Financial Security. For Life.

Carl B. Wilkerson
Vice President & Chief Counsel, Securities & Litigation
(202) 624-2118 t (866) 953-4096 f
carlwilkerson@acli.com

April 16, 2014

Mr. Robert deV.Frierson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551

Re: Advance Notice of Proposed Rulemaking on Physical Commodity Activities; RIN 7100 AE-10

Dear Mr. deV.Frierson :

The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry. Some of our members may be affected by the substance of the advance notice of proposed rulemaking published by the Board of Governors of the Federal Reserve ("Board") on January 21, 2014 in the Federal Register.[1] ACLI respectfully submits the following response to this request for comment on this regulatory matter. We greatly appreciate your attention to our views.

I. Summary of the Advance Notice of Proposed Rulemaking

The Board published an advance notice of proposed rulemaking (the "ANPR") on "issues related to physical commodity activities conducted by financial holding companies ("FHCs") and the restrictions imposed on these activities to ensure they are conducted in a safe and sound manner and consistent with applicable law." [2]

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[1] *See* 79 Fed. Reg. 13 at 3329 (Jan 21. 2014) [http://www.gpo.gov/fdsys/pkg/FR-2014-01-21/pdf/2014-00996.pdf].

[2] The Board is seeking comment in connection with a review of the scope of the activities that it has authorized under the "complementary" authority in the Bank Holding Company Act of 1956 (the "BHC Act") (Section 4(k)(1)(B)) to ensure these activities are complementary to a financial activity and do not pose substantial risks to the safety and soundness of depository institutions or to the financial system generally. It is also considering whether additional limitations or conditions on the conduct of physical commodities activities by FHCs and their subsidiaries under "complementary" and other authority granted under the BHC Act, specifically the Gramm-Leach-Bliiey Act merchant banking authority and commodities grandfather authority, are warranted in order to mitigate any risks to the safety and soundness of FHCs, as well as any potential risks to financial stability.

With respect to "complementary" authority, the Board also questions more broadly whether the relationship between physical commodity markets and commodity derivatives activities "are as close as previously claimed or expected," especially in light of recent public reports that some FHCs plan to cease their physical commodities activities but continue to conduct the related financial activities or sell their physical commodities business to a nonfinancial firm. As a result, the Board elicited comment on narrowing or eliminating altogether the complementary authority to engage in physical commodities activities.

The ANPR discusses, among other things,

- The nature of risks that physical commodity activities could pose to the safety and soundness of FHCs and to financial stability more broadly;
- Potential conflicts of interest and adverse effects of engagement by FHCs in physical commodity activities; and,
- Potential risks and benefits of imposing additional capital requirements or other restrictions on the commodity activities of FHCs.

In support of the Board's review of physical commodities activities, the ANPR cites increased FHC involvement in these activities in recent years, the risks of market contagion, potential dangers posed by "tail risks" as demonstrated by the financial crisis, and "a variety of events and developments involving physical commodities activities that suggest that the risks of conducting these activities are changing and the steps that firms may take to limit these risks are more limited".[3]

The ANPR may have an impact on certain life insurers affiliated with savings & loan holding companies and those designated by the Financial Stability Oversight Council ("FSOC") as systemically important financial institutions ("SIFIs").[4] To date, FSOC has designated two insurance companies, American International Group, Inc.[5] and Prudential Financial, Inc.[6], as non-bank financial institutions subject to the Board's supervision and enhanced prudential standards. Currently, twenty two life insurers are affiliated with savings & loan holding companies.
The reach of the regulatory modifications contemplated in the ANPR, therefore, could in the future be extended to these life insurers through subsequent rulemaking.

II. Statement of Position

The ANPR is a valuable, constructive means to elicit broad comment and achieve its regulatory purpose. Any subsequent proposal should, however, be carefully tailored to its target purpose to prevent overbroad application and unintended consequences.

[3] The Board specifically requested comment on whether one or more of the following limitations should apply to complementary commodities activities: (i) enhanced capital requirements, (ii) increased insurance requirements, and (iii) forcing a reduction in these activities through "absolute dollar limits and caps based on a percentage of the FHC's regulatory capital or revenue." With respect to merchant banking investments, the Board specifically asks whether it is necessary to impose on FHCs: (i) higher or additional capital requirements, (ii) limits on the total amount of such investments, and (iii) additional restrictions on the routine management of merchant banking portfolio companies.

[4] The ANPR invites comment on 24 specific questions about the risks and benefits of allowing FHCs to conduct physical commodities activities under the various provisions of the Bank Holding Company Act of 1956 ("BHC Act") and the conditions under which these activities should be conducted. Three of the questions may involve some life insurance companies. Question 12 focuses on savings & loan holding companies affiliated with insurance companies. Question 22 covers life insurers' controlling investments in nonfinancial companies. Question 11 addresses nonbank entities designated as Systemically Important Financial Institutions ("SIFIs").

