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October 22, 2012

The Honorable Thomas J. Curry
Comptroller
Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, DC 20219

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20551

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., NW.
Washington, DC 20551

**Re: Regulatory Capital Rules**

Dear Sirs:

TIAA-CREF appreciates the opportunity to comment on the three notices of proposed rulemaking ("Proposals") issued on June 7, 2012, by the Board of Governors of the Federal Reserve System ("FRB"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies").[1] We believe the Proposals have created a devil's dilemma for insurance-based holding companies such as ourselves. Because the Proposals do not effectively recognize the long-dated nature of both sides of an insurance company's balance sheet, the requirements of the Proposals will force insurance companies to carry excess capital as well as restructure their balance sheets and fundamental investment activities. Alternatively, they will force insurance companies (as many already have) to exit the banking business. Each of these results is detrimental to individuals, the industry and the economy at large**.** If, on one hand, an insurance company chooses to restructure its balance

[1] 77 F.R. 52,792 (Aug. 30, 2012); 77 F.R. 52,888 (Aug. 30, 2012); 77 F.R. 52,978 (Aug. 30, 2012).

sheet and fundamental investment activities to meet the Proposals' standards, it will both become less competitive with non-bank affiliated insurance companies and may be forced to invest in a manner inconsistent with its long-term obligations. If, on the other hand, an insurance company exits banking, it will further contribute to the increasing concentration of banking activities in a few systemically significant firms and simultaneously deprive consumers of the choice of obtaining banking services from a trusted financial services organization. This dilemma is unnecessary. A reasonable capital regime, coupled with FRB oversight at the holding company level, can address both the prudential and systemic risk concerns the Agencies intended to satisfy through the Proposals without creating this dilemma. We set forth below how, by incorporating existing insurance regulatory requirements, the Agencies can ensure adequate capital at the holding company level without disrupting the business of insurance and the availability of long-term credit, while preserving consumer choice.

TIAA-CREF supports a robust and comprehensive regulatory regime for the financial services sector. Accordingly, we support the efforts of regulators to boost the strength of financial institutions through improving oversight and increasing safety and soundness of such organizations, especially considering the events that unfolded during the 2008 global financial crisis. The crisis tested the strength and resiliency of our financial system and the economy as a whole and it is our hope that the lessons learned will help ensure that when the United States experiences another period of extreme economic stress, the changes made to the regulatory structure will ensure the financial system will be better able to withstand such adverse conditions.

While we understand the need for reforming the current financial system and the important role the Agencies' proposed rules around capital standards play in these efforts, we have identified several areas within the Proposals with which we have concerns. Our overarching concern relates to the approach the Agencies have taken to applying enhanced capital standards to Savings and Loan Holding Companies ("SLHCs") predominantly engaged in the business of insurance ("Insurance-centric SLHCs") and the approach to the business of insurance generally.

The Proposals as drafted would impose a bank-centric consolidated capital regime on Insurance-centric SLHCs. A strong capital regime for banking organizations is vital, but it is equally important to ensure that the Agencies consider an organization's primary line of business when implementing these standards. The business of banking and the business of insurance have a common goal of helping individuals attain important financials milestones. Nevertheless, they each operate under distinct and separate business models that allow them to address different aspects of an individual's financial needs (e.g., long-term vs. short-term financial goals). Applying capital standards that have been developed for banks to the entire enterprise of an organization primarily engaged in insurance could, in short, result in an insurer having to change the model under which it operates, ultimately having a significant affect on those who depend on insurance products for their financial security and the economy as a whole.

We support the steps being taken to ensure that banking institutions are well-capitalized and better able to weather future economic crises. Establishing a strong capital regime that is consistent with safety and soundness and appropriately considers risk is necessary for the continued success of our financial system and the overall health of our economy. We appreciate that in drafting the Proposals the Agencies took steps to consider carefully the potential affects these enhanced standards could have on all banking organizations and accordingly sought to "minimize the potential burden of these changes where consistent with applicable law and the agencies' goals of establishing a robust and comprehensive capital framework."[2] Nevertheless, as an insurer that would come under the new capital structure because of our SLHC status, we believe that there are several issues the Agencies should consider before moving forward with a final rule. In the sections that follow, we will outline our concerns and highlight the important considerations that must be made to ensure that Insurance-centric SLHCs can continue to conduct business in a prudent manner, while still adhering to a robust set of standards that will ensure such organizations are financially healthy and well-capitalized.

## I. Background

TIAA-CREF is a leading provider of retirement services in the academic, research, medical and cultural fields managing retirement assets on behalf of 3.7 million clients at more than 15,000 institutions nationwide. The mission of TIAA-CREF is "to aid and strengthen" the institutions we serve by providing financial products that best meet the needs of these organizations and help their employees attain financial well-being. Our retirement plans offer a range of options to help individuals and institutions meet their retirement plan administration and savings goals as well as income and wealth protection needs.

TIAA-CREF is comprised of several distinct corporate entities. Teachers Insurance and Annuity Association of America ("TIAA") was founded in 1918 and is a life insurance company domiciled in the State of New York operating on a non-profit basis with net admitted general account assets of $213.9 billion.[3] TIAA is a wholly-owned subsidiary of the TIAA Board of Overseers, a special purpose New York not-for-profit corporation. The College Retirement Equity Fund ("CREF") issues variable annuities and is an investment company registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940. TIAA-CREF also sponsors a family of equity and fixed-income mutual funds.

Based on their indirect ownership of TIAA-CREF Trust Company, FSB ("TIAA-FSB"), TIAA and the TIAA Board of Overseers are registered as SLHCs under the Home Owners' Loan Act ("HOLA"). TIAA-FSB provides TIAA-CREF with the ability to offer our clients deposit and lending products integrated with our retirement, investment management and life insurance products in a manner that enhances our ability to help them attain the aforementioned goal of lifelong financial security. TIAA's ownership of TIAA-FSB has made all of our activities potentially subject to the bank-centric consolidated capital standards outlined in the Proposals. For the reasons discussed below, we are concerned that, unless modified, the Proposals will restrict our ability to make long-term investments on behalf of our clients, will unduly reduce our competitiveness and will reduce the availability of long-term credit for many sectors of the U.S.

[2] 77 F.R. at 52,795-6 (Aug. 30, 2012).

[3] As of June 30, 2012.

economy. Moreover, such an outcome can be avoided by incorporating appropriate standards for insurance activities into the Proposals. Throughout our letter, we will highlight our chief concerns with the Proposals and explain why it is not appropriate for the FRB to impose bank-centric capital standards on insurers.

## II. The business of insurance differs fundamentally from banking and this has significant public policy implications

### A. Fundamental differences

As we have stated in our prior letters to the FRB and the Financial Stability Oversight Council ("FSOC"), the business of insurance differs fundamentally from other areas of the financial services sector.[4] Insurance products allow consumers to transfer risk through products such as life insurance (the risk of dying too soon) and annuities (the risk of outliving retirement savings), as opposed to taking on greater risk, as is often the case with other financial products such as stocks (market risk) and bonds (interest rate risk). Retirement and life insurance products generally require that policyholders pay premiums in exchange for a legal promise that is often finally settled years in the future. In addition, insurance liabilities tend to operate independent of the business cycle in that they are predetermined (e.g., annuities, term life) or randomly dispersed (e.g., natural disasters) and thus the payout schedule is not a function of economic conditions. Unlike banks, insurers' stable liabilities provide them far greater freedom to choose when to sell assets, and they are unlikely to be forced to liquidate assets to satisfy short-term obligations in times of economic difficulty or market disruption, as is common among traditional banking entities.[5]

TIAA-CREF believes that the Proposals' failure to take into account the fundamental differences between insurance and banking will harm the macro-economy as well as the insurance industry, thereby hindering the FRB and FSOC in their efforts to promote financial stability and economic growth. Because the Basel capital framework focuses substantially on assets (rather than a more holistic approach that recognizes the value of stable liabilities or financing concerns), the Proposals do not consider the importance of matching duration of assets and liabilities on an

[4] See TIAA-CREF Letters available at: http://www.federalreserve.gov/SECRS/2011/November/20111116/ICP-201114/ICP-201114_110111_88449_343583382755_1.pdf; http://www.federalreserve.gov/SECRS/2012/May/20120517/R-1438/R-1438_043012_107245_506832527948_1.pdf; http://www.federalreserve.gov/SECRS/2011/April/20110413/ICP-201102/ICP-201102_041111_69324_570978081157_1.pdf; and http://www.federalreserve.gov/SECRS/2011/June/20110609/OP-1416/OP-1416_052311_73348_509124981536_1.pdf.

[5] This strength is particularly evident in periods of market disruption or with regard to less liquid assets where insurance companies do not contribute to the downward pressure on asset prices created by the short-term liquidity needs of other types of investors.

insurer's balance sheet. To ignore the fundamental importance of this concept is to ignore the most important element of insurer risk management.

The fundamental differences between insurance and banking have been addressed on multiple occasions by the International Association of Insurance Supervisors ("IAIS"). In its May 31, 2012 consultation document which proposed a methodology to assess the systemic risk of insurance companies, the IAIS stated, "insurers vary widely from banks in their structures and activities and consequently in the nature and degree of risks they pose to the global financial system."[6] The IAIS identified several differences between insurance and banking including: (a) insurers use a predominantly liability-driven investment approach; (b) insurance rests on the pooling of risks and probability theory; and (c) the nature of insurance claims result in cash outflows that are likely to occur over an extended period.[7] Importantly, the IAIS stated insurance underwriting risks generally are "not correlated with the economic business cycle. The nature of insurance liabilities, and the fact that payments to policyholders generally require the occurrence of an insured event, makes it less likely for insurers engaged in traditional activities to suffer sudden cash runs that would drain liquidity."[8]

For insurance companies, a key concern is solvency and the ability to pay policyholders over long periods. Premiums are collected in advance and invested ahead of anticipated claims, insurers have relative predictability of those claims, and products have safety mechanisms such as surrender charges to protect against early liquidity demands.[9] Unlike banks, which typically are funded by immediately payable deposits, insurers have longer-term liabilities and therefore find that longer-term assets, even those with higher short-term volatility, can often pose less risk and be a key component to the long-term viability and financial strength of an insurer. Corporate debt securities represent the largest component of life insurer assets, with life insurers holding approximately $1.7 trillion in fixed income securities at the end of 2010.[10] For insurance companies, in light of their defined liability structure, these substantial holdings of fixed income securities are risk-mitigating, rather than risk-enhancing.

Insurance companies maintain significant reserves against policyholder obligations that are taken into account in determining equity capital. Insurance companies generally do not have large

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[6] IAIS, Globally Systemic Important Insurers: Proposed Assessment Methodology, 11 (May 31, 2012) (www.iaisweb.org/view/element_href.cfm?src=1/15384.pdf) ("IAIS Report").

[7] Id. 8-9.

[8] Id. 8-9.

[9] In the case of TIAA, a majority of our annuity contracts only allow transfers out of the fixed annuity backed by TIAA's general account to other investment options over a period of several years.

