9800 Fredericksburg Road
San Antonio, Texas 78288

May 23, 2011

VIA ELECTRONIC SUBMISSION

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies (Docket No. OP - 1416)

Dear Ms. Johnson:

United Services Automobile Association (USAA) is pleased to provide our comments with respect to the Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies[1] (the Notice of Intent) that the Federal Reserve Board (the Board) is conducting under Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

USAA has significant concerns that imposing existing bank holding company (BHC) supervisory guidelines on insurer savings and loan holding companies (SLHCs) without rationalizing those guidelines with insurance company capital requirements and existing state regulations will result in inappropriate capital requirements and ratings for insurer SLHCs. The assessment of the condition, performance and activities of insurer SLHCs through a consolidated asset-based framework would not capture the unique risk profile of insurers. Because insurers with affiliated depository institutions have traditionally operated in SLHC structures, it is critical the Board incorporate the distinctive features, controls and existing supervision of insurance company operations by modifying BHC supervisory guidance for insurer SLHCs going forward.

We appreciate that the Board has specifically requested comments detailing the unique characteristics that it should take into account when developing regulations for SLHCs.[2] In addition to addressing our views with respect to insurer SLHCs in general, we will highlight the considerations brought by a particularly unique feature of USAA: our holding company is both the parent of insurance and non-insurance subsidiaries *and* at the same time is an active and substantial operating insurer.

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[1] *Notice of Intent To Apply Certain Supervisory Guidance to Savings and Loan Holding Companies*, 76 Fed. Reg. 22662 (April 22, 2011) (Release).
[2] *Id.* at 22665.

Key Points

Property and casualty (P&C) and life insurers possess certain distinctive characteristics relevant to insurer SLHC regulation, including:

1. Insurers have risk profiles and hold capital based on insurance risk as well as asset risk.
2. Insurers manage assets with the primary objective of preserving capital while generating stable cash flows to satisfy claims-paying needs.
3. Insurers hold a substantially different asset/liability mix compared to banks.

We hope the discussion of these factors will establish the following points that we urge the Board to consider when developing capital requirements for SLHCs:

1. The BHC model does not capture the distinct risk of insurers that hold capital based not only on asset – or market risks, but also on a full spectrum of liabilities – or insurance risks, and
2. The BHC model does not take into account that insurer SLHCs are highly regulated by state functional regulators who impose capital requirements intended to protect policyholder claims. These requirements may at times be different from BHC capital requirements that are intended to protect depositor funds.

Because the characteristics of insurer SLHCs make adopting the traditional BHC model inappropriate, we urge the Board to take at least the five years granted by the Dodd-Frank Act to:

1. Partner with SLHCs and study their unique characteristics to systematically rationalize the BHC supervisory guidance with insurer SLHC risk profiles prior to the implementation of any new capital requirements on SLHCs, and
2. Avoid imposing regulatory requirements that create conflict with state insurance laws by determining the proper level of coordination with and reliance on state functional regulators, consistent with the Board's consolidated supervision program set forth in SR 08-9[3] and with the Dodd-Frank Act.[4]

Finally, with respect to the BHC RFI rating system, because the assets and liabilities held by insurer SLHCs are not correlative with those held by banks, we urge the Board to take time to evaluate these distinct aspects of insurer SLHCs before applying the RFI rating system to SLHCs.

[3] Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, Division of Consumer and Community Affairs, SR 08-9 / CA 08-12, *Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations*, dated October 16, 2008 (SR 08-9) (SR 08-9 "reiterates the importance of coordination with, and reliance on, the work of other relevant primary supervisors and functional regulators").

[4] *See* Sections 604(g) and 604(h)(2) of the Dodd-Frank Act (DFA Section 604) (stating that the Board to "the fullest extent possible rely on" state regulatory agencies of SLHCs and suggesting "coordination with other regulators").

Background

The mission and membership of USAA.