[5] See FSOC determination on American International Group at
http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf

[6] See FSOC determination on Prudential Financial, Inc. at
http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf

The ANPR addresses a series of negative developments associated with physical commodities experienced by banking institutions during the economic challenges that began in 2008, such as withdrawals and potential contagion in the marketplace. The market factors the ANPR seeks to regulate are not present or relevant in the life insurance industry. As state regulated entities, life insurers are subject to statutory constraints and regulatory oversight that significantly restrict their investment activity.

Life insurance companies did not experience the circumstances the ANPR seeks to remedy, due to fundamental differences in their products from banks, the associated long-term horizon of those products, and regulatory standards that limit life insurers' acquisition of physical commodities. Accordingly, the Board's further action on the ANPR should be limited to its core purpose and exclude application to life insurers.

III. Background on Physical Commodities in Life Insurers' Investment Portfolios

Life insurers' ownership of physical commodities is an extremely small component of total assets on an industry wide-basis. Life insurance companies engage in physical commodity activities on a direct and indirect basis through their investment programs. While life insurance company general assets are primarily comprised of high-quality fixed income securities, insurers responsibly diversify their portfolio holdings through longer-term investments in real estate (including agriculture and timber), natural resources, energy and other infrastructure assets. Certain activities in this area are analogous to life insurers' longstanding activities in real estate markets.

For example, an insurance company with commercial property investments may also invest in farmland or timberland properties. Such real property may yield commodities associated with farming, timber or natural resources activities. The development, processing and sale of such commodity interests are often overseen by a reputable third party manager retained by the insurance company (or an affiliate), similar to the work performed by property managers engaged by life insurers to manage commercial property holdings. These investments thus fit neatly within existing industry practices regarding development and management of controlled investment properties.

Life insurance companies may make these investments directly, as described above, or indirectly through the purchase of interests in joint ventures, private funds or strategic partners in the physical commodities markets. In the case of such indirect investments, the activity is comparable to investment activity conducted by life insurance companies in their private equity portfolios. Specifically, the life insurance company typically owns an interest in a fund or other venture where a general partner or other strategic company makes asset-specific decisions with regard to the underlying commodity interests. While these indirect investments are often non-controlling, the life insurance company investor may negotiate for minority protection rights or, in some cases, additional rights or interests that could confer control over the relevant investment.

Life insurance companies may also engage in agriculture lending through issuing broad class of loans backed by collateral to farms or agricultural related businesses. Farm loans not only consist of farms that raise crops or livestock, but also extend to timber and forestry, and to businesses that support the agricultural industry. Farm loans held by life insurers total approximately $18 billion, which collectively constitutes less than six percent of the total mortgages held by life insurers and about 0.5 percent of total general account assets.[7] They are concentrated in four companies, each of whom has been engaged in offering farm loans for more than 100 years, and for whom farm loans represent between one and three percent of the company's general account assets. Agriculture loans are secured by the land and, in some cases, by the crops they produce.

The agribusiness sector will also include the real estate as collateral along with commodities used for processing. While the companies do not transact in the commodities directly, the potential exists, that in the event of default, a company may take over the operation of the business until the asset is sold. Typically, these assets would effectively be foreclosed assets and not an active business for the companies. Additionally, a company may own or lend on mineral rights.

In addition to agriculture related businesses, some life insurance companies also invest in electric power production facilities that generally sell the electricity production to utilities under long-term power purchase agreements. These investments can take the form of equity or debt financing. Recently, such investments have been focused on renewable energy resources such as wind, solar, geothermal or biomass.

As a matter of relative perspective, however, life insurers' ownership of physical commodities is an extremely small component of total assets on an industry-wide basis. Commodities reflect only 0.4% of the general assets of life insurers.[8]

IV. Life Insurers' Limited Engagement in Physical Commodities is Outside the Purpose and Scope of the Advanced Proposal

The market factors the ANPR seeks to regulate are not present or relevant in the life insurance industry. As state regulated entities, life insurers have statutory constraints and regulatory oversight that significantly restricts their investment activity. These significant insurance laws are discussed further below.

Life insurers acquire physical commodities according to long-standing investment management criteria and methodologies that they execute as part of a long-term investment strategy to fulfill their long term commitments to customers. Life insurers have been engaged in the physical commodities markets for a long time and have been a source of stability to the market in view of the long term investment horizon. Thus, it would be harmful to the market's stability to unreasonably restrict or burden life insurers' participation in the physical commodities markets. In contrast, other financial institutions began engaging in the physical commodities markets to offer a full menu of products and services to customers. Life insurers do not offer physical commodities to customers or make markets in physical commodities. They acquire them exclusively in managing their long-term assets and liabilities.