[10] ACLI Investment Bulletin, "Invested assets portfolio profile year end 2011." (Aug. 2012) (data from NAIC annual statutory filings).

lending portfolios and thus do not maintain significant loan loss reserves.[11] Unless such differences are considered in calculating regulatory capital, the use of bank-centric standards will discourage conservative insurance company reserving in favor of maintaining bank-centric regulatory capital based on a regulatory model that does not consider the Insurance-centric SLHCs insurance activities and risks, an outcome that would have both negative safety and soundness and macro-prudential consequences. The existing National Association of Insurance Commissioners ("NAIC") insurance company risk-based capital framework utilized by insurance supervisors ("NAIC RBC") accounts for these types of risks, whereas bank-centric capital standards do not.

Bank-centric metrics will not provide regulators with the information they need regarding the capital and long-term solvency of Insurance-centric SLHCs. Indeed, we believe the application of bank-centric capital standards to the business of insurance is not relevant to either the FRB's macro-prudential responsibilities or its micro-prudential supervisory responsibilities for Insurance-centric SLHCs and will likely lead to unintended and inappropriate results. NAIC RBC and life insurance enterprise risk management focus on the solvency of the insurer and the matching of assets to liabilities over the long-term. Insurance regulators require insurers to conduct regular stress tests using conservative assumptions to test insurance company reserves in the context of insurers' long-term liabilities. Bank-centric metrics focus on short-term events and will not accurately reflect an insurer's solvency. More specifically, bank capital standards focus primarily on equity capital, not adequacy of reserves, and lending activities and related regulatory capital considerations.

NAIC RBC, along with other regulatory tools, has proven effective in limiting insolvencies and preserving financial strength, as was highlighted during the recent financial crisis. According to the FSOC's 2011 report, just 28 of approximately 8,000 insurers became insolvent in 2008 and 2009.[12]

B. <u>Implications of differences</u>

Business and risk model diversification is an important element in reducing systemic risk and actions that increase the correlation of different companies' business and risk models will tend to increase systemic risk.[13] By creating incentives that encourage synchronization of the banking

[11] <u>See</u> footnote 35 below.

[12] FSOC, *2011* <u>Annual Report</u>, 61. The FSOC 2011 Annual Report (at 58) also states that: "as the crisis has unfolded, 370 bank and thrift failures occurred through June 30, 2011, or 4.5 percent of institutions operating at the beginning of 2008." During that same time 0.35% of insurers became insolvent.

[13] This was seen in the period leading up to the financial crisis as common business models relying on risk management models with common assumptions regarding the mortgage and securitization markets led to overly aggressive pricing and lending standards and as a consequence significantly higher losses and market disruption during the financial crisis. <u>See</u> International Monetary Fund, <u>Chapter 3, The Reform Agenda: an interim report on progress toward a safer financial system</u>, 5 (Oct. 2012) ("In a ***common pattern*** before and, in some cases, during the global crisis, banks used structured investments and proprietary trading to generate additional return ("alpha") at

and the insurance investment and risk management models, the Proposals will act to increase their correlation and will reduce systemic resiliency. At the same time, the incentives created by the Proposals act as a disincentive in the credit transmission mechanism, and for insurers specifically they create a disincentive to invest in a variety of asset classes that promote long-term economic growth such as long-term corporate bonds, project finance and infrastructure investments, commercial real estate loans and alternative asset classes such as timber. The presence of insurance companies traditionally has been greatest in the bond and mortgage markets. As demonstrated by the table and charts in Exhibit A, insurers are significant investors in these asset classes and types of investments and manage a sizable portion of all financial assets held by intermediaries in the United States. Further, economic research shows that these financial investments are correlated with increased economic activity and that shifts away from these investments will result in a reduction in credit allocation, long-term investment and economic growth.[14]

Similarly, withdrawal of Insurance-centric SLHCs from the business of banking would increase systemic risk and have negative consequences to the economy. Over the past several decades, consolidation in the banking sector has been rapid with the market share of the top ten banking organizations (as measured by total deposits) increasing from 29.8% in 2000 to 43.4% in 2008.[15] The financial crisis only has served to accelerate this trend with the top ten banking organizations now having over a 50% market share of total deposits and the top five organizations having a more than 41% share of total deposits.[16] The insurance sector represents one of the few industries that can provide new competition in banking services and financial intermediation, both directly and through thrift subsidiaries, and decrease systemic reliance on the five largest banking organizations. Such competition is one element of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA")'s approach for mitigating the "too big to fail" problem highlighted by the financial crisis.[17]

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the cost of a rise in "tail-risk" – the risk of rare but catastrophic events. A realization of such risk is likely to bring about long-lasting bank distress." [citations omitted, emphasis added]).

[14] King, Robert G. and Ross Levine, "Finance Entrepreneurship and Growth, Theory and Evidence," Journal of Monetary Economics, (Sept. 1993).

[15] Adams, Robert, "Consolidation and Merger Activity in the United States Banking Industry from 2000 through 2010," Finance and Economics Discussion Series, Division of Research & Statistics and Monetary Affairs, Federal Reserve Board. 22, Table 3 (Aug. 2012).

[16] American Banker, "Banks and Thrifts with the Most Deposits on March 31, 2012," American Banker website; and FDIC Quarterly Banking Profile Volume 6, No. 2, 5 (2012).

[17] See Section 622 of DFA and the analysis in the FSOC "Study & Recommendations Regarding Concentration Limits on Large Financial Companies," (Jan. 2011) (www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf).

History has shown that the insurance industry does not experience the same level of insolvencies as the banking industry. In comparing the financial condition of the U.S. banking system and the U.S. insurance industry, the fundamental differences in their structure, regulation and investment practices help to explain why they perform differently during cyclical downturns. As we have discussed, banks primarily manage short-term liabilities, whereas insurance companies primarily manage longer-term liabilities such as life policies and group annuities. This liability structure allows insurers to invest at fixed rates and not assume significant interest rate mismatch risk. This is very different from banks whose fundamental intermediation function is to collect short-term deposits from investors and lend these funds for a longer-term to borrowers.

Likewise, the very structure of the U.S. banking system and its focus on lending makes it very difficult for any but the few largest banks to diversify their investments by sector and geography and thereby lessen their vulnerability to regional economic cycles. Insurance companies affiliated with Insurance-centric SLHCs, by contrast, are national in scope and hold far more geographically diversified assets in all asset classes, from commercial and residential mortgage loans to corporate bonds. Banks not only are less geographically diversified than insurers, but they also concentrate their investments in fewer and historically higher-risk investment classes. For instance, whereas banks concentrate their lending in highly cyclical credit cards, auto and short-term real estate lending, insurers invest primarily in longer-term commercial mortgages granted on income-producing properties that are well leased and generally have high loan-to-value ratios. With this income and value cushion, the property value must deteriorate significantly before the insurer would suffer a loss. This difference in lending quality between insurers and banks is borne out by the relatively low delinquency rate on insurance company commercial mortgages, as compared to the much higher rate of delinquency experienced by banks. In another example, whereas banks aggressively pursued lending in highly leveraged transactions, insurers followed more conservative investment practices.

One important lesson insurers have learned from the widespread failures in the banking industry is the false security and even weakness caused by reliance on FDIC insurance of deposit funds, which muted the discipline and selection mechanisms of the market and burdened the public and the conservative, stronger banks with the task of bailing out the most aggressive failed banks. The consensus among insurers is that it is not healthy to rely on guaranty funds. In fact, it has been argued that it is the issue of "moral hazard" related to rising amounts of FDIC insurance per account and deregulating the industry that heavily contributed to the increase in risk-taking before the financial crisis. These are lessons that the insurance industry and its regulators have internalized and are reflected in their traditional practices and new rules made since the financial crisis.[18]

[18] Insurers have long been prohibited from advertising the existence of guaranty funds in contrast to banks being required to disclose their FDIC insurance on every advertisement. See N.Y. Ins Law § 7718 ("No person, including an insurer, agent or affiliate of an insurer and no broker shall make, publish, disseminate, circulate or place before the public, or cause directly or indirectly, to be made, published, disseminated, circulated or placed before the public, in any newspaper, magazine or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio station or television station, or in any other way, any advertisement, announcement or statement which uses the existence of the corporation for the purpose of sales, solicitation or inducement to purchase any form of insurance") in contrast to 12 C.F.R. § 328.3(c) (each insured depository institution "shall include the official

## III. Proposed timing for SLHCs to comply with new standards is insufficient

We share the concerns expressed by the Financial Services Roundtable, the American Council of Life Insurers ("ACLI") and other industry associations that the Proposals would require all SLHCs, regardless of size, to meet new minimum capital requirements beginning January 1, 2013.[19] Putting aside for the moment the numerous reasons why applying such metrics to Insurance-centric SLHCs will undermine the very results the FRB is trying to achieve, the FRB itself has acknowledged that certain Insurance-centric SLHCs will require a transition period to build a second accounting system to produce requisite financial reporting and to produce information required to calculate the proposed ratios. The FRB's decision to reverse course now is an error and should be reconsidered.

TIAA-CREF appreciates the flexibility the FRB and our designated Reserve Bank, the Federal Reserve Bank of Boston, have shown as they have assumed supervision for our SLHCs pursuant to Section 312 of DFA. When the FRB began the process of implementing its new supervisory authority over SLHCs, it noted in its April 2011 Notice of Intent that it was considering applying to SLHCs capital and leverage requirements applicable to bank holding companies ("BHCs") "*to the extent reasonable and feasible* taking into consideration the unique characteristics of SLHCs and the requirements of HOLA."[20] In Supervisory Release 11-11, the FRB expressed the view that it would take time for the FRB to understand better SLHCs' business models and operations and that it would take SLHC management time "to make operational changes in response to the Federal Reserve's supervisory expectations."[21] At the same time, the FRB recognized that "SLHCs have traditionally been permitted to engage in a broad range of nonbanking activities that were not contemplated when the general leverage and risk-based capital requirements for BHCs were developed."[22] Similarly, in exempting certain Insurance-centric SLHCs from many of the BHC reporting requirements, the FRB stated that SLHCs, particularly SLHCs that are insurance companies "could not develop reporting systems to comply with the Federal Reserve's existing reporting requirements within a reasonable period of time or without incurring inordinate expense."[23] While the FRB also advised that it would require consolidated

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advertising statement prescribed in § 328.3(b) in all advertisements"). Likewise, insurance regulators' post-crisis restrictions on insurers' security lending activities continue their focus on restricting the risks that insurers are permitted to take. See N.Y. Ins. Dept. Circular Letter No. 16 (2010).

[19] The reporting for compliance with these new capital standards would begin with the March 31, 2013 FR Y-9C filing.

[20] Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies, 76 F.R. 22,662, 22,665 (Apr. 22, 2011). (emphasis added).

[21] FRB Supervisory Release 11-11 (Jul. 21, 2011)(www.federalreserve.gov/bankinforeg/srletters/sr1111.pdf).

[22] 76 F.R. at 22,665 (Apr. 22, 2011).

[23] 76 F.R. 53,133 (Aug. 25 2011).

reporting in the future, TIAA-CREF reasonably believed that the FRB would afford SLHCs a reasonable period to build the systems necessary to comply with the BHC reporting requirements. In the absence of guidance from the FRB to the contrary, TIAA-CREF has engaged in planning based on our understanding that the FRB's comments recognizing the difficulties Insurance-centric SLHCs would have in building the appropriate systems meant that the FRB would conform its implementation date to the specific effective date for SLHC capital standards set forth in the Collins Amendment to DFA of July 21, 2015.