USAA is a membership-based association, and together with its family of companies, serves present and former commissioned and noncommissioned officers, enlisted personnel, retired military, and their families. Since its inception in 1922 by a group of U.S. Army officers, USAA has pursued a mission of facilitating the financial security of our members and their families by providing a full range of highly competitive financial products and services, including personal lines of insurance, retail banking and investment products. Our core values of service, honesty, loyalty and integrity have enabled us to perform consistently and be a source of stability for our members, even in the midst of the unprecedented financial crisis of recent years.

In fact, we have grown deliberately by developing products based on the needs of our members. We have flourished throughout numerous financial and nonfinancial crises. We have gone above and beyond in our efforts to serve our members while placing a strong emphasis on meeting and often exceeding applicable regulatory requirements.

USAA as the holding company parent.

USAA is a holding company for a diversified financial services group of companies and is itself a personal lines property and casualty insurance carrier. USAA is organized as a Texas reciprocal interinsurance exchange highly regulated primarily by the Texas Department of Insurance (TDI) as well as by insurance regulators in all 53 other jurisdictions where we operate. In addition to the traditional regulation of its insurance operations, including its financial condition, investments, rates, forms and underwriting practices, the TDI regulates USAA at the holding company level.

The TDI oversees USAA and its affiliates on an ongoing basis with regular comprehensive exams. Additionally, each material transaction (*e.g.*, service agreements, affiliated reinsurance contracts, capital contributions, dividends) between any insurer and any affiliate of the holding company must be filed with and pre-approved by the TDI. USAA files an annual registration statement and quarterly updates with the TDI that provide a detailed picture of the holding company and outlines all material affiliates and transactions that occurred in the prior year.

Certain affiliates of USAA.

USAA's affiliated companies enhance its product and geographic diversification, and its overall financial strength benefits from its diversification into life insurance, banking, investments and other products and services.

As part of a diversified offering of financial products and services, USAA Life Insurance Company (Life Company), a subsidiary of USAA, offers life insurance, annuities and health insurance products and services to our members. The TDI also regulates Life Company, as do the insurance regulators in the other 49 jurisdictions where it operates.

USAA Federal Savings Bank (FSB), an indirect wholly owned subsidiary of USAA, is a federally chartered savings association organized to offer personal retail banking services. Because FSB was chartered in 1983, and is USAA's only savings association, USAA is a grandfathered unitary savings and loan holding company that is currently regulated by the Office of Thrift Supervision (OTS). As the Board is aware, the Dodd-Frank Act preserves the grandfathered treatment of unitary SLHCs and the application of the Home Owners' Loan Act (HOLA) to SLHCs in general.[5] We appreciate that the Board has reiterated in the Notice of Intent that it will incorporate the requirements of HOLA when establishing its regulatory approach for SLHCs.[6]

In summary, USAA is unique in its structure – it is an SLHC subject to primary regulation by the Board, an operating P&C insurance company and insurance holding company subject to primary regulation by the TDI, and a P&C insurance holding company also subject to primary regulation by the TDI. Therefore, for USAA to continue to provide the best possible service to our members – the U.S. military community and their families – it is crucial that the Board take adequate time to determine appropriate capital requirements for insurer SLHCs and the proper level of coordination with and reliance on state functional regulators.

<u>Regulatory capital changes no sooner than five years.</u>

<u>The Dodd-Frank Act.</u>

Section 171 of the Dodd-Frank Act governs risk-based capital (RBC) requirements and provides that the Board establish minimum leverage and RBC requirements on a consolidated basis for SLHCs. The Dodd-Frank Act provides that for any depository institution holding company that was not previously supervised by the Board, the RBC requirements are effective five years after the date of enactment of the Dodd-Frank Act.[7] We note that Congress drafted this section with the words "shall be effective" five years after the date of enactment and did not provide for a phase-in period over the course of the five-year period. Congress specified a phase-in of certain regulatory capital deductions and provided for a phase-in period elsewhere in Section 171.[8] Congress could have acted similarly with respect to risk-based capital requirements for holding companies not previously supervised by the Board. It did not do so. USAA therefore respectfully requests that the Board partner with insurer SLHCs and take the legislatively provided five years to study their unique structure and carefully rationalize the traditional BHC capital framework with insurer SLHCs.