Life insurers have business models, risk profiles, capital structures, and regulations different from banks. Life insures provide coverage to customers for their long-term risks, and governing regulations require life insurers to match those long-term, illiquid liabilities with appropriate assets to ensure that those liabilities are fulfilled. Capital standards reflect the extent to which life insurers match the duration of their assets to the duration of their liabilities. In contrast, banks do not match

[7] NAIC & the Center for Insurance Policy Research memorandum to Capital Adequacy Task Force (April 19, 2013) Attachment 9.

[8] Source: ACLI Research Department April 2014 tabulations of National Association of Insurance Commissioners (NAIC) data, used with permission.

assets and liabilities, are dependent on short-term, on-demand funding and thus exposed to potential “runs” in periods of market stress. Customers of life insurers remain for the long duration and have not demonstrated mass surrenders or withdrawals during challenging economic or market developments, such as the economic stress that began in 2008. Life insurers have predictable long-term patterns of claims, and the products have mechanisms, such as surrender charges, to control and prevent bank-like runs.

State insurance laws already provide limits on the extent to which life insurers can acquire physical commodities. Risk Based Capital (“RBC”) standards in state insurance codes also operate to constrain the volume of physical commodities in life insurers’ portfolios. State insurance laws also limit investments in operating subsidiaries not engaged in insurance. Thus, limits and firewalls provide an existing framework that protects the life insurance industry and the market.

The ANPR is very broad in its focus on the banking industry. While it may make sense to craft a very broad regulatory solution for banks based on their broader range of activities, such an approach would not make sense for the life insurance industry with an existing, robust regulatory framework that constrains investment and commodity related activities. The scope of the ANPR is too broad to be suitable for application to life insurance companies, as it could impact not only direct investments in physical commodities, but also indirect or passive investments, such as limited partnership investments that are typically commodity pools or hedge funds that are in-turn invested directly or indirectly in physical commodities.

To the extent that it elects to craft any proposals for rulemaking in this area, the Board should carefully tailor such proposals to avoid any unwarranted negative impact on the life insurance industry. The ripple implications on the life insurance industry must be carefully considered, especially in light of the different ways the ANPR could impact life insurers, such as life insurers classified as nonbank SIFIs or life insurers having affiliations with savings and loan holding companies. The initiative should sensibly consider regulatory conflicts that could be created under a one-size-fits-all approach.

V. The Initiative Should Accommodate Life Insurers Unique Legal and Regulatory Architecture under Which Life insurers Operate, and Should Respect their Long-Standing Practices and Long-Term Investment Management

Existing regulatory regimes must be reconciled responsibly. The regulatory purpose in the ANPR can be fulfilled without subjecting life insurers to inappropriate regulation that has no relationship to life insurers’ operations, products and regulatory status. A reasonable and carefully focused approach worked successfully in the Fed’s implementation of the Dodd-Frank Act and avoided unintended negative consequences. Several fundamental insurance laws operate to significantly limit life insurers’ acquisition of physical commodities, including capital requirements, RBC standards and investment limitations. Existing state regulatory oversight through insurer reporting, supervision, monitoring, financial review, and structured examinations ensures compliance with these important provisions.

A. Financial Regulatory Oversight and the Role of Capital Requirements

Financial Regulation Overview

The U.S. insurance financial regulatory system consists of three stages: (1) state lawmakers and regulators eliminate or limit some risks through restriction on activities, prior approval mechanisms and regulatory focus; (2) regulators perform financial oversight, the step in the process where most of the regulatory activity exists, looking for companies in hazardous financial condition and evaluating the potential for insolvency; and (3) lawmakers and regulators establish regulatory backstops or safeguards, most notably the guaranty funds and risk-based capital (RBC) requirements, to make up the final stage of the regulatory process.

Because investments comprise a large part of the insurance business, regulators pay close attention to investment risk, encouraging less risky investment when appropriate. In the 1990s, U.S. regulators buttressed their oversight and restriction of insurer investments by imposing either a defined limits or a defined standards approach. Using a defined limits approach, regulators place certain limits on amounts or relative proportions of different assets that insurers can hold to ensure adequate diversification and limit risk. Using a defined standards approach, regulators restrict investments based on a “prudent person” approach, allowing for discretion in investment allocation if the insurer can demonstrate their adherence to a sound investment plan. Coextensively, the National Association of Insurance Commissioners (“NAIC”) Capital Markets & Investment Analysis Office reviews insurers’ assets for credit risk, potentially driving insurers toward less-risky investment.

Financial oversight and determination of insurers’ financial condition is the most constructive and extensive part of U.S. insurance financial regulation. Oversight focuses on appropriate asset and liability valuation, the risks accepted by the insurer, the mitigation of those risks and the amount of capital held in light of the residual risks.