Simply put, the FRB is now asking Insurance-centric SLHCs that have not been previously subject to consolidated capital requirements to do the impossible. Even if an Insurance-centric SLHC had begun to re-engineer its operations, its compliance systems, its accounting management information systems ("MIS") and its basic capital structure in December 2011,[24] it is unlikely that such work could be completed on time to meet the deadline set forth in the Proposals. Nevertheless, the FRB is now proposing that an insurance group that has heretofore not been subject to U.S. Generally Accepted Accounting Principles ("GAAP") financial reporting or consolidated capital requirements and for which the affiliated savings association constitutes a relatively small percentage of total group assets will somehow be able within a matter of months to comport with bank-centric capital requirements. In addition to never before being subject to consolidated capital requirements, as is the case with all SLHCs, Insurance-centric SLHCs do not engage in a substantial amount of traditional banking activities and therefore have not designed their MIS and other compliance systems to collect and aggregate the types of information necessary to calculate and report regulatory capital ratios on a consolidated basis. Indeed, the financial reporting for BHCs never considered appropriate reporting for the business of insurance and therefore the assumptions underlying its design are inappropriate for supervising an Insurance-centric SLHC.[25]

The Proposals do acknowledge, however, the need for time to transition to new standards, stating:

> [t]his NPR includes transition arrangements that aim to provide banking organizations sufficient time to adjust to proposed new rules and that are generally consistent with the transitional arrangements of the Basel capital framework.[26]

Indeed, the Proposals contain numerous transition periods for banks to comply with changing capital and leverage ratios. Implicit in these transition periods is an understanding that the higher

[24] Agency Information Collection Activities Regarding Savings and Loan Holding Companies: Announcement of Board Approval Under Delegated Authority and Submission to OMB, 76 F.R. 81,933, at 81,936 (Dec. 29, 2011).

[25] For example, on the FR Y-9C report, most of a life insurer's reserves for policies in force are reported as a summary entry on Schedule HC-I (BHCK B994) that is included in Schedule HC-G as "other" (BHCK B984) which in turn is included in Schedule HC as "other liabilities" (BHDM 2750). No granularity regarding insurance reserves is reported - not even a breakdown between annuity and life insurance reserves.

[26] 77 F.R. at 52,798 (Aug. 30, 2012).

levels of capital will require changes to existing business practices. The recognition that banks need time to adapt to changing requirements makes it all the more unreasonable that the FRB would not afford similar consideration to SLHCs, especially those that are insurance companies.

Congress clearly has articulated its intent to afford SLHCs until 2015 to come into compliance with FRB capital standards. Section 171(b)(4)(D) of DFA (part of the "Collins Amendment") provides that SLHCs should not be subject to consolidated minimum capital requirements until five years after the enactment of DFA or July 21, 2015. The language of Section 171(b)(4)(D) is essentially identical to the language of DFA Section 171(b)(4)(E) which affords U.S. BHCs that are subsidiaries of foreign banking organizations and rely on the Board's Supervision and Regulation Letter SR 01-01 ("SR 01-01 Entities") until July 21, 2015, to comply with the Proposals' capital requirements. The FRB offers no rationale for the disparate treatment between SLHCs and SR 01-01 Entities, nor does there appear to be any justification for doing so. Section 171(b)(4)(D) highlights Congressional recognition that because SLHCs never before have been subject to consolidated capital requirements, they require an extended period of time to bring themselves into compliance with the generally applicable minimum capital requirements contemplated by the Collins Amendment. The analysis is precisely the same for section 171(b)(4)(E), as SR 01-01 Entities are not subject to consolidated capital requirements in the United States, and therefore require a similar extended transition period. Because SLHCs and SR 01-01 Entities are similarly situated, it is unsurprising that the language of sections 171(b)(4)(D) and 171(b)(4)(E) are almost precisely the same. Given Congress's clear intent to provide for similar transition periods for both classes of institutions, it is disconcerting that the FRB arbitrarily has chosen to afford one class the benefit of the plain language of the Collins Amendment, but not the other. Moreover, there is no pressing policy reason to accelerate implementation. Indeed, accelerated implementation will itself create prudential implementation risks.

A second, perhaps more important component of the timing issue are the substantive accounting decisions that must be made as a result of applying an entirely new reporting and associated capital regime (i.e., GAAP) to insurance companies, made all the more difficult by the fact that GAAP was never designed to assess the solvency, safety and soundness of insurance companies. The FRB has acknowledged that some insurance companies that are SLHCs have never utilized GAAP to prepare their financial statements. This includes TIAA, which currently utilizes Statutory Accounting Principles ("SAP") to prepare its financial reports. There are numerous differences between the two accounting systems, the most notable of which is that SAP focuses on insurer solvency whereas GAAP focuses on an organization's earnings. Further, we believe such differences are not relevant to the assessment of capital adequacy due to the conservative nature of SAP.[27]

There are numerous substantive accounting policy decisions associated with insurers implementing this new regime that will require analysis and will affect an insurance company's

[27] Indeed, many of the differences between SAP and GAAP involve adding intangible assets to the balance sheet under GAAP that are not recognized as admitted assets under SAP, particularly goodwill and deferred tax assets. Under the Proposals, both goodwill and the deferred tax assets not recognized under SAP are deducted from common equity in determining Tier 1 capital, thus adjusting GAAP capital back to what it was under SAP.

business and investment decisions. Given the number of important decisions that will have to be made regarding appropriate accounting treatment, it is unreasonable to believe that this transition could be accomplished within the proposed timeframe. This is not simply a matter of devoting funds and resources to meet the proposed deadline because, even with unlimited resources, the operational work associated with such a drastic change could not be prudently accomplished in the time afforded by the Proposals.

## IV. Alternative approaches to address capital standards for insurance activities

We believe that the Proposals are significantly flawed when applied to Insurance-centric SLHCs. As discussed above, the business of insurance is fundamentally different than the business of banking. Beginning in 2002, FRB staff recognized the difficulties associated with attempting to "fit" insurers into the BHC model of capital regulation, noting in a 2002 joint report of FRB staff and the NAIC ("2002 Joint Report") that the different capital approaches used by the regulators of insurance companies and banks reflect the "inherent differences between the insurance and banking industries."[28] The different capital approaches "arise from fundamental differences between the two industries, including the types of risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities."[29]

The appropriate capital standards to apply to insurance activities need to address the true risks of the business of insurance. The existing NAIC RBC regime successfully has addressed these risks on an integrated basis. NAIC RBC is functionally equivalent to the Basel bank capital regime in addressing credit risk and under DFA remains the recognized standard for regulatory actions regarding insurance activities.[30] Accordingly, the Proposals' incorporation of an insurance regulatory capital deduction without considering the assets that support the insurance business is especially inappropriate. The Agencies have the necessary flexibility under their statutory mandates to implement a more appropriate capital regime for insurance activities that does not risk increasing systemic risk and recognizes the fundamental economic differences between insurance and banking. Indeed, such an approach would make the Proposals more consistent with the guidance of the recently released "Principles for the supervision of financial conglomerates" which state "[s]upervisors should apply every effort to avoid creating undue burden through duplication and conflicts between the sectoral standards applied at the conglomerate level."[31] Below we outline two alternatives the Agencies should consider to address these concerns.

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[28] Report of the NAIC and the Federal Reserve System Joint Subgroup on Risk-based Capital and Regulatory Arbitrage. 1 (May 24, 2002).

[29] 2002 Joint Report. 3.

[30] See section 313(k) of DFA continuing the primacy of state regulation of insurance companies.

[31] The Joint Forum: Basel Committee on Banking Supervision, International Organization of Securities Commissions, and International Association of Insurance Supervisors, Principles for the supervision of financial conglomerates, 5-6 (Sept. 2012) (www.bis.org/publ/joint29.pdf).

1. <u>Fundamental Differences Affect the Goals of Capital Standards</u>

Based on the fact that the business of insurance is fundamentally different from the business of banking, the goals of capital standards for insurance companies appropriately vary from those for banks. Insurance products serve very different consumer financial needs than those served by banking products. Insurance products address policyholders' long-term savings and asset protection goals, which are profoundly different than the short-term cash investment objectives of bank depositors. In many cases, the insurance products into which policyholders pay premiums carry with them withdrawal restrictions or are non-cashable. Thus, insurance liabilities exhibit stability and relative illiquidity that fundamentally differentiate them from bank deposits and the insurance regulatory goal of consumer protection leads to a focus on long-term solvency.

Unlike bank deposits, insurance liabilities do not put the FDIC insurance fund at risk. The separate state-based resolution regime for insurance has been maintained under DFA.[32] This state-based regime consists of industry funded guaranty funds and, as a result, prevents the federal government from needing to provide a backstop for policyholder obligations. Because the guaranty funds are funded by the industry itself and the failure of one insurer is borne by the entire industry, guaranty funds create an industry-wide incentive for insurers to monitor the effectiveness of the capital rules to which they are subject. This backstop often goes unnoticed and is little known among consumers because insurers are prohibited from publicly discussing or marketing these protections. Nonetheless, such protections provide a significant mitigant to the systemic risk posed by insurers.

Like the prompt corrective action regulations that use bank capital ratios to trigger supervisory action,[33] NAIC RBC, as enacted through state laws consistent with the NAIC Risk-Based Capital for Insurers Model Act, sets triggers for insurance supervisors to take parallel supervisory actions.[34] The model law creates four action levels under which certain company and regulatory remedial actions are required if capital falls below certain specified NAIC RBC percentages, with progressively more severe actions required at the lower capital levels, up to and including mandatory supervisory seizure of control of an insurer.

The four levels are Company Action Level, Regulatory Action Level, Authorized Control Level and Mandatory Control Level. The action levels are determined by comparing an insurer's total adjusted capital to its authorized control level risk-based capital.

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[32] <u>See</u> section 203(e) of DFA.

[33] Section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o); 12 C.F.R Part 325 subpart B (FDIC regulations); 12 C.FR. Parts 6 and 165 (OCC regulations).

[34] <u>See</u> N.Y. Ins Law §1322 implementing the model law in New York.

a. Company Action Level. An insurer with total adjusted capital of 150 to 200% of authorized control level NAIC RBC triggers the Company Action Level, under which the insurer must submit to the insurance commissioner a comprehensive NAIC RBC plan that identifies the conditions that contributed to the insurer's financial condition and its proposals for corrective action.

b. Regulatory Action Level. When an insurer's total adjusted capital is 100 to 150% of authorized control level NAIC RBC, the commissioner will require submission of an NAIC RBC plan, and also is required to examine the insurer and issue a corrective order specifying required corrective actions.

c. Authorized Control Level. If an insurer's total adjusted capital falls between 70 to 100% of the authorized control level NAIC RBC, the Authorized Control Level is triggered, under which the commissioner is authorized to place the insurer in rehabilitation or liquidation.

d. Mandatory Control Level. Total adjusted capital of less than 70% of authorized control level NAIC RBC triggers the Mandatory Control Level and requires the commissioner to place the insurer in rehabilitation or liquidation.

Two of the primary functions of capital standards for financial institutions are: (1) to set triggers for supervisory action leading up to and including liquidation/resolution and (2) to protect consumers and applicable guaranty funds from loss. For insurance activities in the United States, the relevant and well functioning capital standards for insurance company resolution and policyholder and guaranty fund protection are those established by NAIC RBC.