<u>Time for study and evaluation.</u>

Not only is a phase-in or earlier effective date not contemplated by Congress, but there are a number of important reasons for the Board to wait a full five years before implementing regulatory capital changes on SLHCs not previously regulated by the Board.

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[5] *See* Section 626 of the Dodd-Frank Act.
[6] Release, *supra* note 1 at 22663.
[7] *See* Section 171(b)(4)(D) of the Dodd-Frank Act.
[8] *See* Section 171(b)(4)(B) of the Dodd-Frank Act.

The five year effectiveness would give both insurance companies and the Board time to gather information and understand the impact of a new regulatory regime on state-regulated operating insurance companies. Such an understanding would assist the Board in fulfilling its mandate of streamlining and rationalizing the supervision of holding companies of depository institutions[9] and give the Board adequate time to evaluate the unique aspects of insurer SLHCs. The Board needs to identify and consider more appropriate RBC requirements and avoid imposing incompatible regulatory requirements by determining the proper level of coordination with and reliance on state functional regulators. Acting too quickly could have unintended consequences for insurer SLHCs.

Interim assessment of capital adequacy.

The Board has requested comments on the methods it should consider implementing for assessing capital adequacy for SLHCs during the interim period. Rather than implementing interim, temporary, informal requirements, or a new customized approach to regulation prior to final regulations becoming effective five years after enactment, USAA respectfully requests that the Board maintain the existing regulatory framework until the Board is able to study and partner with insurer SLHCs to fully understand the distinctions between the insurance business and retail banking, and how the functional regulator for insurance necessarily tailors insurer capital requirements to address the unique risks of the industry and the company. An interim customary approach would not only look like the phase-in Congress did not enact, but would risk creating inappropriate capital requirements for SLHCs.

If a safe and sound financial institution with well-managed risk has a functional regulator implementing risk controls, capital standards and liquidity requirements, the Board should keep within the spirit of the Dodd-Frank Act and refrain from instituting RBC regulations prior to five years after enactment.

BHC RBC requirements do not contemplate insurance risk or account for different requirements by a functional regulator.

Given that the BHC RBC framework is primarily an asset-based risk assessment and does not include an assessment of insurance risk, we believe additional time is warranted to rationalize the BHC RBC framework to properly measure the capital adequacy of insurer SLHCs.

Capital requirements based on insurance risks.

Over time, regulators of P&C insurers, life insurers and banks have developed distinct RBC models based on the risks faced by each type of business.

Under state functional regulatory standards, P&C insurance companies are subject to RBC requirements that provide for a capital adequacy standard tied to specific insurance activities, which raises a safety net for policyholders and creditors. These RBC requirements take into account liability-based insurance risks as well as asset-based market risks. If an insurer's risk-

[9] *See* Section 301 of the Dodd-Frank Act.

based capital falls below 200%, the insurer must present regulators with a plan to improve its financial position and regulators are authorized to place an insurer in receivership if the RBC ratio falls below 100%, and are required to take control if it falls below 70%.

Life insurance companies are also subject to RBC requirements tied to insurance risk. The RBC formula for life insurers, however, differs significantly from that of P&C insurers. It is designed to capture the unique risks of life insurers, which include asset/liability management and interest rate, mortality and other business risks. Additionally, the insurance regulations governing life insurance entities utilize capital requirements to discourage asset/liability mismatches. A mismatch in the duration of assets and liabilities would result in increased capital requirements. For example, life insurers face interest rate risk because of the material risk of loss due to changes in interest rate levels for many life insurance products. The factors in this calculation represent the surplus necessary to provide for a lack of synchronization of asset and liability cash flows.

