State Farm®

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Via email: regscomments@federalreserve.gov

Re: Request for Comment on Proposed Guidance on Independent Risk Management and Controls for Large Financial Institutions [Docket No. OP-1594]

Ms. Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Dear Ms. Misback:

State Farm Mutual Automobile Insurance Company ("State Farm") is writing to comment on the Board of Governors of the Federal Reserve System's (the "Board") proposed supervisory guidance describing core principles of effective senior management, the management of business lines, and independent risk management and controls for large financial institutions (Docket No. OP-1594) (the "Proposal"). State Farm is a multi-line insurance company that owns a savings bank (State Farm Bank) that has less than $20 billion in assets, which represents less than 10% of State Farm's assets. Thus, State Farm is a savings and loan holding company ("SLHC"); it has total consolidated assets of more than $50 billion and, consequently, would be subject to, and directly affected by, adoption of the Proposal as currently proposed.

State Farm appreciates the Board's willingness to seek input from those institutions subject to supervision on these important issues. State Farm has a number of concerns with the Proposal, principally relating to the potential for inappropriate impact on the insurance operations of insurance based savings and loan holding companies (I-SLHC) relative to their risk management approaches and controls. This Proposal fails to recognize and defer to long-standing insurance regulatory controls and corporate business law. Further, the Proposal qualifies many expectations with the use of subjective terminology and raises many questions around the role of Independent Risk Management (IRM). Also, this Proposal does not afford additional prudential regulatory protection, but rather has the potential to add a costly, duplicative and potentially inconsistent layer of regulation to I-SLHCs, which are already effectively regulated by their primary insurance regulators with respect to risk management. [1]

Finally, matters of organizational culture, structure and operation should not be prescriptive. Boards of directors and senior management need the flexibility and discretion to adapt to changing risks to ensure appropriate actions are taken in unique and unexpected situations. The structure envisioned by the Proposal could become static, leading to unintended consequences. All of the foregoing concerns are rooted in the failure to explicitly recognize fundamental differences in the operation of an entity that is primarily an insurance company but which also operates a savings bank, as compared to a typical SLHC that is exclusively, or nearly so, in the business of banking.

<u>The Proposal Should Recognize and Tailor Itself to the Entire Regulatory Landscape of Supervised Entities and Should Recognize the Tenets of the McCarran-Ferguson Act</u>

State Farm, as the parent company for the State Farm group of companies, is not simply a savings and loan holding company. It is primarily a regulated multi-line insurance company subject to comprehensive regulation by the Illinois Department of Insurance (the "Illinois Department"). The Model Holding Company System Act, adopted in Illinois and other states subjects all of State Farm's subsidiaries, either as domestic Illinois corporations or as assets of State Farm, to comprehensive holding company system reviews and specific individual examination by the Illinois Department and other state insurance regulators. Under insurance holding company laws, all aspects of State Farm and its affiliate businesses are subject to close regulatory scrutiny including operations, material and/or specific transactions within the holding company systems, investments, accounting, corporate governance, and risk management.

The Proposal should recognize and adapt to the thorough prudential or functional regulatory framework that already applies to a state regulated insurer that serves as the parent for a federally regulated thrift, particularly where the banking operations represent a small proportion of the total operations of the entity. Functionally regulated insurance holding companies like State Farm that are both a SLHC and an operating insurance company should not be subject to the Proposal's top-to-bottom duplicative risk management regime. In this case, it is a redundant regulatory burden that creates potential conflicts with little, if any, regulatory utility. While we recognize Congress intended Federal regulation of I-SLHCs to provide an additional layer of supervision and, in certain instances, capital regulation, this must be reconciled with Congress's empowerment of state insurance commissioners as the primary functional regulator of those I-SLHCs that are regulated

