GAAP with Adjustments

ICS Stakeholder Meeting

November 30, 2016

Executive Summary

- Prudential supports the continued development of the GAAP with Adjustments ("GAAP Plus") valuation basis as a viable valuation option within the ICS.

- GAAP Plus provides a well-defined, controlled, and transparent framework for the underlying ICS balance sheet, which leverages auditable practices to value insurance liabilities.

- We appreciate the efforts the IAIS has taken to develop and test GAAP Plus under many different local GAAP frameworks.

- We believe that the ICS can and should accommodate both the MAV and GAAP Plus valuation bases.

- The IAIS can ensure, through appropriate adjustments, that MAV and GAAP Plus are highly comparable and appropriately risk sensitive.

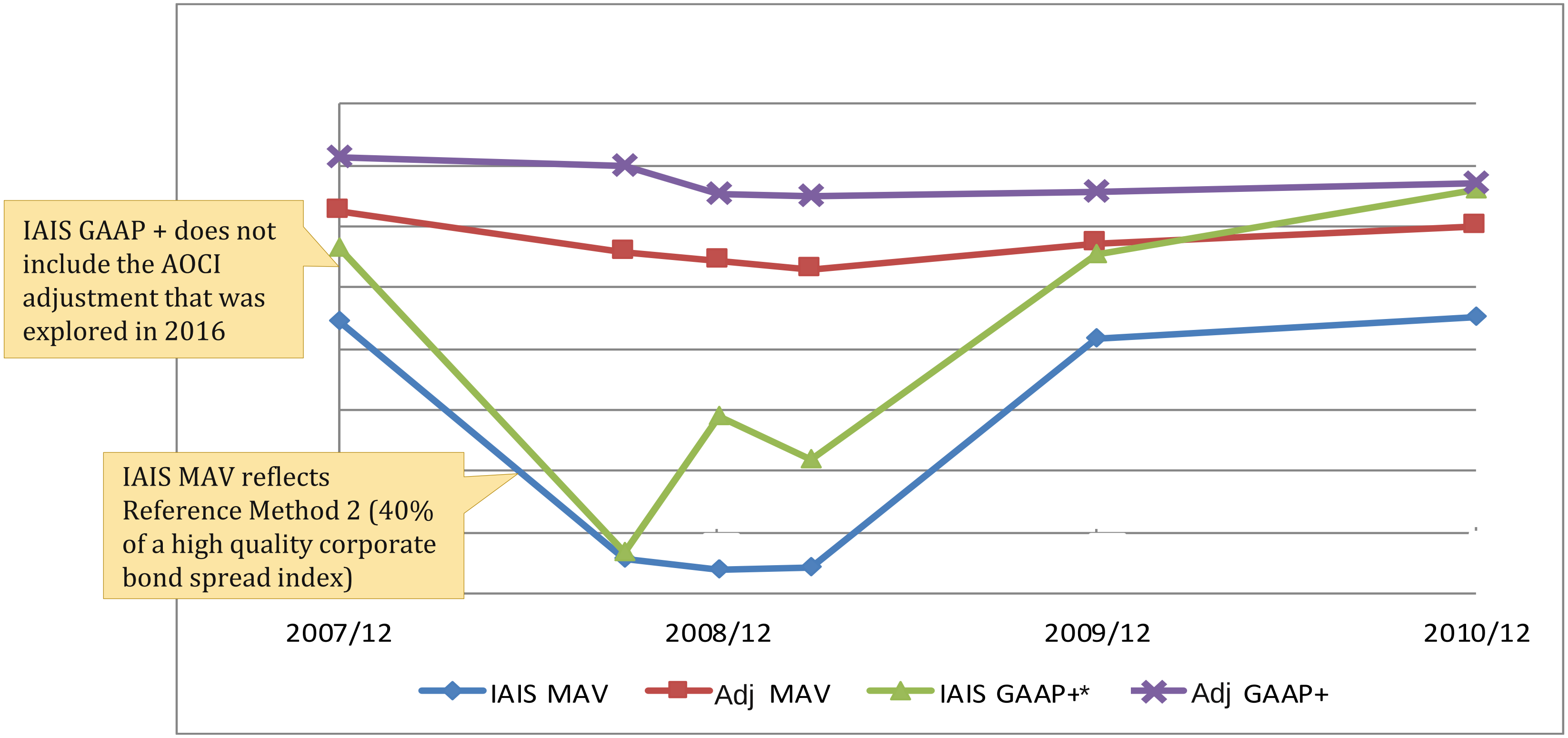
GAAP Plus – Key Considerations

The GAAP Plus balance sheet – regardless of the local GAAP framework upon which it is based – should reflect insurer Asset-Liability Management (ALM) through symmetric valuation of assets and liabilities and appropriate stresses.