2. NAIC RBC Right for Insurance Companies

NAIC RBC and related accounting and reserving requirements have been developed over time to address the risks inherent in the business of insurance. They are based on insurance accounting reserves. This is important since such reserves act as a deduction from Tier 1 capital and are not considered within the context of the Proposals unlike loan loss reserves of banks.[35] Under SAP used to calculate NAIC RBC, both assets and liabilities are valued conservatively, resulting in a conservative measure of capital surplus as the model is designed to mitigate any insurance industry systemic risk by promoting individual insurance company solvency standards.[36]

[35] Even when engaged in holding similar assets, insurance companies and banks may utilize different accounting. For example, an insurance company under general U.S. GAAP guidance of ASC 310 will carry mortgage loans held for investment at outstanding principal, adjusted for premium/discount (if applicable) and net of any credit charges or loan loss reserves. In contrast, mortgage banking entities under ASC 948, report loans held for sale at lower of cost or market net of a valuation allowance which is the deficit of market value to cost.

[36] See 2002 Joint Report. 16 ("A main focus of insurance company solvency regulation is the adequacy of technical provisions (reserves reported as liabilities in statutory financial statements). For life and property/casualty insurance companies in the United States, technical provisions for unpaid policy claims are subject to minimum standards (i.e., the reserves must be determined to be adequate to discharge insurance policy obligations. The conservative nature

SAP intentionally avoids application of fair value accounting rules to most life insurance company assets, thereby avoiding unwarranted volatility in regulatory capital, while at the same time recognizing assets whose creditworthiness has been impaired. Such short-term volatility is inappropriate for life insurers who have long-term and inherently stable liability structures. Credit impairments that are other than temporarily impaired ("OTTI") under SAP are recognized and the value of previously impaired assets will remain at the reduced valuation basis.[37]

NAIC RBC provides a comprehensive approach to measure supervisory capital for insurance activities. NAIC RBC for life insurance companies is calculated using a formula that addresses five key risk components:

- C-0 (insurance affiliates and off-balance-sheet items)
- C-1 (asset risk)
- C-2 (insurance risk)
- C-3 (interest rate/market risk)
- C-4 (business risk)

Of these five, asset-related risks are encompassed in the C-0, C-1 and C-3 categories, which measure risks arising from the assets held by the insurance company and its affiliates, including interest rate and market risks associated with the assets held by the insurer and its affiliates.[38] These three components represent in aggregate approximately 75% of the capital charges (pre-covariance adjustments) under the NAIC formula based on 2003 through 2009 aggregate life insurance industry data.[39]

Statistics on the low levels of insurance company failures validate the success of the NAIC RBC approach through and after the recent financial crisis, which is in marked contrast to a higher level of bank failures and the associated high cost to the FDIC insurance fund and the overall affects on the economy during the same period.[40]

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of the margin in technical provisions relative to liability amounts based on best estimate assumptions for life insurers decreases the need for capital to absorb unanticipated losses.").

[37] SSAP 37 and INT 06-07.

[38] These components of the NAIC RBC framework specifically address asset-specific risks and are analogous to the risk-weights assigned under the Basel capital rules for banks.

[39] Exhibit B provides aggregate life insurance industry data for these years and updates the information contained in Exhibit A-2 to the 2002 Joint Report.

[40] See footnote 12. It is important to note that significant Federal intervention was required to prevent the failure of additional banking organizations including several of the largest BHCs during the financial crisis. Only three insurance enterprises participated in the Capital Assistance Program under TARP, in contrast to 705 banking institutions. (source: TARP website)

The NAIC regularly updates and refines its RBC formula to reflect new products and risks faced by insurers. NAIC RBC asset charges were developed from historical actual loss experience over multiple economic cycles. The NAIC (including its various committees) has frequent periodic meetings at which insurance regulators discuss, recommend and adopt changes to the NAIC RBC formula. Leveraging NAIC RBC is a straightforward way for the Agencies to avoid insurers having to manage their businesses under two different capital paradigms, each of which defines its objectives based on industry specific risks, structures and regulatory requirements.

3. Compatibility and Alignment

There exists significant compatibility and alignment between NAIC RBC and the Basel capital frameworks that should be built upon to create appropriate capital standards for insurance-centric enterprises.

a. Comparable comprehensive regimes.

Both NAIC RBC and the Basel capital standards establish comprehensive capital standards for the activities they seek to cover. The Basel standards are nuanced to impose more complex standards on banks that engage in more complex activities and this approach is reflected in the Proposals' application of the advanced approaches requirements to only organizations with over $250 billion in assets or over $10 billion in foreign exposure. Likewise, SAP and NAIC RBC employ reserving methodologies and capital considerations commensurate with the underlying complexity of a company's insurance products and with the goal of policyholder protection. As discussed above, it is inappropriate to establish the scope of coverage of a capital regime without understanding and taking into account the manner in which liabilities are calculated. SAP requires insurance companies to use conservative actuarial calculations to determine the sufficiency of reserves based on stochastic modeling techniques. Deposits and many other liabilities of banks are accounted for at their contractual value, unlike actuarial reserves, which are conservatively modeled for adverse deviation. The Basel bank capital regime focuses heavily on asset/credit risk, whereas NAIC RBC considers both asset and liability risks, and their interactions.

b. Both regimes used as standard for supervisory intervention.

Just as the Basel bank capital standards are used for the bank prompt corrective action triggers, NAIC RBC, through state laws consistent with the NAIC RBC model law, set triggers that grant automatic authority to the state insurance regulator to take specific actions against insurers based on their levels of capital impairment.

c. Misplaced arbitrage concerns.

In the context of an insurance-centric organization, the concern that recognizing differing capital requirements for banking and insurance activities would create regulatory arbitrage opportunities is misplaced. Working in combination, the Basel bank capital standards and NAIC RBC create proper incentives for an organization to book assets in the appropriate legal entity based on their differing liability structures with long-term assets held by the insurance company and short-term assets held by its depository institution affiliate. Without recognizing NAIC RBC, an Insurance-centric SLHC would be disadvantaged versus its non-SLHC insurance company competitors in purchasing appropriate long-term assets to fund its long-term obligations. Indeed, the FRB would be creating differing capital management incentives for FRB regulated SLHC insurance organizations and non-SLHC insurance companies that will lead to market distortions and economically inefficient regulatory-driven transactions. Through its supervision program, the FRB also has transparency into any SLHC that seeks to engage systematically in regulatory arbitrage and has various supervisory tools that can be utilized to address this risk should it arise.

4. Consequences of Misapplied Standards

a. Capital standards intended to create incentives.

Regulatory capital regimes are intended to create incentives to operate financial institutions in a prudent manner, but different incentives are appropriate for insurance companies and banks. The NAIC RBC regime encourages the matching of cash flows, and in general seeks to have long-term insurance liabilities balanced by holdings of long-term low credit risk assets. The Basel capital regime focuses on minimizing the costs of a rapid liquidation of banking organizations during a period of economic crisis in order to protect depositors and governmental guaranty funds. Thus, the Basel regime as implemented in the United States assumes all liabilities are immediately due and payable, and generally assesses relatively higher capital charges against obligations of private sector non-bank obligors regardless of quality or maturity.[41] The Basel regime, as implemented by the Proposals, encourages the holding of short-term government and agency securities (0% risk-weight), funding of the interbank credit market (20% risk-weight) and discourages the holding of long-term corporate obligations (100% risk-weight) and commercial mortgages (100 – 150% risk-weight). Similarly, the Basel regime recognizes the value of bank and governmental guarantees by lowering the risk-weight of guaranteed assets (a 100% risk-weighted asset becomes a 20% risk-weighted asset), but fails to provide comparable treatment to insurance company guarantees/insurance contracts which are treated as having no value (a 100% risk-weighted asset remains a 100% risk-weighted asset even though guaranteed by an insurance company). Given its focus on banks' inherently short-term financing activities, it is not surprising that the Basel regime encourages unsecured consumer and small business lending, which tend to be floating rate and short-term, yet with historically higher related default rates and credit losses relative to high quality corporate lending/debt.[42] Indeed, the inclusion of loan loss reserves in Tier

[41] Basel II and Basel III give national regulators the ability to recognize lower risk-weights for highly rated corporate obligators including insurance companies, however, the Agencies have chosen not to recognize this higher level of risk granularity. See Basel Committee on Supervision, International Convergence of Capital Measurement and Capital Standards. at paragraph 66 (June 2006) ("Basel II Revised Framework").

[42] See Charge Off and Delinquency Rates on Loans and Leases at Commercial Banks, Board of Governors of the Federal Reserve System. (www.federalreserve.gov/releases/chargeoff/chgallsa.htm) (last updated Sept. 5, 2012).

2 capital to an extent rewards higher risk lending and its related required reserving as long as the organization's reserves in aggregate do not exceed 1.25% of total risk assets.[43]

b. Wrong for insurance, wrong for the economy.

Bank standards would force insurers to change their behavior in ways that hurt their profitability, reduce consumer choice and negatively impact the availability of long-term credit.[44] The Basel standards would encourage investment in illiquid subordinated loans over publicly-traded senior debt securities because there is no recognition of relative risk. Yet under GAAP, only the senior debt would be recorded at fair value with unrealized loses affecting capital. Similarly, to avoid the unwarranted volatility of mark-to-market adjustments, insurers will be encouraged to invest in short-term securities (e.g., T-bills); even though longer-term fixed income investments typically are a better economic match for longer-term liabilities. As a result, the Proposals would tend to increase insurers' exposure to interest rate risk – a mismatch of long-term liabilities with short-term assets.

These incentives to avoid long-term and non-governmental exposures will tend to place insurance guaranty funds and policyholders at risk, without a corresponding supervisory benefit. Policyholders are contracting with an insurer for long-term savings and/or asset protection and are specifically seeking to benefit from an insurer's ability to invest with a longer time horizon and thereby attain higher relative yield, or in the case of asset protection products, lower cost. By discouraging long-term investments, the Proposals ultimately would increase consumers' costs and reduce their returns. Application of the Basel capital regime to the business of insurance is likely to lead to increased macro-prudential risk and potentially significant harm to both consumers and the economy.

Assigning a 100% risk-weight to all corporate bonds may be an appropriate simplification for banks that typically hold relatively few corporate bonds. For insurers, however, the 100% risk-weight significantly overstates the probability of loss on these assets. Moreover, insurers' corporate bond holdings (primarily investment grade) are often among their largest holdings

[43] Measuring this limitation against total risk-weighted assets rather than total loans creates the opportunity for higher risk lending with commensurate higher reserving to inflate Tier 2 capital for banks with a significant proportion of risk assets generated from non-lending activities.

[44] We are already seeing how the conflicting goals of NAIC RCB and the Basel bank capital rules will change our investment process. The Proposals will add not just a new leverage constraint and associated 4% minimum capital charge into our asset allocation modeling process, but also a bank-centric second risk-based capital constraint. This layering of conflicting constraints will change our investment decisions in a manner that reduces our participants' returns, increases risk (particularly increasing the interest rate gap) and reduces long-term investments in the U.S. economy. The regulatory capital charge associated with making an investment is a key factor considered by our investment managers in determining whether to make an investment and under the Proposals this charge is fundamentally changed and consequently their behavior will change.

precisely because of insurers' ability to match the cash flows from these assets to their long-term liabilities.