[1] At the outset, we suggest that the Board should reconsider the scope of its legal authority to adopt the Proposal. While the Board has the legal authority to examine SLHCs and to issue regulations it deems necessary or appropriate to administer and carry out the purposes of Section 10 of the Home Owners Loan Act ("HOLA"), it is not clear that authority extends to the issuance of regulations setting forth management duties and responsibilities of officers of SLHCs or internal controls of such firms particularly when such a Proposal seeks to influence/regulate the insurance business of the SLHC and affiliated legal entities and/or places a management burden on the SLHC for the day to day operations of the separate savings bank entity. We believe that the Proposal would constitute a regulation as it is an agency statement of future effect designed to prescribe policy. (Indeed, the Proposal expressly states, in the context of independent risk management and controls, what senior management should do "so that activities are conducted in a manner that satisfies supervisory expectations.") Under HOLA, the Board may only issue such regulation as it deems necessary or appropriate to administer and carry out the purposes of Section 10. Section 10 addresses SLHC activities, transactions with affiliates, SLHC acquisitions, and dividends, but says nothing about management or internal controls of SLHCs. Thus, the Board's legal authority under Section 10 to issue regulations addressing management and internal controls is not readily apparent. The Proposal is not promulgated as a regulation but, by its terms, is intended to be prescriptive and will be used as a basis for examination and enforcement activities. The Board should distinguish between the two and promulgate both supervisory guidance and regulations pursuant to the Administrative Procedures Act, as applicable. Further, care should be taken when addressing the interaction between this Proposal and current supervisory guidance, which was not subject to public notice and comment prior to its applicability to I-SLHCs.

insurers. Existing functional regulation should not be overlooked, duplicated, conflicted or displaced where it is working.

State Farm argues that the Board should specifically seek comment on how to utilize existing state regulation most effectively for the specific case of I-SLHCs, not only for risk management issues being discussed here, but for all other facets of supervision. Any assessment of the I-SLHC risk management processes should be limited to activities directly related to the control and operation of the thrift and not an assessment of the organization's effectiveness in its oversight of insurance operations.

The McCarran-Ferguson Act[2] reserves the regulation of insurance to the states in the absence of express congressional intent to the contrary. Accordingly, HOLA requires the Board to use "to the fullest extent possible" information that is otherwise available from state regulatory agencies[3] and, "to the fullest extent possible" rely on examination reports made by State regulatory agencies[4] and "to the fullest extent possible" avoid duplication of examination activities, reporting requirements, and requests for information[5]. While the McCarran-Ferguson Act clearly reserves the authority to regulate the business of insurance for the states, this Proposal has the strong potential to impair or conflict with state insurance laws on risk management. The Proposal does not acknowledge the authority of the states under McCarran-Ferguson's reverse preemption regime to establish and enforce risk management requirements and standards for insurance holding companies. Within a family of insurance companies, these state-based requirements are implemented at an entity–by-entity basis, based upon the risks held and carried in each individual entity, as opposed to the Proposal which assumes that the SLHC is charged with controlling and mitigating risk throughout the entire organization without regard to the legal separateness, entity purpose, and the specific risk function of each subsidiary.

The Proposal contravenes these precepts in establishing core principles for the management of business lines by the I-SLHC senior management. The term "Business Lines" is defined in Footnote 34 as "a defined unit or function of a financial institution, including associated operations and support that provides related products or services to meet the firm's business needs and those of its customers. Under certain organizational structures, a business line may cross legal entities or geographic jurisdictions." Not only does this definition fail to distinguish between banking and insurance functions, some insurance companies own relatively small savings banks in which business lines are separate legal insurance entities conducting insurance activities that are already highly regulated by state insurance commissioners and are exempt from federal regulation under McCarran-Ferguson. The insurance regulatory scheme from pricing to financial solvency is based on the legal entity issuing the contract to the policyholder. There is no inferred or indirect reliance on the parent of the holding company for meeting those individual obligations. The Proposal would purport to control an insurance company's implementation of its insurance strategy and insurance risk tolerance, its identification of insurance risk and management of that risk, the resources it devotes to insurance and the infrastructure of how it does that, the controls it places on that insurance business, and how it holds insurance executives accountable by the senior management of the SLHC, a separate legal entity. Not only does the McCarran-Ferguson Act bar the Board from imposing such standards on an insurance company, but Section 10 of HOLA does not give the Board the legal authority to set standards as to how an I-SLHC manages its insurance

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[2] 15 U.S.C. 1011-1015.

[3] 12 U. S. C. 1467a(b)(2)(B)(iii).

[4] 12 U.S.C. 1467a(b)(4)(B)(i).

[5] 12 U.S.C. 1467a(b)(4)(C)(ii).

business or the business of the affiliated insurance entities, or how an insurance company manages its insurance business that is already supervised and regulated by state insurance commissioners. To do so would duplicate those efforts and potentially violate the state insurance law.