Adjustments to GAAP balances	• The appropriate adjustments to GAAP balances include: ○ Adjusting reported liabilities to Current Estimates (e.g., eliminating explicit risk margins and margins in assumptions, using gross rather than net premiums, etc.), reflecting an appropriate discount rate ○ Adjusting assets and/or GAAP Equity (e.g., Other Comprehensive Income) to align with the Current Estimate liability valuation
Stress application	• The ICS required capital stresses must be coherent with the underlying valuation basis. ○ For instance, where the liability discount rate is based on the asset earned rate, the ICS interest rate shocks should apply to the reinvestment component of the discount rate and not the existing asset earned rate component.

- Asymmetric treatment of assets and liabilities and improper stress application will result in inappropriate measures of available and required capital and artificial volatility and pro-cyclicality.
- Developing jurisdictional GAAP frameworks will need to be analyzed, once finalized, to determine necessary GAAP adjustments.

Analysis of Available Capital: "Through the Financial Crisis"



- The analysis above demonstrates the artificial volatility and pro-cyclicality a hypothetical life insurer would have experienced through the financial crisis if subject to frameworks which do not value assets and liabilities symmetrically.
- MAV asymmetry is the result of a prescribed liability discount curve which does not sufficiently reflect the supporting assets. GAAP+ asymmetry is the result of unrealized gains/losses impacting available capital while liabilities are discounted at the portfolio earned rate.
- Through straightforward adjustments to create symmetry in the valuation of assets and liabilities, the "Adjusted" MAV and GAAP+ bases avoid pro-cyclical outcomes and produce results that are highly comparable and appropriately risk sensitive.
- While alternative approaches to valuation included in the Field Test represent a step in the right direction, further refinements are needed.
  - For GAAP+, Prudential continues to believe that all AOCI should be excluded and the adjustment should be applied to the balance sheet – not as a back-end adjustment to ICS capital resources.
  - For MAV, discount rates should reflect the way insurers invest, recognizing jurisdictional differences and appropriate long term forward rates.

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Appendix

Overview of GAAP with Adjustments ("GAAP Plus")

- ICS valuation basis where balances and any adjustments applied to them are anchored to local GAAP frameworks*
  - Liabilities: Current Estimates, as per relevant GAAP rules / utilizing adjustments to reported GAAP balances
  - Assets: reflect GAAP reported values

Key aspects of U.S. GAAP Plus	• Current Estimate liabilities are primarily based on Loss Recognition Testing (LRT) gross premium valuation rules: o Liability cash flows projected using best estimate actuarial assumptions o Discount rate based on the portfolio earned rate and expected future reinvestment yields; adjusted for expected defaults and investment expenses o Excludes overhead expenses • Insurance liabilities not subject to LRT are adjusted to reflect best estimates as relevant (e.g., liabilities for fair value guarantees are adjusted to exclude explicit risk margins and company's own non-performance risk) • GAAP reported assets include a significant proportion of bonds accounted for as "Available For Sale" (AFS), where unrealized gains/losses are recorded in AOCI o 2016 Field Testing included a partial AOCI adjustment

*U.S. SAP for U.S. mutual insurers; Solvency II for European insurers

Prudential's Key Concerns with the ICS

We urge the IAIS to continue to explore the ICS framework holistically, considering the interaction between valuation, capital resources, and capital requirements. Currently the ICS is excessively punitive, through improper design and calibration of capital requirements and redundant risk provision in the CC-MOCE, especially for long term protection and retirement type business.

1) Volatility – asymmetric treatment of assets and liabilities in the valuation basis creates artificial volatility and pro-cyclicality

MAV

MV of Assets

Current Estimate Liabilities based on **prescribed discount curve**

We are encouraged by the IAIS' consideration of discounting options to address asymmetry between the valuation of assets and liabilities

GAAP Plus

GAAP Value of Assets (mostly **MV**)

Current Estimate Liabilities based on GAAP LRT rules (asset earned rate)

We are encouraged by the IAIS' consideration of an AOCI adjustment to address asymmetry between the valuation of assets and liabilities

2) Excessive conservatism – improper design and calibration understates Available Capital and overstates Required Capital

Available Capital

Capital resources should include all tangible loss absorbing resources (including margins in reserves)

Margin Over Current Estimate (MOCE) double counts risk already captured in Required Capital

Required Capital

Intended as a 1-in-200 level of stress over one year (99.5% one-year VaR)

Improper design & overly punitive calibration overstates Required Capital

- The above issues are especially impactful for long term protection and retirement products.

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