5. Equivalency and Calibration Solution

We believe that the Agencies should modify the Proposals to recognize that the business of insurance has different economic characteristics and serves different economic purposes than the business of banking and, accordingly, should be measured through capital standards designed to create appropriate incentives and standards for the business of insurance. We strongly support the use of an equivalency and calibration approach for calculating insurance related risk assets of Insurance-centric SLHCs. We believe that the NAIC RBC should be viewed as equivalent to the Basel regime of bank risk-based capital in comprehensively addressing on and off-balance sheet risk and that through calibration of required capital can be incorporated into a consolidated risk-based capital requirement for Insurance-centric SLHCs. As discussed below, we believe that the Collins Amendment and the Agencies' June 28, 2011 final rules implementing the risk-based capital floor ("June 2011 Rulemaking")[45] provide the Agencies with adequate authority to incorporate NAIC RBC into the SLHC capital adequacy framework. Further, such an approach (i.e., to in effect recognize an "insurance book" in addition to the trading and banking books) is entirely consistent with the Basel II and III framework.[46]

a. Holistic approach.

We believe the definition of generally applicable risk-based capital requirements of DFA Section 171(a)(2), which sets a floor for SLHC risk-based capital standards, requires the FRB to determine holistically that the capital, risk-weighted assets and required capital ratios are not less than under the risk-based capital standards applicable to depository institutions. The requirement of DFA Section 171(b)(2) setting the "generally applicable risk-based capital requirements" floor does not require an asset-by-asset testing of risk-weights, but instead speaks to a "numerator" of capital, a "denominator" of risk-weighted assets and a ratio of the two. The Collins Amendment does not require asset-by-asset nor exposure-by-exposure minimum requirements, but instead calls for holistic floors.

b. Precedent for holistic Collins determination.

Under the June 2011 Rulemaking, the Agencies stated that they "anticipate performing a quantitative analysis of any new capital framework developed in the future for purposes of ensuring that future changes to the agencies' capital requirements result in minimum capital requirements that are not "quantitatively lower" than "generally applicable" capital requirements for insured depository institutions in effect as of the date of enactment of the Act." Since the

[45] 76 F.R. 37,620 (June 28, 2011).

[46] See paragraphs 30, 33 and 34 of the Basel II Revised Framework. Under Basel II, assets and liabilities of insurance subsidiaries are deducted and an adjustment to bank capital may be made to reflect the surplus capital in the insurance subsidiary (e.g., the capital in excess of insurance regulatory requirements that is available to be transferred to the parent company) with this residual capital risk-weighted as an equity investment.

Agencies have proposed several reductions in risk-weights for particular assets or off-balance sheet items under the Proposals (e.g., lowering the risk-weight assigned to certain residential mortgages from 50% to 35% and creating incentives for swaps cleared through clearinghouses), the Agencies presumably already have performed or intend to perform such holistic quantitative analysis and could use such an approach to analyze incorporating NAIC RBC into the Basel framework.

c. Equivalency of scope and coverage.

The facts demonstrate that the NAIC RBC is a comprehensive capital regime for insurance activities and in its components of regulatory capital, assigning risk-weights to assets and activities, addressing credit risk, and requiring maintenance of a ratio of capital to asset charges is equivalent in scope and coverage to the Basel requirements.

d. Two alternative approaches to calibration and incorporation of NAIC-RBC into the Proposals.

We believe the Agencies should strongly consider two alternatives to the Proposals' treatment of insurance activities.

1. Deduction and Calibration Alternative. The first is to follow the approach agreed to in Basel II and Basel III and deduct both the capital and assets of insurance subsidiaries. The FRB could then hold these insurance subsidiaries to a prudent level of capital in excess of insurance regulatory minimums with such a standard measured in terms of NAIC RBC. This approach would be consistent with the "not qualitatively less than" requirement of the Collins Amendment since under the Agencies' risk-based capital standards in effect on July 21, 2010, each Agency reserved the right at its discretion to deduct the capital and assets of any subsidiary from the calculation of bank level risk-based capital.[47] Likewise, the "not less than" test of the Collins Amendment would be satisfied by applying this deduction equally to both bank- and holding company-owned insurance company subsidiaries. The resulting standard would remain "on a consolidated basis" since the capital deduction would be part of the numerator calculation and the asset deduction would be part of the denominator calculation for determining a SLHC's capital ratios. Such an approach is identical to the treatment for other assets that are deducted from consolidated capital under the Proposals and still satisfy the "consolidated basis" standard of the

[47] See 12 C.F.R. Part 208 Appendix A, Section II.B.ii. (FRB Regulation H); 12 C.F.R. Part 3, Appendix A, Section 2(c)(7)(i) ("*Deductions from total capital.* The following assets are deducted from total capital: (i) Investments, both equity and debt, in unconsolidated banking and finance subsidiaries that are deemed to be capital of the subsidiary; and [t]he OCC may require deduction of investments in other subsidiaries and associated companies, on a case-by-case basis"); 12 C.F.R Part 325, Appendix A, Section II.B.3. (FDIC regulations) ("FDIC may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or functional nature of the subsidiaries.").

Collins Amendment.[48] On a preliminary basis, we believe setting an NAIC RBC ratio of 300% as equivalent to the well-capitalized ratios required for banks is appropriate.

This approach solves: (1) the Agencies current situation where the Proposals' treatment of insurance is inconsistent with Basel III as is noted in a recent report of peer international supervisors;[49] (2) the problems for insurers of needing to manage their business to conflicting risk-based capital regimes and (3) the potential harm to the economy of reduced long-term private sector financing.

2. Conversion and Calibration Alternative. The second alternative has been proposed by the ACLI in its comment letter dated October 12, 2012. Under this approach as outlined in Appendix AA to the ACLI's letter, NAIC RBC is used to calculate risk-assets to be included in the SLHC's risk-based capital calculations. This approach incorporates NAIC RBC into the Basel-based rules in a manner that avoids the misalignment of the incentives for managing insurance activities through a quantitative calibration of insurance capital requirements with and into the Basel requirements. Thus, it maintains the numerators of Tier 1 common equity, Tier 1 capital and total capital, and through a calibrated conversion process calculates risk-weighted assets for the denominator and the capital ratio calculations.

e. Consolidated coverage.

Under these approaches only activities conducted under an insurance company would be subject to NAIC RBC and any non-insurance subsidiary of a SLHC not also an insurance company would be subject to Basel capital standards. Likewise, the activities of the thrift subsidiary would remain subject to Basel capital standards. In combination, all activities would be subject to consolidated capital requirements. This eliminates the regulatory gap that led to AIG Financial Products not being subject to regulatory capital requirements.[50] A non-insurance subsidiary of a

[48] See §_____.22 Regulatory capital adjustments and deductions generally deducting items from Tier 1 common equity and subsection (f) treatment of assets that are deducted – "A [BANK] need not include in risk-weighted assets any asset that is deducted from regulatory capital under this section." 77 F.R. at 52,863 (Aug. 30, 2012).

[49] See Basel Committee on Banking Supervision, Basel III regulatory consistency assessment (Level 2) Preliminary report: United States of America, 20 (Oct. 2012) ("Nonetheless, the assessment team has identified a difference in the treatment of insurance subsidiaries that may be potentially material and has listed it for further follow-up analysis").

[50] Indeed, the Financial Crisis Inquiry Report concluded "because of the deregulation of OTC derivatives, state insurance supervisors were barred from regulating AIG's sale of credit default swaps even though they were similar in effect to insurance contracts. If they had been regulated as insurance contract, AIG would have been required to maintain adequate capital reserves, would not have been able to enter into contracts requiring the posting of collateral, and would have not been able to provide default protection to speculators; thus AIG would have been prevented from acting in such a risky manner." The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report, 352 (Jan. 2011) (http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf).

non-insurance company SLHC would be subject to the Basel risk-weighting and consolidated capital requirements under these approaches.

f. Leverage ratio acts as a floor.

Under these proposed approaches, the consolidated leverage ratio requirement of holding 4% Tier 1 capital to average total assets would continue to set a universal capital floor for all SLHC activities, including those conducted through insurance companies.

g. Consistent with DFA Congressional intent.

We believe Congress clearly demonstrated its intent to allow Insurance-centric SLHCs continue to own thrifts throughout the DFA legislative process and in the text of various provisions within DFA. Congress went so far as to instruct "the Federal Reserve [to] take into account the regulatory accounting practices and procedures applicable to, and capital structure of, holding companies that are insurance companies (including mutuals and fraternals), or have subsidiaries that are insurance companies" in determining SLHC capital standards.[51] Congress specifically did not make SLHCs BHCs. DFA left in place the provisions of the Gramm-Leach-Bliley Act, which grandfathered nonbank activities of certain SLHCs, maintained the Qualified Thrift Lender test and maintained the thrift charter. Indeed, as demonstrated by the Volcker Rule insurance exemption, Congress expected insurance companies to own thrifts.[52] In DFA, Congress clearly demonstrated its intent that insurance-centric organizations would continue to own thrifts and offer their customers banking products and services. Unfortunately, FRB oversight as implemented through the current Proposals will make continued ownership of thrifts by insurance organizations economically prohibitive and thereby have done through regulation what Congress, not only did not intend to do by statute,[53] but what it specifically directed the FRB to avoid doing.

h. Limited potential for BHCs to engage in regulatory arbitrage.

We recognize the FRB's historic concerns regarding regulatory arbitrage. The equivalency and calibration approaches do not provide free rein to BHCs to park assets with insurance affiliates to lower their consolidated capital requirements, because they could be tailored to apply to

[51] Senate Report 111-176 at footnote 161 (Apr. 30, 2010) – discussion of Section 616 amending HOLA to clarify the FRB's authority to issue capital regulations for SLHCs where the Committee specifically notes:

> It is the intent of the Committee that in issuing regulations relating to capital requirements of bank holding companies and savings and loan holding companies under this section, the Federal Reserve should take into account the regulatory accounting practices and procedures applicable to, and **capital structure of, holding companies that are insurance companies (including mutuals and fraternals)**, or have subsidiaries that are insurance companies. " [emphasis added].

[52] Section 619(d)(1)(F) of the DFA.

[53] "Dodd-Frank amps insurers for banking exit," SNL Financial (Jul. 11, 2012).

organizations primarily engaged in the business of insurance and then only for activities of regulated insurance companies. In addition, these approaches could include a provision providing the Agencies with discretion to apply the general bank risk-weights to insurance company assets on a case-by-case basis in order to counter identified cases of regulatory arbitrage. We do not believe any BHC or FHC would have an incentive to become primarily engaged in the insurance business in order to take advantage of the differing capital treatment of individual assets under NAIC RBC and the Basel capital standards. Indeed, regulatory arbitrage between these two standards cannot be eliminated for the financial system as a whole unless all regulated and unregulated financial institutions are subjected to a single integrated capital standard. In this regard, we are concerned that insurance companies not subject to FRB oversight will set the market price for insurance products and that the additional capital and other costs imposed by FRB oversight will make insurance products offered by SLHC affiliated insurance companies non-competitive.