For example, the Proposal expressly provides that business line management should inform the SLHC senior management when the business line's risk management capabilities are insufficient to achieve business and risk objectives. Under McCarran-Ferguson, such judgments are reserved to the states. As discussed below, those state regulators have already established a vigorous review of the risk management framework, financial solvency and risk assessment of the insurance business lines as well as recognizing that the individual business lines (often separate legal insurance entities) must demonstrate financial solvency on their own merits in the course of their business, including with respect to any material transactions among affiliates.[6] Section 10 of HOLA, under which the Board has legal authority to adopt regulations of SLHCs, was never intended to impact the management of property and casualty insurance risk. Such risk is considered by state regulators, and their experienced judgment ought not to be duplicated or second-guessed, particularly for the singular purpose of evaluating the SLHC maintenance of a financial position to stand as a source of strength for the affiliated savings bank.

The Proposal would impose obligations on insurance companies that own relatively small savings banks and whose insurance operations are otherwise reserved to the supervision of state insurance regulators. The text of the notice states in pertinent part that "[i]n order to minimize unnecessary duplication for firms subject to this guidance, the Federal Reserve would, to the extent possible, evaluate a firm's governance and controls in coordination with other relevant Federal and state agencies…." As coordination with, and deference to, other regulators is of paramount importance for effective regulation of insurance-centric SLHCs, State Farm requests that this language be included in the text of the Proposal, not merely in the notice, so that the controlling principle is not lost or forgotten.

The Proposal May Subject State Regulated Insurance SLHCs to Duplicative and Conflicting Regulation

Insurance groups that would be subject to the Proposal, by definition, "possess sufficient financial and operational strength and resilience to maintain safe and sound operations through a range of conditions." This is because state insurance regulators review the institution's strength and resilience to ensure the institution has the ability to satisfy its obligations to policyholders. In carrying out this important task, state insurance regulators require insurance companies to file a capital plan; subject such companies to prudential regulation that, in many ways, is more conservative than that applicable to banks, and bank holding companies (e.g. statutory accounting principles, and stricter limits on permissible investments); corporate governance scrutiny that obviates the need for the proposed Supervisory Guidance; annual disclosure requirements; regular financial examinations; interstate collaboration of state insurance regulators in the form of supervisory colleges; risk-based capital requirements; Own Risk and Solvency Assessments ("ORSA") of an insurance company's risk management and solvency under normal and stress scenarios; annual filing of Form F assessing risk created by non-regulated entities; and professional standards for insurers. This examination and evaluation is done by state regulators in a consistent fashion within the overall insurance regulatory scheme. Thus, the need to apply the Proposal to

[6] Like the Board, state insurance regulators require the filing of quarterly and annual financial statements as well as risk management centric filings commonly known as Form F and ORSA.

regulated insurance companies is not at all apparent, potentially conflicting, and in fact, is duplicative.

One example of an issue addressed in the Proposal that is already specifically regulated by the Illinois Department and other state insurance regulators is the Board's expectations for a firm's IRM to aggregate risks across a firm as set out in the Proposal. ORSA is required to be filed annually as an evaluative tool for state regulators and has been adopted as an accreditation standard by the National Association of Insurance Commissioners. The Illinois Department of Insurance has implemented this requirement and provides regulatory oversight and review of the process. One of the primary goals of the ORSA is to provide a group-level understanding of risk and capital, while remaining mindful of the separate legal entity approach that is key to the business of insurance.

In addition to the duplicative nature of the Proposal in this respect, State Farm is concerned that the Proposal's expectations for aggregation of risk is bank-centric, without regard to fundamental aspects of insurance risk management and may create an inaccurate appearance that funds are fungible among all the affiliated legal entities. This could potentially limit the risk-mitigating effect of the establishment of such subsidiaries and actually substantively increase risk at certain I-SLHCs.

Should the Board still choose to apply this Proposal (once finalized) to I-SLHCs the Proposal should provide that no written supervisory criticism of an insurance company's governance or controls that is a SLHC will be issued by the Board. This would be a step necessary to avoid duplication and conflict. Rather the Board should confer with the firm's domiciliary state insurance regulator and ensure such state insurance regulator has agreed in writing with such criticism. That not only would ensure the Board's compliance with HOLA's coordination requirements, but also minimize unnecessary duplication which is an expressed goal of the proposal. Further, and more important, such a process would ensure regulated I-SLHCs are not caught between conflicting and/or inconsistent views of two regulators.