Insurers are required to file standardized annual and quarterly financial reports that the regulators use to assess the insurer’s risk and financial condition. These reports contain both qualitative and quantitative information and are updated as necessary to incorporate significant common insurer risks.

An actuarial opinion on major components of an insurer’s financial statement (asset adequacy and claim/loss/premium reserves) is required to ensure the adequacy and/or reasonableness of reserves. The independent financial audit helps to provide assurances that all material aspects of the insurer’s financial reporting are accurate. Statutory accounting is, generally, more conservative than general purpose accounting. Consequently, insurers may choose to deemphasize investments in assets valued more conservatively.

Regulatory Backstops

As a final backstop in the U.S. financial oversight process, state insurance regulators utilize RBC calculation and analysis. Regulators developed RBC to supplement the fixed minimum capital and surplus requirements, which vary by line of business and do not sufficiently account for differences in size, risks or financial conditions among insurers. Although the RBC formula is the same for companies in a particular line of business, the specific calculation for each company reflects the particular risks unique to that specific company.

RBC strengthens the regulatory safety net in the U.S. system by recognizing a company’s different size, financial condition and types of risks assumed. More important, regulators created RBC as a legal authority to provide for timely regulatory action, consistent across jurisdictional borders, with minimum court involvement when a company triggers an RBC intervention level.

Financial Analysis

NAIC financial analysis tools and resources (e.g., Financial Analysis Solvency Tools (FAST) scores and handbooks) supplement individual state regulatory efforts. FAST is a collection of analytical solvency tools and databases designed to provide state insurance regulators with an integrated approach to reviewing the financial condition of insurers operating in their respective jurisdictions. FAST is intended to assist regulators in prioritizing resources to those insurers in greatest need of regulatory attention. The creation and development of sophisticated and comprehensive financial tools and benchmarks (through data management evolved from personal knowledge of troubled companies) encapsulate various categories, including leverage, asset quality, liquidity and insurer operations.

State regulators developed an NAIC Financial Analysis Handbook to advise use of a “stair-step” approach that directs analysts to perform more in-depth analysis commensurate with the financial strength, prospective risks and complexity of each insurer. The Financial Analysis Handbook requires regulators to use many analytical tools, databases and processes in completing their quarterly analysis of insurers (such as ratio analysis and review of the actuarial opinion, audited statutory financial statements, holding company filings, and the management discussions and analysis filings).

Ensuring a nationwide system of checks and balances, the NAIC and, specifically, the NAIC Financial Analysis Working Group (FAWG), offer a layer of peer review for each regulator’s solvency monitoring efforts, thus ensuring that experienced state regulator colleagues improve and enhance state regulator judgments regarding a company’s financial condition.

Financial Examination

U.S. regulators carry out periodic risk-focused, on-site financial examinations in which they evaluate the insurer’s corporate governance, management oversight and financial strength. Regulators exercise risk identification and evaluate mitigation systems both on a current and prospective basis, assessing the reported financial results through the financial examination process.

Examinations consist of a process to identify and assess risk and assess the adequacy and effectiveness of strategies/controls used to mitigate risk. The process includes a determination of the quality and reliability of the corporate governance structure, risk management programs and verification of specific portions of the financial statements. Financial examiners evaluate the insurer’s current strengths and weaknesses (e.g., board of directors, risk-management processes, audit function, information technology function, compliance with applicable laws/regulations, etc.) and prospective risk indications (e.g., business growth, earnings, capital, management competency and succession, future challenges, etc.).

Another focus of the U.S. insurance financial regulatory system is financial surveillance to buttress financial oversight. Financial surveillance is predominately built around an extensive and uniform financial reporting system that allows for detailed analysis of asset holdings, reinsurance, loss/claim reserves, etc. Through the use of an extensive centralized database, regulators can perform stress tests on companies, determine the impact of other company insolvencies on the market, find anomalies from one company to another through benchmarking and other processes, and look for new risk concentrations and/or optimistically valued risks.

VI. Conclusion

The life insurance industry greatly appreciates the opportunity to offer comment on the ANPR. Any proposals that evolve from the ANPR should be tailored to clarify that they do not apply to life insurance companies due to fundamental differences in their products from banks, the associated long-term horizon of those products, and regulatory standards that limit life insurers' acquisition of physical commodities. In this way, future regulatory initiatives in this area will be constructively focused on the regulatory objectives cited, and will avoid unnecessary unintended negative consequences harmful to the economy.

If any questions develop, please let me know.

Sincerely,

Carl B. Wilkerson

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CC: Legal Division
Laurie Schaffer, Associate General Counsel
Michael Waldron, Special Counsel
Benjamin McDonough, Senior Counsel
April Snyder, Senior Counsel
Will Giles, Counsel

Division of Banking
Timothy Clark, Senior Associate Director
Todd Vermilyea, Senior Associate Director
Robert Brooks, Senior Supervisory Financial Analyst