6. Insurance Capital Deduction Inappropriate

Irrespective of the equivalency and calibration approaches suggested above, the Proposals' treatment of insurance underwriting subsidiaries, under which they are first consolidated for purposes of determining SLHC risk-weighted assets and then a deduction from Tier 1 and Tier 2 capital (the "Insurance Capital Deduction") is made for the insurance subsidiary's minimum required capital amount (the "Consolidate and Deduct Approach"), is inappropriate.

a. The 2007 Advanced Approaches rulemaking.

FRB staff has pointed to the 2007 Advanced Approaches rulemaking process as demonstrating that the Consolidate and Deduct Approach already has been fully considered and that the FRB is just applying its existing policy to SLHCs.[54] We are troubled by this position given the context and different constituents affected by the rulemaking and by the implication that the principles of stare decicus and collateral estoppel apply to this "policy" decision. Both on process and policy grounds the record underlying the 2007 rulemaking does not support the Insurance Capital Deduction. Our review of the comments the Agencies received on the Advanced Approaches Releases revealed only five comment letters addressing the Consolidate and Deduct Approach with three opposing consolidation. The only letter supporting consolidation was submitted by Citigroup after its spin off of Travelers Insurance, and Citigroup only supported a possible capital deduction for risks such as mortality or morbidity with proxies derived from the NAIC RBC requirements.[55] None of the comment letters supported deducting insurance capital supporting affiliate (C-0), asset (C-1) or interest rate/market risk (C-3).

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[54] The advanced approaches rulemaking process included the 2003 advanced notice of proposed rulemaking [68 F.R. 45,900 (Aug. 4, 2003)], the notice of proposed rulemaking [71 F.R. 55,830 (Sept. 25, 2006)], and the final rule [72 F.R. 69,288 (Dec. 7, 2007)] (collectively, the "Advanced Approaches Releases").

[55] Citigroup Letter (Nov. 3, 2003) (http://www.federalreserve.gov/SECRS/2003/November/20031118/R-1154/R-1154_62_1.pdf ); HSBC North America Holdings Letter (Mar. 26, 2007) (http://www.fdic.gov/regulations/laws/federal/2006/06c50ac73.pdf); The Risk Management Association Letter (Mar. 26, 2007) (http://www.fdic.gov/regulations/laws/federal/2006/06c75ac73.pdf); Bank of America Letter (March 26,

It is not surprising that no insurance companies participated in this highly technical and extended rulemaking process, because the Advanced Approaches Releases, by their terms, would not apply to an insurance organization unless it both had $250 billion in non-insurance assets and was already a BHC. Indeed, the FRB specifically stated that the Advanced Approaches framework was inappropriate to apply to insurance activities.[56] The FRB should re-examine this issue anew in light of the significant effect the Consolidate and Deduct Approach will have on Insurance-centric SLHCs.

In the preamble to the 2007 final rule implementing the Advanced Approaches, the FRB stated, in response to the banking industry comments discussed above objecting to the required deduction of capital held by insurance underwriting subsidiaries, that it:

> [does] not agree that the proposed approach results in a double-count of capital requirements. Rather, the capital requirements imposed by a functional regulator or other supervisory authority at the subsidiary level reflect the capital needs at a particular subsidiary. The consolidated measure of minimum capital requirements should reflect the consolidated organization.[57]

The FRB's policy rationale for the Insurance Capital Deduction differs in the various rulemaking releases associated with the extended Advanced Approaches rulemaking.[58] Starting with the 2002 Joint Report, FRB staff has expressed a view that "it may be appropriate to deduct the insurance company's capital, or at least a portion of capital, not freely available to the holding company before calculating the consolidated capital ratio."[59] Yet even in 2002, over 76% of life insurance capital was understood to be held against risks comparable to those covered under the Basel framework.[60] The concept that capital is somehow maintained at the holding company level

2007) (http://www.fdic.gov/regulations/laws/federal/2006/06c47ac73.pdf); Wachovia Corporation Letter (Mar. 26, 2007) (http://www.fdic.gov/regulations/laws/federal/2006/06c62ac73sup.pdf).

[56] "The final rule continues to exclude assets held in an insurance underwriting subsidiary of a BHC from the asset threshold because the advanced approaches were not designed to address insurance underwriting exposures." 72 F.R. at 69,298 (Dec. 7, 2007).

[57] 72 F.R. at 69,325 (Dec. 7, 2007).

[58] See 68 F.R. 45,907-8 (Aug. 4, 2003)(no mention of regulatory arbitrage, but "[a] deduction would be required for capital that is not readily available at the holding company level for general use throughout the organization."); 71 F.R. at 55,857-8 (Sept. 25, 2006)(again no mention of regulatory arbitrage, but belief that "full deconsolidation and deduction approach does not fully capture the risk in insurance underwriting subsidiaries at the consolidated BHC level..."); 72 F.R. 69,325 (Dec. 7, 2007)(first raising a regulatory arbitrage concern – "it eliminates incentives to book individual exposures at a subsidiary that is deducted from the consolidated entity for capital purposes where a different, potentially more favorable requirement is applied at the subsidiary.")

[59] 2002 Joint report, 11.

[60] Id. Exhibit A-2.

is extremely odd in light of the reality of financial holding company ("FHC"), BHC and SLHC structures, where the vast preponderance of parent company assets are in the form of investments in their subsidiaries. Only in the case of insurance companies is the FRB imposing a penalty for minimum capital requirements of a subsidiary.

Unsurprisingly, the Advanced Approaches Releases assume a typical BHC structure in which insurance companies and banks are sister subsidiaries of a common holding company parent. While such a structure is predominant for BHCs, the structure of Insurance-centric SLHCs is more diverse with most having their thrifts owned under an insurance company that is itself registered as a SLHC and many insurance companies that are SLHCs have insurance company subsidiaries for business or regulatory reasons. This situation is not contemplated in either the Advanced Approaches Releases or the Proposals.

b. Why the Insurance Capital Deduction is inappropriate and discriminatory.

The FRB's position that NAIC RBC does not address credit risk is factually incorrect. As discussed above, for life insurance companies 75% of their NAIC RBC capital requirement reflects risks comparable to those for which capital requirements are applied under the Proposals. Why the FRB has chosen to single out the insurance industry for this draconian deduction appears to be based on regulatory history, rather than considered regulatory policy. All holding company subsidiaries that have minimum regulatory capital requirements are limited in how much financial support they may provide to their parent holding companies. All other types of regulated holding company subsidiaries are consolidated under the Proposals with no required capital deduction. Even though broker-dealers, future commission merchants and most importantly bank subsidiaries are restricted by their respective capital regimes from being able to provide financial support to their parent and/or affiliates when they would fall below regulatory minimums, ONLY in the case of insurance companies has the FRB required a deduction from holding company capital.

If the approach of the Insurance Capital Deduction were to be followed for all BHC regulated subsidiaries, including banks, it would be quite difficult for any existing BHC to satisfy the Proposals' minimum capital standards. Nevertheless, the FRB proposes to apply such a discriminatory deduction to Insurance-centric SLHCs with equally inappropriate results.

Further, the deduction is inappropriate based on the assumption in the FRB's 2007 Rulemaking of a typical BHC organizational structure with a public holding company parent. This is not the case for many Insurance-centric SLHCs, where insurance companies themselves or special purpose non-public entities are often the top level SLHCs. If this deduction were imposed at the level of the TIAA Board of Overseers (the special purpose non-profit entity that owns TIAA),[61] then the deduction of TIAA's required control amount would reduce consolidated capital by nearly 20%. Yet nearly 100% of consolidated assets and all associated financial activities, including all banking activities, are recorded at the level of TIAA and its subsidiaries. How would

[61] This approach would be contrary to current and historic supervisory practice of focusing supervision on TIAA.

such a deduction protect TIAA's thrift subsidiary? What purpose would the deduction serve? Alternatively, would the deduction be applied at the TIAA level and only TIAA's insurance subsidiary TIAA-CREF Life Insurance Company's capital be deducted from TIAA's total capital? How do the Proposals contemplate the treatment of capital of insurance companies that own insurance companies?

Notwithstanding the forgoing, if the FRB still deems it necessary for a SLHC to deduct capital held by an insurance underwriting subsidiary, such a deduction should be limited to capital held against insurance underwriting risk (e.g., C-2), which like may other risks faced by financial institutions is not specifically addressed by the Basel framework.[62]

## V. Exclude insurer separate accounts from the leverage ratio and ensure they receive the same treatment as similar bank affiliated investment vehicles

We disagree with the Proposals' inclusion of insurance company separate account assets in the denominator of the proposed Tier 1 leverage ratio. This inclusion is contrary to the FSOC's determination that separate accounts are "not available to claims by general creditors of a nonbank financial company" and, therefore, should be excluded from the calculation of the leverage ratio used in the DFA Section 113 determination process.[63] The Agencies' implicit rationale for the inclusion of separate account assets appears to be based on GAAP's treatment of separate account assets as balance sheet assets of an insurance company. The Agencies, however, have selectively chosen to overlook the accounting treatment of other assets when in their view the underlying economic value/risk varies from the treatment afforded under GAAP. Specifically, in the areas of the value of goodwill, mortgage servicing rights and deferred tax assets, the Agencies have adjusted GAAP measurements for purposes of the calculation of various regulatory capital considerations as well as the leverage ratio, to reflect the underlying economics of these assets in the context of prudential oversight and supervision. Yet, to the best we have been able to determine, the rationale for inclusion of separate account assets in the leverage ratio calculation is that "GAAP treats them as balance sheet assets."[64]

Importantly, this position misconstrues the position of the Financial Accounting Standards Board ("FASB") regarding the treatment of separate account assets for financial reporting

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[62] We would note that, under the general Basel framework, BHCs do not hold capital against regulatory compliance risk, reputational risk, interest rate risk and operational risk (except for Advanced Approaches institutions), yet under the Proposals only insurance enterprises would be subject to a capital deduction for a risk not specifically addressed by the framework.

[63] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 F.R. 21,637, 21,661 (Apr. 11, 2012).

[64] See Ask the Fed: Basel III for banking organizations with assets of at least $50 billion (Jul. 17, 2012) at minute 101 of the archived audio recording.

purposes.[65] Under GAAP treatment of separate accounts, separate account assets representing contract holder funds are reported on an insurance company's financial statements as a summary total with an equivalent summary total reported for related liabilities, if the following requirements are satisfied:[66]

a. the separate account is recognized legally, that is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws;

b. the separate account assets supporting the contract liabilities are insulated legally from the general account liabilities of the insurance entity, that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account;

c. the insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies; and

d. all investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.

This presentment reflects a recognition of the legal, but not economic, ownership of separate account assets by an insurance company. Most clearly this is seen in the requirement that only fees and assessments related to the separate account and not income and other expenses are reported on the insurance company's statement of operations – a treatment mirroring that of affiliated mutual funds.[67] Indeed, to the extent that an insurance company has an economic interest in assets maintained in a separate account or has any liability related to the separate account in excess of the fair value of the separate account's assets, GAAP requires such assets and liabilities to be reported as general account assets and liabilities.[68] The underlying economic reality of separate account assets and related liabilities has not been clearly considered in the Agencies' proposed approach to rely on total assets including separate account assets for calculation of the leverage ratio. Any contingent obligations regarding a separate account would be recognized by the insurer in accordance with the applicable general account reporting

[65] ASC 944-80 (Financial Services – Insurance, Separate Accounts).

[66] ASC 944-80-25-2.

