of fully participating policies and the adjustment of distributions to policyholders should be addressed by holding sufficient liquidity rather than by holding capital.
 - FAS 115 (U.S. GAAP Mismatch): Since an insurer's General Account assets are held to match liabilities, accounting for assets should follow accounting for liabilities (consistent with how FAS 115 AOCI should be removed from the definition of Tier 1 capital).
 - Remove the FAS 115 mark on assets so that GAAP assets and liabilities are captured at historical cost rather than marked to market. This reflects that the economic impact of an interest rates shock is largely offset by a change in value of the corresponding liability, which is not reflected in U.S. GAAP.*

* This can be reevaluated once the FASB finalizes its projects on insurance contracts and financial instruments, as those updated standards might capture a reasonable economic estimate of asset-liability mismatch.

Endnotes

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- ¹ As defined in the Basel III final rules published in July 2013 for implementation of Basel III for regulatory capital
- ² C2 and C4 would not be deducted from the numerator because the corresponding risk-weighted assets are captured in the denominator. This deduction could still apply to banks with small insurance operations, but would not be applicable to companies primarily engaged in the insurance business.
- ³ There should be an explicit requirement to disclose key assumptions used to calculate margins in reserves, as the level of conservatism in reserves varies across insurers. This explicit disclosure of the margins in reserves will be required in GAAP once the FASB finalizes its projects on insurance contracts.
- ⁴ Remove FAS 115 (other than for foreign exchange remeasurement) since insurance reserves are not MTM (other than for foreign exchange remeasurement). This creates consistency in the treatment of assets and liabilities. This can be reevaluated once the FASB finalizes its projects on insurance contracts and financial instruments, as those updated standards might capture a reasonable economic estimate of asset-liability mismatch.
- ⁵ Obtain RWA/RWL by dividing capital need by 0.08 (to be consistent with well capitalized standards of 8% Tier 1 Capital Ratio)
- ⁶ Use stress analysis to capture capital markets risk (e.g., equity returns, interest rates) in variable annuity and other separate account guarantees
- ⁷ Use stress analysis to capture capital for insurance risk. Reflect the lack of correlation of insurance risks vs. market risks.
- ⁸ Use same advanced approach as for banks. Defined in the Basel III final rules published in July 2013 for advanced approaches under Basel III regulatory capital rules

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- ¹ As defined in the Basel III final rules published in July 2013 for implementation of Basel III for regulatory capital.
- ² C2 and C4 would not be deducted from the numerator because the corresponding assets held for these risks are captured in Total GAAP Average Assets (denominator). This deduction could still apply to banks with small insurance operations, but would not be applicable to companies primarily engaged in the insurance business.
- ³ There should be an explicit requirement to disclose key assumptions used to calculate margins in reserves, as the level of conservatism in reserves varies across insurers. This explicit disclosure of the margins in reserves will be required in GAAP once the FASB finalizes its projects on insurance contracts.
- ⁴ Remove FAS 115 since insurance reserves are not MTM. This creates consistency in the treatment of assets and liabilities. This can be reevaluated once the FASB finalizes its projects on insurance contracts and financial instruments, as those updated standards might capture a reasonable economic estimate of asset-liability mismatch.
- ⁵ Basel III defines the Supplemental Leverage Ratio as Tier 1 Capital / (Total GAAP Average Assets + Off Balance Sheet Contingencies)