Not only would measuring only asset-based market risks under a BHC RBC framework be inappropriate for insurance companies that also face liability-based insurance risks, but it may result in insurance SLHCs actually being under-capitalized in terms of insurance risk, and therefore a risk to policyholders.

Inconsistencies with state functional regulators.

SLHCs are highly regulated by state functional regulators who impose capital requirements intended to protect policyholders and claimants. Moreover, insurance regulators measure insurance risk by understanding and regulating detailed insurance operations. Insurance risk requires a regulator who has a specialized knowledge of insurance operations and claims.

Current regulation of insurer SLHCs by federal regulators has been largely complementary to state insurance regulation of these entities. Consistent with the Board's stated policies on consolidated supervision of BHCs,[10] USAA urges the Board to rely to the fullest extent possible on the reports and examinations made, as well as the information gathered and assessments developed by, the state functional regulator. In areas in which the Board's regulatory regime for BHCs conflicts with regulation by the entity's functional regulator, USAA requests that the Board take the time to rationalize the two regulatory regimes to minimize conflicts and allow insurer SHLCs to maintain a competitive position.

BHC Rating System does not take into account the risk profile of insurance companies.

The assets and liabilities held by insurance companies are not correlative to those held by banks. Therefore, to the extent that the Board begins to implement the RFI rating system after July 21, 2011, we urge the Board to consider the distinct aspects of insurer SLHCs before applying the rating system to SLHCs.

[10] *See* SR 08-9, *supra* note 3 at paragraph 12. *See also* DFA Section 604, *supra* note 3. Moreover, we understand some level of deference to the functional regulator has historically been applied to bank holding companies (see 12 U.S.C. 1844(c)(2)), and some level will exist going forward.

The RFI Financial Condition "F" rating is comprised of four parts, commonly known as CAEL. Two components of CAEL do not adequately take into account the unique risk profile of insurance companies: (i) ''A'' Assets, which reflects the quality of an organization's consolidated assets, and (ii) ''L'' Liquidity, which reflects the consolidated organization's ability to attract and maintain the sources of funds necessary to support its operations and meet its obligations.

Asset Quality (the "A" in CAEL).

Unlike banking entities, the health of P&C insurance companies is equally, if not more so, affected by the liabilities on the balance sheet (principally related to insurance claims) and the pricing of insurance risks in the form of policyholder premiums. Risks of personal P&C insurers occur independently of the economic cycle and vary by geography. Bank risks are highly correlated with the economic cycle and, during a crisis, there is increased insolvency risk for depository institutions with asset concentrations in affected areas. Insurance companies must deal with the underwriting risk that premiums may not cover the cost of claims, a result of which may materialize only over a period of years. Also, insurance company investments are subject to extensive investment regulation and focus on providing adequate diversification, liquidity and quality with the primary objective of preserving capital to pay claims.

The OTS has recognized this difference. For example, Section 930 of the OTS Holding Company Handbook points out that insurance regulators use RBC to evaluate the adequacy of an insurance company's capital level.[11] The Handbook recognizes that insurance companies are already highly regulated entities and insurance risks are already accounted for by the functional regulator.[12] In this regard, the Handbook could serve as a useful tool to guide the Board and its examination staff in understanding the unique aspects of regulating an insurer SLHC.

Liquidity (the "L" in CAEL).

Liquidity comes into play in both the P&C and the life insurance businesses, each of which face unique risk profiles and therefore have the following distinct liquidity management practices:

1. P&C Insurance Risk and Liquidity. Personal line P&C insurers rely primarily on premiums and long-term capital to support risk-taking positions. Insurance company assets are mostly comprised of fixed income and highly marketable securities in an inherently diversified portfolio. Typically, only a limited portion of insurance company assets are at risk at any time given the highly regulated nature of insurance company balance sheets. P&C insurance companies have a lack of procyclicality of capital. Whereas banks will be required to build capital buffers in strong economic times to prepare for economic downturns, P&C insurance companies build capital in proportion to the risk that natural catastrophes (*i.e.*, acts of God) will impact claims. Threats from the natural environment do not coincide with the economic cycle. Also, risks from events such as hurricanes are not similarly cyclical.