[67] ASC 944-80-25-3(c). Under ASC 944-80-25-4(c), only revenue and expense of non-qualifying separate accounts are reported on the insurance company's statement of operations.

[68] ASC 944-80-25-3(b) and ASC 944-80-25-4.

requirements, and the appropriate means to address concerns regarding contingent obligations is through the risk-based capital framework, not the leverage ratio.

The Proposals' treatment of separate accounts is a significant issue for life insurance companies and the consumers who rely on them for lifetime income and retirement savings products. Variable annuity contracts funded by insurance company separate accounts are a significant investment vehicle for individuals to use for their retirement savings. As of 2010, $1.3 trillion was invested in 32.4 million variable annuity policies.[69] In the retirement space, variable annuity products compete with mutual funds and collective investment funds as funding alternatives for defined contribution retirement plans.[70] Nevertheless, annuities, unlike mutual funds or collective investment funds, offer payout options that are designed to provide lifetime income.[71]

The Agencies' proposed inclusion of separate accounts in the calculation of the leverage ratio stands in marked contrast to the agencies' treatment of bank-affiliated mutual funds and bank-maintained common and collective investment funds. We recognize that mutual funds and common and collective investment funds are not included as balance sheet assets under GAAP. Even so, the economics, risk and regulatory relationship of these vehicles to banks is nearly identical to the relationship of separate accounts to an insurance company.[72] Indeed, most separate accounts supporting variable annuities are registered with the SEC as unit investment trusts under the Investment Company Act of 1940 and invest in mutual fund shares. For example, a bank may act as a trustee of a retirement plan (e.g., have technical legal ownership of the plan's assets as trustee) and the plan can invest in mutual funds advised by the bank's affiliates and the bank will have no capital charge under the leverage ratio for the plan's mutual fund holdings. In contrast, under the Proposals, when an insurance company issues a variable annuity contract to fund the same retirement plan and for which insurance company affiliate-advised mutual funds are the underlying investments held in a separate account, the insurance company would need to hold at least 4% Tier 1 capital against these mutual fund shares held in the separate account.

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[69] ACLI Product Line Report: Annuity Insurance (Jan. 2012).

[70] Just under 70% of separate account assets fund qualified retirement plans, including IRAs. Id.

[71] The importance of providing consumers with annuities as retirement plan options to address longevity risk has recently been highlighted by both the U.S. Department of Labor and the President's Council of Economic Advisers. See Executive Office of the President, Council of Economic Advisers, Supporting Retirement for American Families, (Feb. 2, 2012) (www.whitehouse.gov/sites/default/files/cea_retirement_report_01312012_final.pdf) and Department of Labor Press Release, "U.S. Treasury, Labor Departments Act to Enhance Retirement Security for an America Built to Last." (Feb. 2, 2012) (www.treasury.gov/press-center/press-releases/Pages/tg1407.aspx).

[72] See New York Law Insurance Law § 4240 ("If and to the extent so provided in the applicable agreements, the assets in a separate account shall not be chargeable with liabilities arising out of any other business of the insurer"). Which is in effect parallel to the treatment of fiduciary assets of a bank under 12 U.S.C. § 1464(n)(2) ("A Federal savings association exercising any or all of the powers enumerated in this section shall segregate all assets held in any fiduciary capacity from the general assets of the association").

Under the Proposals, the Agencies are in effect imposing a capital "tax" on insurance company variable products, while exempting comparable bank products from such a requirement. We believe this position is not supported by any public policy rationale, favors bank products over competing insurance products, and will negatively effect consumers' ability to obtain access to appropriately priced lifetime income and retirement savings products. We believe the inclusion of separate account assets in the leverage ratio has significant anti-competitive implications and a detrimental consumer impact. Accordingly, the Proposals should be modified to exclude separate account assets from the leverage ratio calculation.

## VI. Affects of recording AOCI for unrealized capital gains and losses

We have concerns with provisions in the Proposals that would require insurers to record unrealized gains and losses on financial instruments within regulatory capital ["accumulated other comprehensive income ("AOCI")], thus recording unrealized gains and losses of certain debt securities in common equity Tier 1 capital. The Agencies recognize that, "including unrealized gains and losses related to certain debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate could introduce substantial volatility in a banking organization's regulatory capital ratios."[73] We believe this statement is especially true for insurers, whose business requires investments in long-dated fixed income securities that are susceptible to such volatility.

The business of insurance largely involves investing assets on behalf of policyholders in a way that will ensure these assets are available for policyholders and/or their families at a future date. As a result, insurers invest heavily in long-term fixed income assets that can be greatly affected by the interest rate fluctuations referenced by the Agencies. Insurers tend to have a larger portion of their investments in longer-term interest rate-sensitive securities when compared to banks. For example, insurers held \$2.5 trillion of bonds in their general accounts in 2010, and 62% of these holdings were in bonds with maturities of 10 years or more.[74]

Recording unrealized gains and losses certainly would increase volatility resulting from either interest rate fluctuations or other factors that affect the short-term valuations of investments (e.g., market illiquidity) and would disproportionately affect insurers' regulatory capital calculations compared to traditional banking organizations

To avoid the negative affects of non-credit fluctuations on their capital ratios, many insurers may decrease investments in longer-duration securities, which, considering the significant investment activity of insurers in these securities, not only would decrease the availability of long-

[73] 77 F.R. at 52,811 (Aug. 30, 2012).

[74] ACLI, 2011 Life Insurers Fact Book. 8 (2011) (www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%20Book/Documents/2011%20Fact%20Book.pdf).

term credit in the economy, but also would effect insurers' ability to best match asset and liability duration.

We strongly support the exclusion of unrealized gains and losses related to long-term debt securities, including long-term debt securities whose valuations primarily change because of fluctuations in interest rates, within the calculation of regulatory capital. Such securities include, but are not limited to, long-term Treasuries, securities issued or guaranteed by Fannie Mae and Freddie Mac, long-term obligations of U.S. states and municipalities, and other forms of long-term debt securities.

In the absence of such exclusion, insurers would be forced to diminish their investments in long-term debt securities and increase the amount of short-term debt securities held in their general accounts. Because insurers rely on long-dated assets to match their long-term liabilities, such a shift would counteract the safety and soundness principles utilized by insurers by making it more difficult for them to engage in effective asset-liability management.

An exclusion of unrealized gains and losses from long-term debt securities is appropriate for measuring the regulatory capital requirements of insurers because of the nature of their business model compared to traditional banking organizations. Furthermore, it is integral to ensuring that Americans who rely on insurance products for their lifelong financial security are not suffering disproportionate negative effects from the imposition of such a proposal.

## VII. Capital treatment of owned securitizations

We have concerns with the proposed securitization framework outlined in the Proposals, requiring banking organizations to satisfy specific due diligence requirements for securitization exposures. As part of this due diligence, a banking organization must conduct a detailed analysis of all owned securitization vehicles no less frequently than quarterly and maintain an extremely granular level of data for all such investments. As part of this analysis, banking organizations "would be required to demonstrate to the satisfaction of their primary federal supervisor a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure." The banking organization's analysis would be required to correspond with the complexity of the exposure and the materiality of the exposure in relation to capital.

Demonstrating such a comprehensive understanding would require the banking organization to conduct and document an analysis of the risk characteristics of the exposure prior to acquisition and periodically thereafter. As part of this analysis, the banking organization would need to consider various factors including any structural features of the securitization that could materially influence the performance of the exposure, relevant information regarding the performance of the underlying credit exposure, and relevant market data on the securitization. If a banking organization were unable to demonstrate a comprehensive understanding of an exposure, it would be required to assign a risk weight of 1,250% to the exposure.

This new requirement likely would call for most banking organizations to enhance their recordkeeping and tracking processes for securitization activity. Traditional banking organizations that own and originate such securitized vehicles would have in place the systems and compliance infrastructure necessary to manage proprietary loan data, enabling such organizations to better prepare for the proposed due diligence requirements.

By contrast, implementing these enhancements may prove to be an excessive burden for insurers who invest in, but do not originate the loans included in these securitized vehicles, and therefore do not have the same level of data as the loan originator. This dichotomy in data collection capability places insurers at a significant disadvantage relative to traditional banking organizations, and will make it substantially more difficult for insurers to comply with the proposed due diligence requirements for securitizations. Further, if insurers were to determine that the proposed requirements were too burdensome, too costly to implement, or too difficult to maintain, insurers would likely diminish their investments in such securitized vehicles. Removing insurance enterprises as an investor in these vehicles has the potential to diminish the liquidity currently available in the private securitization market.

It is also worth noting that insurers primarily invest in the high quality, upper tranches of the securitization exposures. In fact, two recent NAIC studies looking at recent changes made to the procedure for assigning NAIC designations to non-agency residential mortgage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS") demonstrated that 95% of insurer investments in CMBS and 80% of insurer investments in RMBS received either the highest or second highest NAIC-assigned ratings.[75] These studies reflect continued improvements in insurers' methodologies for assessing the credit quality of securitization exposures based on experience of the recent crisis as well as insurers' overall investment history in securitizations as a long-term investment, and demonstrates that insurers both understand the credit risk inherent in securitization exposures and are committed to holding adequate capital for these exposures.

The results of these NAIC studies indicate that the insurance industry already has adequate measures in place that have resulted in improvements in transparency and regulatory oversight of the securitized vehicles, as well as accurate valuation processes. We believe that the current process and modeling results show the strong principles maintained by the insurance industry with regard to ensuring adequate levels of capital and that insurance holdings are appropriately sensitized to the credit risks inherent in securitization activities.

Finally, as the FRB moves forward with the rulemaking with respect to securitization exposures of insurers, we strongly recommend reviewing the SSAP 43R standard, which requires investors conduct a prudent discounted cash flow ("DCF") analysis of their investment and record valuation impairments based on proprietary valuation results compared to the externally derived NAIC valuation.

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[75] See NAIC, Modeling of U.S. Insurance Industry's Holdings in Commercial Mortgage-Backed Securities, (www.naic.org/capital_markets_archive/120626.htm); NAIC, Modeling of U.S. Insurance Industry's Holdings in Residential Mortgage-Backed Securities, *available at* http://www.naic.org/ capital_markets_archive/120601.htm.

## VIII. Conclusion

As the Agencies and particularly the FRB implement their responsibilities under DFA, we hope that they will keep in mind the ancient maxim - *Primum non nocere* – "**First, do no harm.**" We believe that, if the Agencies fail to address our concerns regarding the impact of the Proposals on insurance companies, the likely outcome will be the continued exiting of banking by these firms, which would result in an increase in the concentration of banking activities in a few systemically significant firms as well as a reduction in competition and consumer choice. Capital regulation for insurance activities in the United States is important to get right because it affects Americans' ability to mitigate longevity, mortality and catastrophe risks as well as the availability of long-term financing for the economy. Insurance capital regulation is not a problem looking for a solution – NAIC RBC works. Just as the Basel framework addresses trading and banking activities separately, it also addresses how insurance activities should be treated by respecting the insurance sectoral standards at the "conglomerate level" through a parallel capital and asset deduction. As drafted, the Proposals are inconsistent with Basel III and would harm consumers, insurers and the economy, while providing no discernable supervisory benefit. We have outlined above two alternative approaches that would allow the Agencies to satisfy their mandate under the Collins Amendment, while simultaneously avoiding disruption to consumers, insurers and the economy.