Flexibility for Insurance SLHCs is Necessary

The Proposal outlines the expectations of IRM and its controls. However, the discussion is not clear in explaining the difference between the business lines establishing "risk tolerances" and IRM determining "risk limits". As stated in the Proposal under its discussion of Core Principles of Independent Risk Management and Controls on page 1354, it is recognized that there are organizational structures that business line management should drive the development of risk tolerance.

> *While IRM would be expected to evaluate the firm's risk tolerance, the proposed* guidance would not set the expectation that IRM would have sole responsibility for the risk tolerance. *Depending on a firm's organizational structure, it may be appropriate for business line* management to provide input into the risk tolerance or drive its development. The proposed guidance would assign responsibility for enterprise-wide risk limits to IRM, but acknowledge that business line management may develop its own limits for internal business line use and may provide input to the risk limit-setting process defined by IRM. However, the internal limits of a business line should not be less stringent than the limits set by IRM because the IRM limits should be the operative, formal, and binding limits across the firm.

While the Proposal recognizes that there are organizational structures where it is more appropriate for business line management to provide input into the risk tolerance or drive its development, there is no discussion of when such is appropriate and therefore leaves the impression that the business line management is at best secondary to IRM's determination of risk limits. An example of the further confusion over the expectation of IRM in the Proposal is on page 1360 of the Notice where it is stated, "Principle: IRM should establish enterprise-wide risk limits consistent with the firm's risk tolerance and monitor adherence to such limits." Whatever semantic difference there may be between "risk limits" and "risk tolerance," the Proposal creates confusion about where that obligation rests. It should be made clear that establishing risk tolerances or risk limits is inherently within the purview of senior management. The monitoring and evaluation of established tolerances and limits is appropriately executed by IRM.

Given State Farm's earlier discussion in these comments, an I-SLHC with a majority of affiliated legal entities operating under an insurance regulatory scheme and corporate business law, IRM would still be able to provide objective, critical assessment of risks and evaluation of whether a business line is aligned with the established risk tolerance and report to the risk committee of the board of directors. To the extent the Proposal blurs the roles of senior management and IRM is establishing risk limits, it diffuses responsibility and accountability and, ultimately undercuts the important contributions of each. For all the reasons mentioned previously, State Farm urges the Board to clarify the expectations for regulated entities, recognizing that for an I-SLHC, IRM is to provide an objective, critical assessment of risks and to evaluate whether a business line remains aligned with its stated risk tolerance.

<u>The "Role" of IRM may not be Optimal for Reducing Risk</u>

Governance and culture of firms should be respected and the framework for establishing risk tolerances and limits should not be prescriptive in regulation or guidance. The Proposal requires IRM to establish enterprise-wide risk limits regardless of the organizational structure, including for risks associated with revenue generation activities and those inherent to the business. Many, if not all, of this limit-setting historically has been undertaken by business line management. In effect, the Proposal would convert IRM into business line manager rather than being an independent identifier and evaluator of risk.

As IRM develops expertise in risk assessment, its role should be to consult with line management, to provide advice, and to bring risks to the attention of line management. In some cases, it should challenge line management and its assumptions. However, IRM should not make ultimate risk decisions for the firm, as that is, and historically has been, the function of business line management. Transferring that authority to IRM, in effect, makes IRM line management.

Ultimately, the decision as to how much risk to undertake, consistent with risk tolerance set by the board of directors, should be that of management, not that of a control function, such as IRM. The Proposal has the effect of raising the question as to who should ultimately have the authority to determine how much risk a firm should undertake. It suggests that decision should be made by IRM in IRM's setting of risk limits. That would be a significant departure from prevailing concepts of corporate governance and should not be undertaken lightly. Historically, such decisions have been left to management, in consultation with the board of directors, and management has been held responsible for such decisions. To change that precedent by taking that responsibility away from management and giving it to IRM would dramatically change how large financial institutions are governed and would split existing responsibility, creating parallel management structures, not necessarily for the good of such firms, their customers, or of the overall economic system.

Thank you for your consideration of our comments on this important Proposal. We welcome an opportunity to discuss the issues in greater detail at your convenience.

Sincerely Yours,

Stephen McManus

Stephen McManus, Senior Vice President and General Counsel
State Farm Mutual Automobile Insurance Company