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[11] Office of Thrift Supervision, *Holding Company Handbook*, dated January 2003, at 930.1.
[12] *Id.*

Insurers, however, have ways of predicting and measuring risk that differ from the way banks measure risk. Actuarial sciences have been developed to model and manage insurance risks. Insurers mitigate risk not only by underwriting and loss modeling but also through integrated reinsurance programs that manage risk exposures by type, location and severity.

In addition, the capital framework of P&C insurance companies is designed to capture unique insurance, liquidity and investment risks. Insurers manage these risks by employing underwriting, continuous pricing adjustments, catastrophe management and loss reserving. BHC regulations may not accurately capture an insurer's use of these risk modeling and management tools or reinsurance programs and certain government pools that reduce risk exposure on the liability side of the balance sheet.

2. Life Insurance Risk and Liquidity. Life insurers have fundamentally different liquidity risk profiles from both banks and P&C insurers. A key risk for life insurers arises from the association of life insurance assets (corporate bonds) and liabilities (unique contracts with specific characteristics, such as surrender charges). Actuarial science, sound financial management, regulator mandated cash-flow stress testing, and asset-liability modeling are all actively used to manage those risks. Asset-liability modeling is performed by projecting asset and liability cash flows under stochastically generated scenario sets. Risks that are evaluated include interest rate sensitivity, stock market sensitivity, combined asset sensitivity, liquidity, credit, reserving, pricing / underwriting, concentration, and catastrophe risks.

   Liabilities arising from life insurance activities are managed primarily through asset-liability management and subjected to strenuous liquidity scenarios. For most life insurance policies, benefits are only paid in the event of policyholder death, and policy lapses result in a loss of coverage. Again, this is in contrast to banks, for which most funding comes through callable deposits, exposing banks to runs. Risks from mortality catastrophes affecting large numbers of policyholders are managed through diversification across large numbers of policyholders and the use of reinsurance to spread the risk of sudden losses across several reinsurers via syndication. Reinsurers, in turn, manage highly diversified portfolios across many geographies and risk types, as well as further reinsuring their respective risks and concentrations. While life insurers have some liquidity exposure to sudden lapses of annuities, this risk is mitigated through policy features such as surrender charges, additional capital required by the existing RBC framework designed to address this risk, and the asset-liability management previously discussed.

   On the other side of the balance sheet, while the assets of life insurers are generally more liquid than those held by other financial institutions (typically tradable securities versus more illiquid loans), they are matched to the duration of the insurance obligations and therefore are not generally traded prior to maturity.

Conclusion

USAA appreciates the important role the Board will play in providing for the safe and sound operation of the banking system in the United States. We believe the objectives of Title III of the Dodd-Frank Act – to streamline and rationalize the supervision of depository institutions and their holding companies – should strike a balance with Title III's other objective – to ensure the supervision is fair and appropriate. Further, we are confident that these objectives can be met while still allowing historically safe and sound institutions like USAA to continue to provide a full range of financial services and products to customers in the same highly regulated, low-risk manner they do today. USAA looks forward to fulfilling our promise to U.S. military service members and living out our mission of facilitating the financial security of these service members and their families by providing highly competitive financial products to many future generations.

We appreciate the Board's consideration of our comments and look forward to working with the Board in the future. Should you have any questions or wish further clarification or discussion of our points, please contact Mark Howard, Deputy General Counsel, at 210-498-8696.

Sincerely,

Steven Alan Bennett
Executive Vice President
General Counsel & Corporate Secretary