Again, we appreciate the opportunity to participate in this critical rulemaking process and are more than willing to discuss our views further to assist the Agencies in this important endeavor.

Very truly yours,

Brandon Becker

Brandon Becker
Executive Vice President and
Chief Legal Officer

cc: Mr. Michael McRaith
Director, Federal Insurance Office
U.S. Department of the Treasury

Exhibit A - Corporate and Foreign Bonds

Billions of dollars; amounts outstanding end of period, not seasonally adjusted

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Q2 - 2012 | Relative Holdings Q2 - 2012 |
|---|---|---|---|---|---|---|---|---|
| Household sector | $1,653.5 | $2,118.4 | $2,052.8 | $2,213.1 | $2,185.8 | $2,118.1 | $1,948.9 | 16.30% |
| State and local governments | 135.0 | 149.1 | 147.9 | 154.7 | 157.0 | 150.6 | 147.0 | 1.23% |
| Federal government | 0.0 | 0.0 | 0.0 | 0.6 | 0.9 | 0.8 | 0.8 | 0.01% |
| Rest of the world (2) | 2,320.5 | 2,719.1 | 2,354.0 | 2,465.3 | 2,523.3 | 2,500.5 | 2,444.7 | 20.45% |
| U.S.-chartered depository institutions | 563.4 | 714.6 | 650.5 | 667.1 | 548.9 | 551.8 | 528.9 | 4.42% |
| Foreign banking offices in U.S. | 292.5 | 369.5 | 401.6 | 244.9 | 233.9 | 234.5 | 216.6 | 1.81% |
| Banks in U.S.-affiliated areas | 0.4 | 0.5 | 0.5 | 2.0 | 0.6 | 4.2 | 4.1 | 0.03% |
| Credit unions | 30.6 | 34.6 | 25.7 | 18.6 | 3.7 | 4.1 | 4.8 | 0.04% |
| Property-casualty insurance companies | 277.0 | 282.9 | 267.5 | 298.3 | 322.6 | 361.0 | 359.5 | 3.01% |
| Life insurance companies | 1,819.5 | 1,862.6 | 1,817.0 | 1,927.2 | 2,030.2 | 2,123.6 | 2,124.8 | 17.77% |
| Private pension funds | 317.6 | 357.4 | 400.1 | 442.9 | 440.1 | 440.9 | 437.4 | 3.66% |
| State and local govt. retirement funds | 283.4 | 297.0 | 312.9 | 308.6 | 312.4 | 320.9 | 324.5 | 2.71% |
| Federal government retirement funds | 4.8 | 6.3 | 5.8 | 5.8 | 5.9 | 7.4 | 8.0 | 0.07% |
| Money market mutual funds | 368.3 | 376.8 | 228.0 | 169.9 | 154.2 | 129.6 | 116.5 | 0.97% |
| Mutual funds | 767.0 | 889.9 | 959.9 | 1,126.8 | 1,275.4 | 1,465.8 | 1,617.8 | 13.53% |
| Closed-end funds | 75.1 | 74.0 | 49.2 | 55.4 | 59.5 | 57.6 | 60.5 | 0.51% |
| Exchange-traded funds | 7.6 | 13.8 | 27.7 | 55.4 | 74.1 | 107.7 | 135.7 | 1.13% |
| Government-sponsored enterprises | 481.7 | 464.4 | 386.6 | 310.8 | 293.9 | 260.5 | 227.1 | 1.90% |
| Finance companies | 184.8 | 189.4 | 192.4 | 198.6 | 84.3 | 85.1 | 87.2 | 0.73% |
| REITs | 64.6 | 34.4 | 11.7 | 15.5 | 20.8 | 22.1 | 27.6 | 0.23% |
| Brokers and dealers | 355.5 | 382.8 | 123.8 | 154.4 | 189.5 | 103.7 | 135.5 | 1.13% |
| Holding companies | 16.7 | 35.9 | 35.8 | 31.1 | 38.3 | 18.3 | 94.3 | 0.79% |
| Funding corporations | 60.4 | 170.0 | 667.3 | 710.2 | 760.1 | 792.4 | 904.3 | 7.56% |
| Total assets | $10,080.0 | $11,543.4 | $11,118.5 | $11,577.0 | $11,715.3 | $11,861.1 | $11,956.6 | 100.00% |

FEDERAL RESERVE statistical release - Flow of Funds Accounts of the United States,
Flows and Outstandings Second Quarter 2012, 100 (Sept. 20, 2012) - L.212 Corporate and Foreign Bonds.

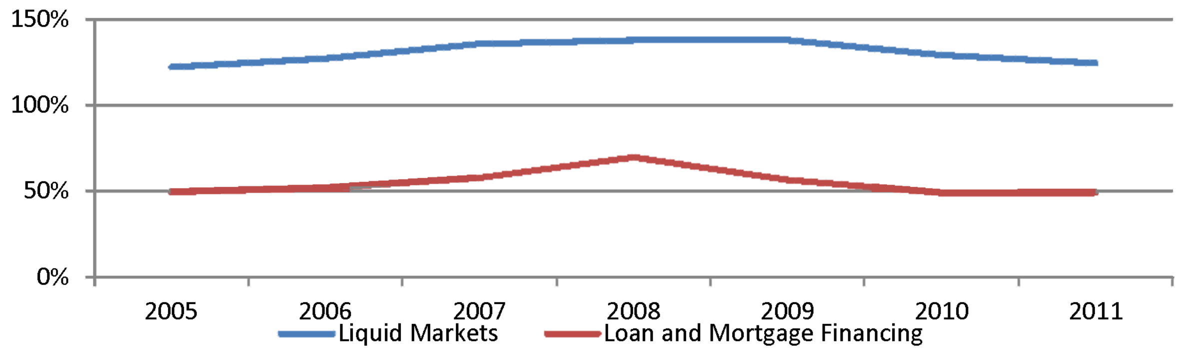
Exhibit A - Composition of U.S. Credit

# Composition of U.S. Credit

## Financing and Holdings

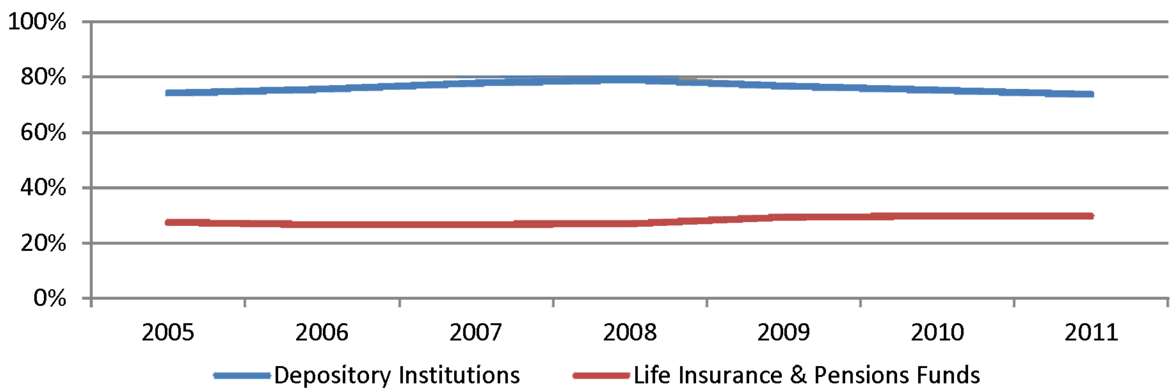
### Total U.S. Business Financing: Percent of GDP

Liquid  Securities versus Loan and Mortgage Financing



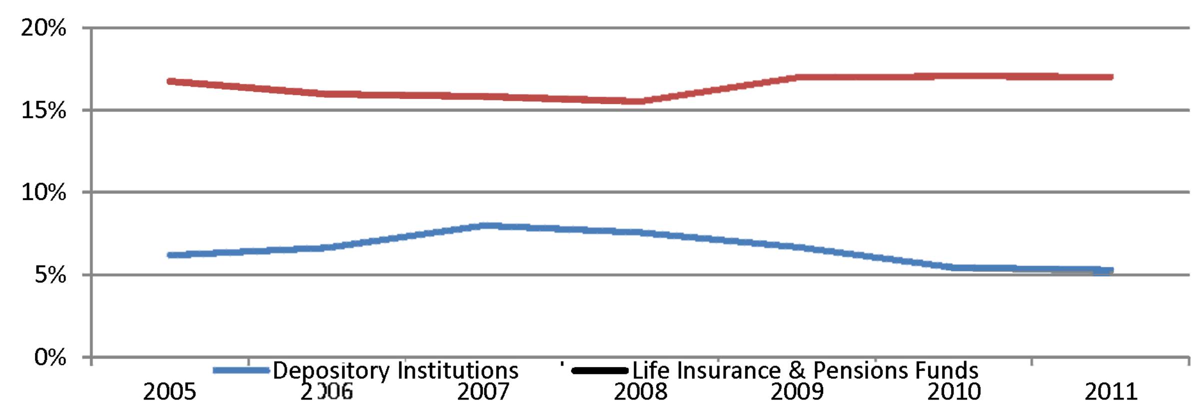

### Total U.S. Credit Market Instrument Holdings: Percent of GDP

Depository Institutions versus Life Insurers and Private Pension Funds




### Total U.S. Corporate and Foreign Bond Holdings: Percent of GDP

Depository Institutions versus Life Insurers and Private Pension Funds




Note: Liquid Markets is composed of commercial paper, municipal securities, and corporate bonds. Loan and Mortgage Financing is composed of depository institutions loans, other loans and advances, net inter bank lending, and mortgages, less reserves and vault cash at the Federal Reserve Banks.

Source: Federal Reserve Bank System Flow of Funds

Exhibit B - compositon of NAIC RBC by risk element - 2003-2009

| | 2009 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|---|---|---|
| C-0 - Asset Risk - Affilates | 16.25% | 15.70% | 17.26% | 16.26% | 16.56% | 17.67% | 18.09% |
| C-1Cs - Asset Risk - Common Stock | 14.11% | 13.43% | 17.42% | 15.96% | 14.51% | 13.66% | 11.20% |
| C-1O - Asset Risk - All Other | 32.41% | 33.87% | 31.24% | 30.43% | 30.57% | 31.35% | 33.83% |
| C-2 - Insurance Risk | 18.53% | 19.97% | 17.76% | 18.93% | 18.00% | 18.02% | 17.43% |
| C-3A - Interest Rate Risk | 9.73% | 9.94% | 9.37% | 11.23% | 13.35% | 13.82% | 13.82% |
| C-3B - Health Credit Risk | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.03% | 0.03% |
| C-3C - Market Risk | 3.02% | 1.04% | 1.97% | 1.85% | 1.73% | 0.00% | 0.00% |
| C-4A - Business Risk | 5.39% | 5.49% | 4.50% | 4.87% | 4.85% | 4.85% | 4.98% |
| C-4B - Business Risk Admin. Expenses | 0.57% | 0.55% | 0.47% | 0.47% | 0.43% | 0.60% | 0.62% |
| | | | | | | | |
| Total of C-0, C-1 and C-3 elements | 75.51% | 73.98% | 77.27% | 75.73% | 76.73% | 76.50% | 76.94% |

Source: AGGREGATED LIFE RBC AND ANNUAL STATEMENT DATA